A corrective and distributive justice analysis of creditor entitlements in bankruptcy

John Anthony PURCELL
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Melbourne Law School
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This thesis is dedicated to my daughters Laura and Emily. I acknowledge, in particular, the support provided by Mr Michael Crewdson, and that of my colleagues at CPA Australia. Foremost, I thank Professor Michael Bryan for his tireless support of the idea and its development.
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The Research Question

The proposition to be tested is the correctness of the assumption that in bankruptcy law the pre-bankruptcy entitlements of creditors should be recognised and enforced as far as practically possible. My conclusion is that this proposition requires modification in a number of areas. The further specific conclusions drawn are that this proposition does not adequately address outcomes in the following controversial areas of the law:

- The relative treatment of consensual and non-consensual unsecured claims. Most non-consensual claimants are recipients, or potential recipients, of tort damages. In Australia the inquiry into the reorganisation of James Hardie Industries, and the impact of corporate structures on the recoverability of damages, has highlighted the obstacles faced by this category of claimant, and will be touched upon in the thesis. Some personal restitution claimants, for example those who make payments by mistake or under duress also fall into this category.

- The recognition of ‘remedial’ proprietary interests, entitling the claimant to an interest in property to which he or she had never previously held title.

The thesis proposes a conceptual framework for analysing and suggesting solutions to these challenges to the assumption of enforcement of pre-existing entitlements. It proposes an understanding of the nature of legal obligations from the perspective of a transition from pre-bankruptcy to bankruptcy based on corrective and distributive justice analysis and informed by natural law reasoning. In the development of this framework, the following themes are considered:

- The classification of obligations and the identification of events that create them, and the nature of the rights to which they give rise. Not all unsecured creditor claimants should invariably receive equal treatment. For example, there is a reasonable case for giving priority to at least some tort claimants and holders of remedial proprietary interests.

- The extent to which theories of corrective and distributive justice, and natural law, are relevant to this process.
Whether bankruptcy law is ideally understood in terms of its own internal coherence, as well as of the internal coherence of private law generally. The concept of internal coherence stands in contra-distinction to instrumental accounts of bankruptcy law, of which the most influential have been based on economic analysis.

The conclusion reached is that bankruptcy law potentially requires the application of a more flexible approach to the prioritising of different types of entitlement than at present applies. The challenge is to develop a structure based on recognised models of private law rights and obligations. For this purpose the thesis examines the theoretical literature on natural law as a basis for developing a model which explains bankruptcy’s processes for recognising and resolving creditor entitlements.
Motivation for the research (Preface)

The undertaking of this thesis is stimulated by the truism that bankruptcy law as a discrete body of rules has been subject to less theorising than the private law claims of solvent parties. In particular, it is deficient in theorising that focuses on the totality of the scheme in terms of purpose, outcomes and interaction with other bodies of legal rules. Such theorising as has been undertaken, such as identifying the rationale for attaching to directors personal liability for insolvent trading, has tended to concentrate on relatively specific elements of liability, often conducted from a predominantly economic perspective. Moreover, modern scholarship on corrective justice and natural law theory has been largely ignored by the theorists.

The research method adopted in this thesis is deliberately oriented to fundamental ideas of coherence and universality, and prima facie acceptance of a distinctive moral or ethical underpinning to the law. The thesis therefore draws on themes originating in natural law jurisprudence. Such sources of knowledge and insight inform most directly the corrective justice attributes of the model proposed in the thesis. But the essential character of bankruptcy law, which is directed to ensure orderly outcomes on the occurrence of bankruptcy, entails the application of notions of distributive justice. It is also from a distributive justice perspective that the thesis proposes that consideration can be given to altering otherwise corrective justice-based outcomes. Subtly, attributes of corrective and distributive justice interact as part of the overall rationality of the bankruptcy regime. That regime can be justified in terms of natural law theory.

The thesis seeks also to explore the dynamic nature of bankruptcy law which has tended over time towards prescriptive rule-based treatment. Of particular interest is the examination of how bankruptcy rules interact with the common law which itself, of course, is never static or fully settled. The intensity of the bankruptcy process requires close consideration of the nature and the value to society of different kinds of private law obligation.

The thesis's focus is predominantly on the critical aspects of recognition of creditor entitlements and the development of rules of distribution. It is in these areas that complexities arise; they are the source of the most intense debate about the objectives and limitations of bankruptcy law. The proffered normative
natural law framework provides valuable insights into the operation of bankruptcy law and forms the basis for consideration of the future directions bankruptcy law might take.

**Structure of the thesis**

The arguments of this thesis are explained in six chapters.

Chapter 1 has a number of purposes. It sets the context for explaining the objectives of both personal bankruptcy and corporate insolvency law. Within the collectivised treatment of creditor claims and pari passu distribution are fundamental objectives that provide the basis for the specific rules of bankruptcy. The key objective of this chapter is to introduce the assumption held by most writers that in bankruptcy law the pre-bankruptcy entitlements of creditors should be recognised and enforced as far as practically possible. This, when addressed particularly from the perspective of economic analysis of the law implicit in the idea of the “creditors’ bargain”, seems largely self-evident and intuitively appealing. The thesis does not suggest abandonment of this fundamental tenet of bankruptcy law. Rather, the chapter suggests that when viewed from the perspective of the underlying rights affected by supervening debtor insolvency, the bankruptcy process is more complex and uncertain. The various types of complexity and uncertainty are introduced in Chapter 2 so as to develop the idea that strict homogeneity of claim cannot always be assumed, whilst the subsequent chapters develops a normative model which seeks to better explain norms of claim recognition and entitlement distribution. The chapter also argues for the value of deductive reasoning as a basis for identifying normative legal principle from which specific rules can be developed. The model thus seeks to identify a rational basis for developing and applying bankruptcy principles.

Chapter 2 makes the argument for the development of a normative model of bankruptcy. The chapter identifies both tension and uncertainty in the multi-party setting of insolvency distribution. The tensions are created by the interaction of bankruptcy law with other sets of legal rules, specifically the rules for recognising and enforcing private law entitlements. The related uncertainty concerns the norms of ordering legal entitlements, and where, and how, these might respond generally, or specifically, to changes occurring outside of bankruptcy itself. The

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1 Reference to legislation is, unless otherwise stated, the relevant Australian bankruptcy and corporate insolvency legislation.
changes discussed are developments within the law of private obligations. An additional source of tension within bankruptcy itself is caused by ‘competition’ amongst consensual and non-consensual creditors whose rights, as the chapter demonstrates, are not homogenous. The thesis does not set out to resolve these various sources of tension. A theoretical model of the type developed in the thesis, which explains the logic of bankruptcy's norms of entitlement recognition and distribution is, however, propounded as a key element in preserving bankruptcy law’s own integrity. A theme of the thesis is that normative insight into the nature of bankruptcy law assists in establishing a practical framework for possible judicial rule development and statutory law reform. The model is developed across Chapters 3 and 4, and is summarised in a shorter Chapter 5.

Chapter 3 commences with posing the question as to whether bankruptcy’s system of distributing entitlements is internally intelligible, or whether it can only be explained in terms of values and policies that lie outside its system. The rights-based and normative character of the model developed in the thesis strongly favours the former of these understandings. The chapter draws upon theoretical analysis of private law which emphasises acceptance of the law’s own structure and ends, and which explains law normatively in non-instrumental terms. The adoption of these theoretical perspectives is used to explore the complexity of the legal relationships which are the subject matter of the bankruptcy process and the idea of private law which is implicitly recognized by bankruptcy law. The chapter draws extensively on the contrast between corrective and distributive justice as a basis for explaining how bankruptcy law deals in an orderly manner with the transition of private law obligations into a multi-party setting of claim recognition and entitlement distribution. The analysis shows bankruptcy, in its key features of collectivism and pari passu ranking, to be internally coherent. This close aligning of bankruptcy law with the rationality of private law is presented as a highly important feature in understanding the limits to which bankruptcy principles and rules of intervention can reasonably be applied. The aims of bankruptcy law are to be found in its rules and principles; they are not to be found externally, for example in economic explanations. Bankruptcy law when considered in these terms, whilst not necessarily directly solving the various complexities, controversies and uncertainties examined in Chapter 2, nevertheless can be justified in terms of its own principles, without the need to resort to external theorising.
Chapter 4 further develops two themes introduced in Chapter 3; these being the attributes of virtue, or absence thereof, on the part of the insolvent debtor, and the nature of consent and merit associated with creditors’ claims. The approach taken focuses initially on the nature of the event of supervening debtor insolvency. Methods of legal classification are drawn upon in order to explain both the nature of the event, as a distinct legal phenomenon, and to address the manner in which it affects existing rights. From this, in turn, the response of entitlement distribution can be assessed in terms of the remedy applicable to the bankruptcy context. Highly significant to this analysis, and those to be found in Chapter 3, is the character of intervention necessary to achieve distributive outcomes and to resolve the debtor’s affairs. Two dimensions of intervention are considered. The first concerns the related elements of transition of obligations from a bipartite to a multi-party setting in which relationships between debtor and creditor, and between creditors, must be resolved. Natural law theory is used to explain the moral rationality of collectivised treatment, as well as to the exceptions to collective treatment, to which there is wide community acceptance. Natural law analysis is applied also to suggest the basis upon which developments in private law are reflected within bankruptcy law. The second dimension of intervention concerns the authoritarian features of bankruptcy law. Reference is made to both the Rule of Law and the distinction between private law and public law to explain the type of coercion required to impose collectivised outcomes and to guard against errant or opportunistic behaviour, neither of which need be justified in instrumental terms of deterrence.

Chapter 5 draws together the analysis in the previous two chapters so as to present a natural law model for the recognition and treatment of creditor entitlements in bankruptcy distribution. Working from the premise of internal intelligibility within private law, a predominantly non-instrumental and internally coherent model of bankruptcy emphasises ideals of conforming to conditions of a just social order and of meeting the collective purposes of the community within which its rules are applied. This does not mean that bankruptcy law should apply simple notions of equality in meeting the claims of creditors. Rather, it recognises the necessity for allocating the deficiency in the debtor’s funds which reflects the transition of various types of obligation from a pre- to a post-solvency context. Addressing this transition in terms of how the law can apply justice either correctively or distributively illuminates the purposive character of bankruptcy law. Whilst directly focusing on the private law character of obligations, bankruptcy
distribution is necessarily modified by elements of process and rationality drawn from both public law and the Rule of Law. Reference to these elements is necessitated by both the multi-party setting and the need to resolve disputes within that setting. The resolution of disputes, if left to the parties themselves, could not be efficiently or optimally achieved. All of these elements are underpinned by a natural law perspective of moral rationality which explains why creditors must be justly treated. ‘Just treatment’ requires both a just and fair collective process for adjudicating their claims, and recognition that some claims require individual assessment outside the collective process, for example where exceptions to the ‘pari passu’ principle of claimant sharing apply. To achieve this, the natural law framework developed in the thesis draws together perspectives of a ‘virtuous debtor’ in terms of his presumed conduct towards multiple and individual creditors, and a ‘meritorious creditor’ in terms of both the basis of the claim and a reasonable expectation of self-protection where available.

Chapter 6 presents a conclusion briefly stating how the model developed in the thesis resolves the research question posed above, the critical areas of concern being the extent to which creditor claims are either enforced or modified by the bankruptcy process.

The diagram which follows is a representation of key components of the thesis. Whilst indicative of the model developed in the thesis, it should not be considered as an absolute or exhaustive summation. It illustrates the major theoretical sources, and significantly, the interrelationships developed across the thesis as part of presenting a normative non-economic model of creditor entitlement recognition and bankruptcy distribution.

‘Blue’ components signify a particular primary normative theory of private law, features of which the thesis model adheres to within the applied context of bankruptcy distribution. Within this normative theory are a number of alternative perspectives from which law and justice can be understood – these are presented in the diagram in ‘Green’. These are the formal components which are adapted to the model’s purposes. Pivotal to this process of adaptation is reference to natural law, the central point of the diagram. The reference is both

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2 Specific and narrow definitions or understanding of both public law and the Rule of Law are applied in the model developed in the thesis. It is acknowledged that both are subject to debate and controversy as to their nature.

3 Generally, throughout the thesis ‘his’ is used to denote both ‘his’ and ‘her’.
retrospective in explaining the theoretical stance adopted in the thesis and prospective in urging a reappraisal which illuminates the ethical challenges at the centre of determining a rational basis of resolving debtor-creditor dealings. Stressing again the applied context of the thesis model, those components appearing in ‘Red’ are broader schemes for explaining the nature and purpose of the law – these elements are referenced within the model to give both validity and authority to a natural law-based explanation of bankruptcy law’s distributive processes.

Those elements presented in ‘Yellow’ signify attributes around which the model suggests a degree of informed judgment is applied in forming an understanding of both private law, and in the thesis context, bankruptcy law. The theme is not one of discretion, rather ones under which societal outcomes and preferences can be expressed through the law – be it judge-made or legislatively determined.

The five components at the right-hand of the diagram are the attributes to which a natural law-based model suggests bankruptcy law should, as an ideal, seek to conform. The ‘thin’ lines illustrate the sequential development of the thesis model. The larger arrowed connections signify interdependencies which give coherence to the model in a manner consistent with the normative explanation of private law presented and adopted at the outset.
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CHAPTER 1

THE OBJECTIVES AND INSTRUMENTS OF BANKRUPTCY AND INSOLVENCY STATUTORY REGIMES – THE CREDITORS' BARGAIN AND COLLECTIVISM PRESUMPTIONS IN BANKRUPTCY PROCEDURES

Introduction

The authors of Keay’s Insolvency state the principal objective of insolvency law as being “to provide an equal, fair and orderly procedure in handling the affairs of insolvents ensuring that creditors receive an equal distribution of the assets of the debtor.” In simple terms, bankruptcy and insolvency laws involve a formalised process of collection and liquidation of the debtor’s available assets from which a rateable distribution is made to creditors. Our present laws of personal and corporate insolvency have evolved over many centuries and demonstrate a range of shifting emphases, perhaps most notably that “[o]ver time the rehabilitative purpose of insolvency has become increasingly important, at least as important as the deterrent and punitive aspects, if not more so.” The purpose of this thesis is to present a theoretical understanding of these evolving objectives and to identify some difficulties that arise in achieving them.

Within this context two major themes are introduced in this chapter. Section 1 commences by setting out the character of the distributive assumptions informing personal and corporate insolvency law. This section then discusses the predominantly economic explanations of collectivism, which is bankruptcy law’s most distinctive distributive feature. Some of the criticisms of these explanations are also presented. The second theme introduced in Section 2 discusses indeterminacy in the law and the manner in which such uncertainty can be overcome by the application of deductive explanatory norms as an outcome of judicial reasoning. The avoidance in insolvency and bankruptcy law of undue indeterminacy centres on

5 Ibid at p 7.
6 Collectivism is inexorably linked with the equitable principle of pari passu (see footnote 11) within an overarching concept of equality - “The notion of equality can be regarded as being linked to the idea that liquidation is a collective procedure as it is necessary to have a collective process before there can be any equal distribution of the assets; the collective procedure is required to ensure that creditors are not prejudiced by the creditors acting unilaterally.” Andrew Keay, McPherson’s The Law of Company Liquidation (4th edition) (1999) LBC Information Services, Pyrmont NSW p 575.
issues of both timing and certainty – the timing of resolving debtor/creditor relationships and the uncertainty as to how obligations between debtor and creditor are to be set aside or, in some manner, still to be enforced. Additionally, there are wider considerations around the theme of indeterminacy related to bankruptcy law’s capacity to accommodate novel situations and to harmonise private law developments within its scheme.

Bankruptcy and insolvency broadly describe the circumstances of, and the law’s response to, the condition - respectively amongst natural and artificial persons – of an inability to repay debts.

This thesis takes the view that little attempt has been made to apply theoretical perspectives to Australian bankruptcy and insolvency regimes. This view is supported by an observation made by Professor Goode in relation to English corporate insolvency law, which Australian law in general terms resembles:

“Questions such as the legitimate province of corporate insolvency law and the social and economic policy basis for ordering of entitlements, which have long been the subject of debate and controversy in the United States, have - - - only recently - - - begun to attract the attention of scholars.”

Some academic debate about the social and economic functions of bankruptcy has occurred in the two decades since this observation was made. In particular, there has been some consideration of the theoretical assumptions underlying the insolvent

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7 The two terms are used interchangeably at various points in this Chapter. This stems in part from the United States academic literature where the terminology (bankruptcy) does not distinguish between insolvent individuals and corporations. Because of the existence in Australia of separate bodies of legislation dealing with individuals and companies, the distinction in terminology will be more strictly applied elsewhere within the thesis. Generally for consistency in the thesis, ‘bankruptcy’ is used to refer to a system or regime of rules and ‘insolvency’ to refer to the debtor’s condition, unless of course the reference and discussion is specific to individual (bankruptcy) or a corporation (insolvency) related statute. The advantages and disadvantages of a unified personal and corporate insolvency law regime are examined by Professor Andrew Keay in “The Unity of Insolvency Legislation: Time for a Rethink?” (1999) 7 Insolvency Law Journal 4.

8 Both the Bankruptcy Act 1966 (Cth) in s 5(2) and the Corporations Act 2001 (Cth) in s 95A, define solvency in terms of an ability to pay debts “when they become due and payable.” Judicial decisions have interpreted these definitions in terms of cash flow rather than as a balance sheet test. This case law is concisely summarised by Mandie J in Australian Securities and Investments Commission v Plymin, Elliot & Harrison [2003] VSC 123 at [368]-[380], esp. [370] [371]. This mirroring of a bankruptcy definition in corporate insolvency law is characteristic of a much broader modeling of the corporate insolvency law on older personal bankruptcy law principles. Over recent decades the complexity of commercial dealings has generated a degree of divergence between the two regimes.

trading provisions. The aspects of bankruptcy and insolvency dealt with in this thesis nonetheless provide fertile ground for theoretical analysis, particularly within a context which addresses the objectives of the law in terms of their policy and philosophical foundations.

The specific features of bankruptcy law examined in this thesis are the principles governing the sharing of the deficiency in the debtor’s resources between creditors. Apart from enhancing our philosophical understanding of the objectives of bankruptcy and insolvency law, a theoretical analysis can assist in guiding policy and legislative developments.

Bankruptcy and insolvency are both characterised by a complex framework of statute and case law. The relationship between the broadly accepted normative objectives of insolvency law, and the legal and administrative structures by which the objectives are implemented, are described in this chapter of the thesis. The account reveals that there is tension, and even inconsistency, between objectives. Additionally, the interaction of bankruptcy law with other branches of the law, particularly branches of private law, requires close analysis. In Chapter 2 the types of private law dealing which generate uncertainty in their treatment upon debtor insolvency are explored. An alternative perspective is introduced in Chapter 3 which incorporates modern scholarly perspectives on the role of corrective and distributive justice in private law into a model of bankruptcy law. Such an approach is proposed in order to present a clearer understanding of how bankruptcy law applies in practice, and should develop in the future.

In the next chapter I discuss two specific problems that relate to the impact of bankruptcy on private law, and indeed conversely, to the impact of private law on bankruptcy. The first is the application of corporate insolvency law to mass tort

claims. The second concerns the impact of the recognition of equitable proprietary interests upon insolvency distribution. In each case the thesis considers the distinct interaction of two branches of the law of obligations – the tort of negligence and equity – with insolvency law. There are two justifications for considering these interactions. First, tort and equity are major components of the law of obligations. Secondly, they foreshadow how analysis of both obligations and bankruptcy in corrective and distributive justice terms can shed light on both bankruptcy’s logic and the limitations of that logic. In each area a small number of critical cases will be considered. Analysis of the cases forms a basis for identifying how the more fundamental jurisprudential perspectives of corrective and distributive justice apply to bankruptcy.

Statutory bankruptcy and insolvency regimes are heavily premised on the notion that unsecured creditors are to be paid out of the debtor’s pool of assets and, after distributions to preferred creditors, on a pari passu\textsuperscript{11} basis. Application of the pari passu principle demonstrates that bankruptcy is a collective procedure under which each creditor forfeits his or her individual right to take action to enforce the debt owed, and in lieu receives benefits determined by collective proceedings. This orthodoxy is seen as providing the fairest possible outcome for persons affected by a debtor’s insolvency, and is conducive to the orderly conduct of commercial dealings. The principle of creditor collectivism assumes that distribution should reflect as closely as possible non-bankruptcy entitlements. Collectivism is achieved by the surrendering of individual remedies. Application of this principle means that there is no justification in this scheme for the “implementation of a different set of relative entitlements,”\textsuperscript{12} or for the recognition or creating of new entitlements “conflicting with the collectivisation goal”.\textsuperscript{13} The English common law rule is expressed in the idea that:

\textsuperscript{11} Equally; without preference to one side or another. In a statutory context now contained in provisions such as Corporations Act 2001 s 555 ‘Debts and Claims proved to rank equally except as otherwise provided’ and s 559 ‘Debts of a class to rank equally’. The focus of this thesis is on the application of the pari passu principle in its statutory context. A common law principle of invalidating dispositions which purported to modify the application of the principle was identified and discussed by the Supreme Court of the United Kingdom in \textit{Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd} [2011] UKSC 38.


\textsuperscript{13} Ibid.
“It [bankruptcy] takes them exactly as it finds them, and divides the assets among the creditors, paying them their dividend on their debts as they then exist.”

Rizwaan Mokal’s view is that this explanation of the pari passu principle in corporate insolvency merely answers the broad question of how the law “decides on the treatment of different types of creditor.”

The pari passu principle is encapsulated in the words of Professor Seligson:

“Equality is equity. The maxim is a theme of bankruptcy administration – one of the cornerstones of the bankruptcy structure. All persons similarly situated are entitled to equality in treatment in the distribution of the bankrupt estate.”

Recent Australian judicial consideration of the meaning of s 555 of the Corporations Act in which the pari passu principles is embedded, whilst not extensive, is nonetheless definitive:

“It is not necessary to examine in any detail the several cases in which the rule [proportional distribution] is said to be recognised and applied - - - Instead, it is essential to begin from the elementary proposition that insolvency law is statutory and primacy must be given to the relevant statutory text.”

These remarks from the High Court point to two significant issues dealt with in the thesis. The first concerns the extent to which bankruptcy law, notwithstanding its statutory form, can be understood in non-instrumental terms (this idea first introduced in 3.1.1 of Chapter 3). The second concerns the interplay of the statutory rules of pari passu treatment and the formalised structure of priority (Corporations Act s 556) – the issue here being identification of how post-insolvency entitlements are to be treated, if reordering of the pre-insolvency position is to be justified (refer 3.3.1 of Chapter 3).

Creditor collectivism is said to negate the risk of unilateral action by individual creditors to advance their own position either by precipitating bankruptcy or by opting out of the collective procedure. Consistent with the objective of maximization of

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14 Re Smith, Knight & Co (1868) LR 5 Eq 223 at 226 per Lord Romilly M.R..
distribution returns to creditors, it has been asserted that “bankruptcy law should change a substantive non-bankruptcy rule only when doing so preserves the value of assets for the group of investors holding rights in them”. Contrary to this assertion, the thesis seeks to identify a justification for altering some pre-bankruptcy entitlements during the bankruptcy process whilst still achieving the goal of predictability and commercial certainty in bankruptcy administration.

1.1 The philosophy and objectives of bankruptcy and insolvency regimes

Professor Goode identifies four overriding objectives of the law of corporate insolvency:

1. to restore the debtor company to profitable trading where this is practicable;
2. to maximise the return to creditors as a whole where the company itself cannot be saved;
3. to establish a fair and equitable system for the ranking of claims and the distribution of assets among creditors; and
4. to provide a mechanism by which the cause of failure can be identified and those guilty of mismanagement brought to book.

The second and the third of these objectives are the focus of this thesis. Between them they embrace one of the central themes of my research – the interplay of principles of fairness, defined in terms of natural law reasoning, with the goals of the bankruptcy process. This interaction takes place in ordering the resolution of a debtor’s obligations in the transition from solvency to the application of the bankruptcy statutory regime. An over-emphasis on process in bankruptcy may detract from the recognition of fairness related to some types or class of creditor, whereas a preoccupation with individual fairness within what would otherwise be a collectivised process may create a threat of indeterminacy. Corrective and distributive justice analysis is applied in this thesis to explain how the tension between fairness and excessive indeterminacy should be resolved.

At its most rudimentary level "bankruptcy [and insolvency] law addresses the situation where a debtor does not have sufficient resources to pay all its creditors in

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This gives rise to a tension between those individual remedies that might be resorted to by creditors on "a first come, first served basis," as opposed to a wider utility that might be achieved by a collective debt settlement system. The critical task for the law is to establish a theoretically rigorous basis to replace the “first come, first served” principle that would apply in the absence of a bankruptcy law. The principle of creditor collectivism assumes that all private law claims are morally neutral. It is this assumption that this thesis challenges. Ethical principle has a role to play in determining claims within bankruptcy and an ethical framework will be proposed later in this thesis. Briefly, notions of corrective justice are examined, initially to explain the nature and ethical basis of private law obligations in the absence of bankruptcy, which are then transformed into a natural law-based distributive context brought about by the debtor's insolvency.

Continuing his analysis of the aims of corporate insolvency law, Professor Goode describes a series of ‘instruments’ by which the objectives are achieved, three of which are specifically germane to this thesis:

1. substitution of collective action for individual rights of pursuit,
2. a scheme of predetermined distribution, and
3. avoidance of transactions and recovery of misplaced assets.

Each of these ‘instruments’ are manifest in the present law. An objective of this thesis is to present an alternative basis for examining both the interrelationship of these legislative mechanisms, and their collective interaction with legal doctrine. The approach is derived from an understanding of obligations within the context of theories of corrective and distributive justice. The analysis will provide a basis for balancing the statutory policy objectives identified by Professor Goode, whilst at the same time providing a basis for the better reconciliation of claims against the assets of insolvent corporations or bankrupt estates.

1.1.2 Substitution of collective action for individual rights of pursuit and the scheme of predetermined distribution

The first and second ‘instruments’ can to a degree be dealt with together as each is an integral condition for the application of the other:

21 Ibid.
“The universal principle of insolvency law, which can be traced to the bankruptcy statute of 1570, and which has been regularly applied in bankruptcy, is that the unsecured creditors are to be paid on a pari passu basis, namely equally and rateably. **Applied to the pari passu principle is the fact that bankruptcy is a collective procedure** in that each creditor forfeits the individual right to take action to enforce the debt owed, and in lieu thereof the creditor must depend on the result of the collective proceedings.”

This idea of the universality of the pari passu principle, it must be acknowledged, is subject to academic criticism. Rizwaan Mokel argues that the pari passu principle is a nullity – adherents to the principle accept a contradiction by, on the one hand, recognising exceptions by way of a preferred claim, yet on the other hand, maintaining the need for rateable treatment amongst such preferential creditors. More than a principle that is merely trivial, it fails to provide meaningful explanation as to “why insolvency law chooses to declare certain creditors to be ‘equals’.”

Mokel restates insolvency law’s general rule to be “that the assets available in insolvent estates are to be distributed ‘unequally’, unless attempting to do so would be pointless because wasteful.” He concludes that the “different priorities afforded to different types of claimant are sometimes arbitrary” suggesting that “this area of the law could do with extensive re-thinking and rationalisation.” The model developed in this thesis offers a basis for overcoming such arbitrariness, explaining the rationale for particular ‘unequalness’ outside of secured transactions, whilst still supporting the principle of pari passu treatment within distinct categories of claimant.

Central to the creditor collective action rationale is the assumption that such cooperation “maximises the value of assets, which will be used to repay them,” along with the minimising of monitoring costs which would otherwise be incurred were creditors allowed to seek satisfaction of individual claims. The maximising of

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22 13 Eliz 1 c. 7.
25 Ibid.
26 Ibid at pp 620-621.
27 Ibid at 621.
28 Ibid.
returns to creditors derives, at one level, from the policy of preserving, where possible, a 'going concern' rather than permitting a piecemeal break-up of assets. More pragmatically, from Goode's perspective, the bankruptcy process avoids "the free-for-all in which the race goes to the swiftest [by which] individual assets of the company are picked off one by one in the process of execution." Such a risk is "seen as inimical to the efficient organisation of the affairs for the benefit of creditors as a whole." In so doing the administration, collection, realisation and distribution of assets against ascertained liabilities is premised on the assumption that the interests of creditors should be preferred to other parties. The necessary corollary to maximisation of returns is the imposition of rules which equitably rank creditor claims to a distribution, thus "convert(ing) creditors' rights of action into rights of proof in competition with other creditors." Hence, all creditors of equal ranking can upon winding-up participate in the common pool in proportion to the size of their admitted claims (pari passu).

Aside from statutory exceptions, the pari passu principle makes allowance for any rights "accrued prior to the insolvency proceeding". The collective nature of corporate insolvency law has been rationalised by Professor Jackson, writing from an economic perspective, as necessarily "ensuring that the rights that exist [prior to bankruptcy] are vindicated to the extent possible." No creditor acting unilaterally is therefore subject to an incentive either to precipitate liquidation or to seek to gain by standing outside the collective proceedings. Not only is a more orderly and equitable relationship between creditors fostered; a greater stability and predictability in commercial relations is encouraged with "bankruptcy [triggered] when, and only when, it is in the interests of the creditors as a group." In these terms bankruptcy law can be regarded as being initially subservient to non-bankruptcy law, the former

30 This objective can be most directly found in Australian legislation in the Corporations Act 2001 under Part 5.3A Administration of a Company's Affairs with a View to Executing a Deed of Company Arrangement. These rules function separate from the Part 5.4 Winding Up in Insolvency procedures – though of course there is interaction particularly in terms of the outcomes of an assessment by the administrator that the company should proceed to liquidation (s 438A(b)(iii)).
32 Ibid at p 31.
33 Ibid at p 141.
34 See in the corporations context, s 556 Priority Payments and s 559 Debts of a Class to Rank Equally of the Corporations Act 2001.
37 Ibid at p 21.
in its development being "directly associated with the notion of preserving relative values"\textsuperscript{38} derived from transactions voluntarily bargained for by the parties or imposed by private law.

Two further aspects of the \textit{pari passu} principle are noteworthy.

First, whilst it must clearly be acknowledged as "fundamental and all-pervasive"\textsuperscript{39}, the principle is excluded where it would upset valid rights arising \textit{in rem}. This is consistent with the objective of preserving rights accrued prior to liquidation. Insolvency law typically gives priority to secured creditors' pre-bankruptcy net value entitlements, thus ensuring those creditors' participation in the collective process.\textsuperscript{40}

As will be shown, this demarcation of rights often is the outcome of an application of equitable principles, particularly constructive trust principles, which frequently results in a residual pool of assets which are of little or no value to unsecured creditors. The application of Jackson's policy perspective, which seeks to "allocate the common pool of assets in such a way as to maximise benefits for creditors as a whole"\textsuperscript{41}, provides at least a tentative basis for assessing the outcome of recognising equitable proprietary interests, in addition to those secured interests whose priority is already recognised by bankruptcy legislation\textsuperscript{42}.

Secondly, Goode\textsuperscript{43} makes the important observation that the \textit{pari passu} principle underpins the notion of invalidation of pre-liquidation transactions that would seek to advantage one creditor over other equally ranking creditors. This interrelationship between the \textit{pari passu} principle and the invalidation of pre-liquidation transactions connects directly to Goode's third instrument of corporate insolvency law – that of the body of rules for the avoidance of pre-insolvency transactions and the recovery of misplaced assets. Extensive analysis of the bankruptcy and insolvency transaction

\textsuperscript{38} Ibid at p 34.
\textsuperscript{40} Ibid at p 71-72. Mokele sees this interaction as one of the critical elements undermining the explanatory value of the \textit{pari passu} principle. He states that "Bridge sees an inherent tension between the ‘two fundamental principles of credit and insolvency law’ that of freedom of contract which allows one to bargain for priority, and the mandatory \textit{pari passu} principle."
\textsuperscript{42} Ibid p 36.
\textsuperscript{43} See generally Part 5.6 Div 6 Subdivision C - Special provisions relating to secured creditors of insolvent companies. Sections 554D – 554J.
clawback provisions is outside the scope and objectives of this thesis. Nonetheless, some further discussion of their interaction with the *pari passu* principle is warranted.

The broad thrust of the regime contained within Division 2 of Part 5.7B of the Corporations Act 2001 (Cth) is to empower a liquidator by the making of a court order to have particular transactions set aside, thus restoring the company being wound up to the financial position in which it would have been had the transaction not been entered into. Significantly, s 588FE goes on to specify time zones within which each of three categories of antecedent transactions can be attacked by a liquidator.

This thesis deals only with the unfair preference aspect. It is here that the interplay between unsecured creditor claims is the most critical where a proprietary claim to debtor property is made. The unfair preference aspect of insolvency law has, as Professor Keay indicates, its foundation in the equitable principle of *pari passu* which, to reiterate, seeks "the assets of a company to be distributed fairly and rateably amongst its creditors." As such, the relevant law can be paraphrased by saying that where a creditor receives payment in respect of a debt, such payment will be set aside if it is greater than the amount the creditor would have received upon the winding up of the insolvent company.

At this juncture it is worthwhile examining in more detail how the preference provisions promote the objectives of the *pari passu* principle.

Jackson describes preference provisions as a transitional rule that militates against "strategic planning in the pre-bankruptcy period." This is to prevent creditors changing their existing position in a way that is detrimental to the collective proceeding. Similarly, Goode expresses the objective in terms of negating the diminution of assets available to the body of creditors, though more significantly he

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44 Recovering Property or Compensation for the Benefit of Creditors of Insolvent Company.
45 Section 588FF Courts May Make Orders About Voidable Transactions. Moneys recovered by a liquidator pursuant to s 588FF are impressed with a trust in favour of unsecured creditors but must be initiated by the liquidator within three years from the relation-back day (date of filing application to wind up).
46 Section 588FE Voidable Transactions.
47 Section 588FD Unfair Loans to a Company, s 588FA Unfair Preferences and s 588FB Uncommercial Transactions.
49 Section 588FA Unfair Preferences
emphasises the relative distribution aspects in terms that would "involv[e] the unjust enrichment of a particular party."\textsuperscript{51} This unjust enrichment measure is pivotal to the American writer Professor Emily Sherwin, who has formulated criteria in terms of unjust enrichment, according to which the constructive trust can be allowed to have qualified application in a bankruptcy context.\textsuperscript{52} Goode further identifies two sources of unjust enrichment affecting the general body of creditors; transfers of a fraudulent nature\textsuperscript{53} having about them an element of under\textsuperscript{54} or over-valued\textsuperscript{55} property transfer, and transfers by which a particular creditor receives either partial or complete satisfaction of a debt.\textsuperscript{56}

\textsuperscript{51} R.M. Goode, \textit{Principles of Corporate Insolvency Law} (2011 4\textsuperscript{th} ed. Sweet & Maxwell, London) p 522, Professor Goode here stressing the use of the terminology "in a restricted sense."

\textsuperscript{52} Constructive Trust in Bankruptcy (1989) 2 \textit{University of Illinois Law Review} 297.

\textsuperscript{53} As with \textit{pari passu} treatment, the concept of fraud in bankruptcy can be traced to the Elizabethan statute. In dissenting judgment in \textit{Cannane v Cannane Pty Ltd; Cannane v Official Trustee in Bankruptcy} [1998] HCA 26, 192 CLR 557 Kirby J observed at 588 that "The source and origin of all the English legislation was the Statute of Elizabeth (13 Eliz 1, c 5). That enactment contained within it the ideas which persist to this day in Australian law and give rise to the issues in these appeals. Thus, the Statute provides that transfers of property for the purposes of delaying, hindering or defrauding creditors of their lawful debts were "to be clearly and utterly void, frustrate, and of none effect." Gaudron J in the same case at 571-572 remarked that "It is notoriously difficult to provide an exhaustive statement as to what is involved in the concepts of "fraud" and "intent to defraud.". It is noted however that in the more recent drafting of bankruptcy and insolvency statute, the Australian legislature has tended away from the use of the term 'fraud'. For example, former Bankruptcy Act s 121(1) read in part " - - - a disposition of property - - - with the intent of defrauding creditors - - - void against the trustee in bankruptcy." The current corresponding section (s 121(2)) enacted in 1996 is now built around a test of an inference that at the time of the transfer, the transferor was, or would become, insolvent. A comprehensive analysis of the development and nature of the fraudulent transaction concept can be found in J. Edelman \textit{"The Meaning of Fraud in Insolvency and Bankruptcy: A 400 Year Old Riddle"} (2000) 18 \textit{Company and Securities Law Journal} 97. Further judicial analysis of the 1571 "Elizabethan Statute" and voluntary alienation to defraud creditors can be found in \textit{Marcolongo v Chen} [2011] HCA 3.

\textsuperscript{54} See for example in the corporate insolvency context s 588FB Uncommercial Transactions subsection (1): "A transaction of a company is an uncommercial transaction of the company, if and only if, it may be expected that a reasonable person in the companies circumstances would not have entered the transaction, having regard to: (a) the benefit (if any) to the company of entering into the transaction; and (b) the detriment to the company of entering into the transaction; and (c) the respective benefits to other parties to the transaction of entering into it; and (d) any other relevant matter."

\textsuperscript{55} See for example in the corporate insolvency context a 588FD Unfair Loans to a Company subsection (1): "A loan to a company is unfair if, and only if: (a) the interest on the loan was extortionate when the loan was made, or has since become extortionate because of a variation; or (b) the charges in relation to the loan were extortionate when the loan was made, or have since become extortionate because of a variation; even if the interest is, or charges are, no longer extortionate."

\textsuperscript{56} See for example in the corporate insolvency context s 588FA Unfair Preferences subsection (1): "A transaction in an unfair preference by a company to a creditor if and only if: (a) the company and the creditors are parties to the transaction (even if someone else is also a party; and (b) the transaction results in the creditor receiving from the company, in respect of an unsecured debt that the company owes to the creditor, more than the creditor would receive from the company in respect of the debt if the transaction were set aside and the creditor were to prove for the debt in a winding up of the company."
One common feature of both American and English approaches to bankruptcy distribution policy is that they disregard both parties' intentions in entering into the dealing which gave rise to the alleged preference. Professor Countryman\textsuperscript{57} identifies the 1571 Statute of Elizabeth as the key historical foundation of the law of preferences, as construed, by a series of eighteenth century decisions of Lord Mansfield. He concludes that:

"Under the English concept, therefore, a preference, which is not voidable outside of bankruptcy, is a culpable act of the debtor with or without the preferred creditor's complicity, who can be compelled to surrender the property even though he received it in all innocence."\textsuperscript{58}

According to Professor Keay this principle, carried over into corporate insolvency\textsuperscript{59}, is most clearly articulated in the Australian context in \textit{S Richards and Co Ltd v Lloyd}.\textsuperscript{60} Starke J stated that (the Act) "looks to the effect of the transaction and not to the intent, or state of mind, of the debtor."\textsuperscript{61} This approach to the application of the antecedent transaction aspects of bankruptcy legislation, and the further complementary element of application of an objective test of motive, is also evident from Evatt J's remarks:

" - - - to hit at the results and effects of the debtor's action whatever his motive and intent may have been."
And further,

"The test adopted is completely objective and in no way subjective."\textsuperscript{62}

The assumption here is that the policy foundation of both bankruptcy and insolvency law is the maximisation of returns to creditors. Professor Goode is mindful of claims that have been advanced against his and Jackson's arguments, noting amongst

\textsuperscript{57} "The Concept of a Voidable Preference in Bankruptcy" (1985) 38 Vanderbilt LR 713.
\textsuperscript{58} Ibid at p 718. Professor Countryman continues at p 725 to discuss how this attitude has been adopted and developed upon in USA bankruptcy legislation.
\textsuperscript{59} McPherson's \textit{The Law of Company Liquidation} (4\textsuperscript{st} edition LBC Information Services Sydney 1999) p 442.
\textsuperscript{60} (1933) 49 CLR 49.
\textsuperscript{61} Ibid at 62.
\textsuperscript{62} Ibid at 64. This case more recently is cited as authority in \textit{Airservices Australia v Ferrier and Another} (1996) 21 ASCR 1 where at 26 Toohey J states: "They (the words 'having the effect of' contained in s 122 of the Bankruptcy Act) do not look to the intent - - - when making the payment. In this respect the bankruptcy law of this country and of the United Kingdom are different." This latter point of distinction between UK and Australian law is criticised by Goode, the argument developed by the Cork Committee against adopting a primary effect rule that disregards intention being viewed as unpersuasive. (R.M. Goode, \textit{Principles of Corporate Insolvency Law} (2011 4\textsuperscript{th} ed. Sweet & Maxwell, London) pp 569-571).
others the proposition advanced by Professor Elizabeth Warren "that to concentrate so exclusively on maximising returns to creditors is a dangerous over-simplification of the nature of the bankruptcy process." Warren has identified important criticisms of the theory of creditor collectivism advocated by Jackson and Goode.

First, the theory that the objective of bankruptcy law is to enforce pre-bankruptcy claims fails to recognise other aims of the bankruptcy regime. Professor Goode’s list of the objectives of an insolvency regime identifies a variety of related objectives in dealing with business failure, including the provision of opportunity for business rescue and avenues for investigation of misconduct. These objectives should not be ignored in any discussion of creditor-maximisation. Balancing the compatibility of these objectives is a challenge for policy-makers.

Second, it is arguable that the objective of preserving pre-existing interests is applied too strictly. It gives no scope for flexibility or for the application of discretion. This criticism is central to the arguments of this thesis. Two distinct issues in determining these interests are examined – first, the circumstances in which equitable proprietary interests affect the application of pari passu principle, and second, whether there is any case for prioritising the claims of tort victims over the claims of other creditors. Related to the latter of these points is the extent to which other significant bodies of legal rules, such as those relating to separate legal personality and limited liability within the law of corporations, obstruct the aim of achieving just outcomes for some categories of claimant.

The remainder of this section of Chapter 1 explores and evaluates economic and other policy assumptions to be found in the academic debate on bankruptcy objectives. The debate provides a background for developing an alternative basis for understanding the social and economic ramifications of the ordering of such entitlements developed in the later chapters of this thesis. Professor Goode has effectively “debunked” much of the theoretical basis of Professor Jackson’s assertion of paramount creditor collectivism, concluding the “argument [to be] neat but ultimately unpersuasive” 64. Although the principle of enforcing pre-existing entitlements is a central feature of the bankruptcy system, Professor Warren’s

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64 Ibid at p 73.
arguments demonstrate that it is not a complete explanation of how the system operates.

1.1.3 The proper scope and objectives of bankruptcy law – a critique of the ‘one or several interests’ debate

1.1.3.1 Creditor collectivism
The notion of collectivism espoused by Professor Jackson, both individually and jointly with Professor Baird, maintains that bankruptcy distribution should accord as closely as possible to non-bankruptcy entitlements. This is achieved by the surrendering of individual remedies as part of the bankruptcy process. According to this logic there is no justification in this scheme for the “implementation of a different set of relative entitlements”\(^{65}\), or for the recognition or creating of new entitlements “conflicting with the collectivisation goal.”\(^{66}\)

The embodiment of the collectivism policy ideal in bankruptcy procedures negates the risk of unilateral action by individual creditors to advance their own position by either the precipitation of bankruptcy or opting out of the collective procedure. Consistent with the parallel objective of maximization of distribution returns to identified creditors, “bankruptcy law should change a substantive non-bankruptcy rule only when doing so preserves the value of assets for the group of investors holding rights in them.”\(^{67}\)

The principle of preserving pre-bankruptcy relative entitlements is termed by Jackson as the “creditors’ bargain” and is supported by the economic justifications of reduced costs of monitoring and collection, and of the facilitating of an increased pool of aggregate assets through the orderly resolution of the bankrupt’s affairs.\(^{68}\) On this analysis it is logical for Jackson to conclude that “it likely that a general unsecured creditor will agree to a collective system in lieu of a scheme of individualistic remedies.”\(^{69}\)

\(^{66}\) Ibid
\(^{69}\) Ibid at p 866.
Much of Jackson's and Baird's analysis is directed to providing a rationale for the priority given to secured credit. Of greater significance to the thesis is the view of the authors that the content of bankruptcy law can be precisely described, and that a clear distinction can be drawn between bankruptcy laws and the entitlements external to bankruptcy law which are being enforced. For present purposes the secured creditor aspect is dealt with briefly whilst the second receives more detailed treatment.

1.1.3.2 The reconciliation of unsecured and secured claims and the basis of the latter's protection

Central to the principle of collectivism is the notion that non-bankruptcy entitlements, including secured interests, should be recognised in bankruptcy. It is pertinent to ask what it is that has been bargained for by the creation of these interests. Jackson and Baird state that “secured credit is concerned with ensuring that the secured creditor receives priority rights in certain assets over the rights of other owners with claims against the assets of a debtor.”70 They assert that the ‘quid pro quo’ for the granting of priority to secured creditors is that:

“Because a secured creditor bears less risk of his debtor’s insolvency than does an unsecured creditor, he enjoys a lower interest rate.”71

But, as Goode points out, this justification “is simply not how lending works.”72 The bargaining power of lenders is such that whilst they may take security, they still retain and exert the capacity to charge ‘what the market will bear’. Considered conversely from the unsecured creditors’ perspective, it is equally untenable to presume that this group has the bargaining power to charge higher interest or to factor into their pricing an allowance for greater risk. Similarly, it is unsound to assume that limited pricing flexibility in dealing with the risk of debtor default is a risk that can be negated through a process of diversification across a sufficient number of debtors.

Jackson and Baird place significant emphasis on the law’s capacity to “isolate bankruptcy issues.”73 One conclusion, based on their premise that bankruptcy law should respect non-bankruptcy entitlements, is that security once bargained for

71 Ibid
should prevail, irrespective of immediate and wider distributional consequences. This rationale allows the authors to claim that:

“Questions about the desirability of secured credit and the wisdom of allowing secured creditors to be paid in full ahead of others are not relevant. These questions -- - are not bankruptcy questions.”

Nonetheless, the negotiation of security is surely anticipatory of the risk of failure. The entitlements sought by such bargaining would not exist but for the possibility of bankruptcy and the fact that the holder’s priority will prevail.

In response to Jackson and Baird’s argument, Warren makes the following counter-argument:

“- - - collectivism is nothing but a veil to conceal a relentless push for single-value economic rationality, an excuse to impose a distributional scheme without justifying it, and, incidentally, a way to work in a damn good deal for secured creditors.”

The risks to policy development associated with applying a ‘single-value’ economic rationality are all the more apparent when considering the law’s treatment of uncertain or unquantifiable claims. The law must, on the one hand, deal with the pressing resolution of pre-existing entitlements, yet at the same time make allowance for claims that will materialise in the future though arising out of the debtor’s pre-bankruptcy actions. Warren’s analysis highlights the need for development of alternative explanations for understanding the scope of bankruptcy law. Warren does not put forward an alternative analytical framework for bankruptcy, instead describing its policies as complex, elastic and interconnected. Her insight, I believe, is nonetheless significant in pointing to a need for a more principled understanding of the dynamics of the relationships between the various parties to an individual’s bankruptcy or a corporation’s insolvency. Moreover, such an understanding is a key element in identifying the limits and purposes to which bankruptcy law’s various mechanisms can be applied.

76 Ibid at p 811.
1.1.4 The domain of bankruptcy law

1.1.4.1 The reconciling of claims in bankruptcy

In reply to Professor Warren, Professor Baird asserts that his and Jackson’s theory of bankruptcy enables bankruptcy issues (such as the treatment of voidable preferences) to be isolated from the wider “question of how losses should be borne in the event that a firm fails.”77 Using the example of employees’ wages priority upon bankruptcy, Baird78 questions the logic of such protection, which exists neither in non-bankruptcy business failure nor as a pre-bankruptcy entitlement – thus creating, in his view, the type of perverse incentive79 described by Jackson which would see a creditor gaining an advantage by opting out of the collective proceeding. Baird argues that a policy that would treat differently the circumstances of “existing management - - - closing a plant and throw(ing) workers out”80 and that of “the firm failing to meet its obligations to them” as being internally inconsistent.81

The argument is used to support the assertion that the question of how the losses of firm failure are distributed are “questions of the general law”82 and not “peculiar to bankruptcy law (as Warren would argue).”83 Business failure outside of bankruptcy, be it specific to a firm or part of a wider economic cyclical downturn, impacts upon a wide community of interests (employees, suppliers, customers and so forth through an extended ‘network’ of relationships). The economic and social consequences cannot reasonably be dealt with within the law, except insofar as it enforces recognised legal obligations. Issues of how the impact of economic adjustment and transformation are to be ameliorated clearly belong to the domain of government policy, and are therefore external to commercial law. Legislators may however, choose to facilitate economic change through incentives which are embodied in commercial law. In a similar vein, Baird and Jackson’s statement that “social reform should be brought about through broad changes to the substantive law rather than through ad hoc modification of rights in bankruptcy”84 is correct. However, I will

78 Ibid at p 817.
81 Ibid
82 Ibid at p 816
83 Ibid
suggest later that the imperative of avoiding the imposition of undue or extraneous purposes on bankruptcy law requires a greater degree of sensitivity to the interaction of various branches of the law than is suggested by Baird and Jackson’s analysis. In Chapter 2 I describe challenges presented to bankruptcy law by multiple tort claims and equitable discretion. These illustrate the point that enforcing pre-existing entitlements is not as straightforward as Jackson and Baird assume. Likewise, uncertainties or obscurities in private law are necessarily reflected in uncertainty and obscurity in the administration of the bankruptcy process. Professor Goode deals with this element of the debate as follows:

“It is only on insolvency that the ranking of unsecured claims arises. - - - Such a priority rule [for employees or tort claimants] would make no sense except in the context of bankruptcy, when there is not enough to go round.”\(^{85}\)

This explanation in addressing the practicalities of bankruptcy distribution is pragmatically based. This thesis offers a natural law explanation, alternative to both this and economic based explanations.

The theme of maintaining parity\(^{86}\) of creditor rights in and outside of bankruptcy is further emphasised by Baird’s comment that “whenever we must have a legal rule to distribute losses in bankruptcy, we must also have a legal rule that distributes the same loss outside of bankruptcy.”\(^{87}\) The practicality of achieving such certainty in the law is doubted by Warren who observes that it is false to assume that “the behaviour of debtors and creditors is known and can be predicted in new circumstances.”\(^{88}\) Thus in Warren’s terms the reality of bankruptcy is “more complex” and is an “ultimately less confined process”\(^{89}\) in which it is neither practical nor advisable to quarantine the development and application of bankruptcy law from analysis of non-bankruptcy policy. Relevantly to this thesis, she also remarks that it is impractical to predict definitively the way in which the event of insolvency affects all types of possible debtor/creditor relationship.

As was foreshadowed in the introduction, the objective of this thesis is to present a normative based framework for examining the extent to which non-bankruptcy policy

\(^{87}\) Ibid at p 822.
\(^{89}\) Ibid.
should impinge upon the distributive attributes of bankruptcy law. While being susceptible of practical application, the approach contrasts with economic and similar functional explanations discussed above. Such an approach must avoid the commercial uncertainty inherent in the application of a strong discretion. This is the objective of the natural law-based model developed in chapters 3 and 4.

1.1.4.2 Predicting and controlling the behaviour of players
In terms of “control[ling] the conflicting incentives of the various parties” 90, Baird expresses a strong preference for legislative approaches that would presumably eliminate from the outset the ‘bad incentive’ of encouraging debtors to use the bankruptcy process strategically. He states that whilst he, along with Jackson, “ha[s] no objection to judicial discretion” 91 there are “other ways of keeping the parties in line.” 92 This thesis will argue that a principled approach to the exercise of discretion is potentially a more effective method of balancing the competing interests involved in the bankruptcy process, and that moreover there is a compelling argument for development of a non-economic normative framework of bankruptcy as a basis for handling complexity. Only such an approach can prevent the type of mischief described by Trebilcock and Katz in which “bankruptcy law has been used creatively and opportunistically by some large companies to avoid or minimize a particular obligation.” 93 The complexity within the law from which ‘bad incentives’ and opportunity for exploitation can emerge is introduced in Chapter 2 from the perspective of the interrelated issues of corporate personality and veil piercing.

In describing bankruptcy variously as ‘complex’ and ‘interconnected’, Warren points to the importance of a greater understanding of the interaction of bankruptcy with other areas of the law, and the need to respond to uncertainty in both debtor/creditor relationships and within inter-creditor distributive schemes. The exploration of these insights is pertinent to determining the function and limitation of priority arrangements within bankruptcy regimes. These issues are considered, initially at a theoretical level, in the context of the creditor collectivism debate and associated academic analysis dealing with mass tort liability and bankruptcy.

91 ibid
92 ibid
1.1.4.3 Further consideration of the utility and limitations of priorities in bankruptcy

The structure of any bankruptcy priority system must deal with practical challenges in two key respects:

first, the scope given to reordering interests in a distributional hierarchy, excluding reference to holders of proprietary interests, and

secondly, anticipating the consequences of default for claims whose existence or quantification are hard to assess.

As will be explained, quantification in terms of the latter challenge may be imprecise and even deficient. Nonetheless, as Warren indicates, distributive schemes have a bias towards including, not excluding, these claims.

The “creditors' bargain” perspective of Jackson and Baird suggests that the manner in which the balance between secured creditors, unsecured creditors and shareholders is translated into a distributive hierarchy, “merely reflects the different bargain each interest holder has struck in acquiring these rights.” Apart from difficulties around assumptions of information asymmetry, this aspect of the “creditors' bargain” theory obscures our understanding of how the law manages the transition from solvency to bankruptcy. The problem arises because of an absence of adequate account of the nature of legal obligations and how they relate to each other. The notion of bargain can only be made intelligible by a deeper understanding of the character of private law obligations.

Admittedly, Baird and Jackson acknowledge the limited capacity of particular creditors to bargain and 'price adjust' for the risk of debtor default – “non-consensual creditors, such as tort victims, may not make such adjustments.” To further conclude, however, even at the level of theoretical postulate, that “questions over the priority of tort claimants, given the goals of a tort system, are a non-bankruptcy issue” is, I submit, wrong. Such an assertion ignores the arguments that:

96 Ibid at fn. 54.
97 Ibid.
first, the event of bankruptcy precipitates the need for the law to manage tort claims, particularly in resolving uncertainty in determining the quantum of damages, and perhaps even the liability of alleged tortfeasors (for example, where contributory negligence matters arise); and

secondly, the bankruptcy system contains disincentives to proving such claims, which in some cases are supplemented by the obstacles posed for plaintiffs by the limited liability of the defendant.

Professor Jackson nonetheless seems willing to entertain tentatively the possibility of a relaxation of strict unsecured creditor collectivism within a broad distributive framework, particularly where non-consensual claimants are concerned:

“Several reasons, other than simply political expedience or special interest group pressure, may explain a state’s desire to provide a level of protection to certain types of claimants, instead of leaving the issue to the area of consensual security interests.”98

The various rationales advanced by Jackson, are presented as brief propositions within the “creditors’ bargain” theory, rather than as the result of empirical survey. The three circumstances identified as possibly warranting state imposed protection are: non-consensual claims, cases of informational disparity, and State claims to tax debts. Each of these cases demonstrate the need for a wider principle-based perspective on debtor-creditor relationship characteristics and their interaction with public and private law.

Professor Jackson at the outset fairly acknowledges the irrelevance of consensual models to explain bankruptcy law’s treatment of tort creditors. To conclude, however, that a system of granting priority to victims might provide an underpinning to the State’s intention of achieving “a certain level of deterrence - - - desirable to protect against certain behaviour,”99 I suggest, gives insufficient weight to the nature and objectives of tort law. There are of course numerous explanations of the aims of negligence law. For example, in corrective justice terms, it has been convincingly argued that tort law seeks to rectify the injustice suffered as part of a correlative duty between persons.100 Other explanations are economic or instrumental in character.

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99 Ibid p at 903.
The aim of this thesis is to advance a model of priority of interests based on a natural law explanation of the coherence of private law.

The proposition that priority creates for unsecured creditors an increased incentive to monitor debtor behaviour is tenuous. Aside from posing questions of empirical support for such an assertion, the merits of treating the more complex problem of the distributive merits of tort claimants from an economic perspective is highly problematic as it is apt to ignore proper consideration of the legal character of the relationships created by the commission of a tort. This is why the thesis emphasises a rights and ethical-based analysis which is particularly pertinent to an examination of the treatment of consensual and non-consensual claimants in bankruptcy.

The further suggestion that the State may choose to elevate the position of a particular category of creditor where they suffer a disadvantage by reason of ‘informational disparity’, though certainly valid, again introduces an element of subjectivity contrary to the economic rationale upon which the “creditors’ bargain” is premised. Whether any creditor suffers from lack of information of the debtor’s financial position is an empirical question; it cannot be presumed that any class of creditor is a victim of information asymmetry.

The third category of non-consensual relationship identified by Jackson as possibly warranting recognition within a hierarchy of priorities, is that of the State acting in its taxing capacity. The economic ‘nexus’ for granting priority is that the higher probability of recovery is “part of the cost calculus it (the state) has decided on in setting its rates.” Here again some caution is required in assessing the cogency of the rationale in terms of its characterisation as a non-consensual debt. In many cases unsecured creditors are involuntary or non-adjusting; “their debtors will not bear the full cost of defaulting and will not take optimal care to avoid default.” The corollary of this position is the extent of the creditors’ powers to enforce the debt. As Finch and Worthington conclude:

101 It is worth noting here Professor Goode’s more general comments about the problematic nature of law and economics based theories of insolvency – “... they begin with untested hypotheses of creditor behaviour which, by the end of the argument, have imperceptibly converted into findings of fact and are thus made the basis for firm conclusions and policy recommendations.” Principles of Corporate Insolvency Law (2011 4th ed. Sweet & Maxwell, London) p 76.


“A further factor which is relevant in assessing the efficiency of granting protection to certain unsecured creditors is the creditor’s ability to monitor the debtor’s performance thereby preventing the debtor’s default or taking inefficiently low levels of care.”

Taxing authorities, certainly in Australia where tax debts are treated equally alongside unsecured debts, have extensive capacity to monitor debtor behaviour supported by substantial recovery powers.

The creditors’ bargain rationale developed by Professor Jackson is valuable at a high level of abstraction in presenting a plausible explanation of the policy objectives and consequent legal structure of bankruptcy and insolvency regimes. His justification, and that of Professor Baird, explains most cases of statutory priority. However, the rationale’s explanatory power is less robust when applied to specific “hard cases” where other explanations are needed. These shortcomings, which relate to the uncertainty in quantifying some creditor claims and the discretion involved in recognising others, will be examined in the next chapter. The conclusion will be that “creditors’ bargain” cannot constitute a complete justification of contemporary bankruptcy law and practice.

To summarise, Warren’s conclusion that “to obliterate all creditor differences in bankruptcy would of course impose costs elsewhere in the debtor – creditor system” is highly compelling. I would add further that such ‘obliteration’ would also incur significant costs elsewhere in the wider legal system. As will be explained, locating where within the legal system the failure of debtor – creditor relationships is identified and resolved, amounts to more than merely identifying a system of distributive priority after bankruptcy has supervened.

1.2 Uncertainty in the law and the merits of normative justification
The complexities examined in this thesis are symptomatic of the type of more general uncertainty identified by Professor Robert Austin in his paper “The Melting Down of the Remedial Trust.” Professor Austin commenced with the observation that the

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104 Ibid at p 4.
105 See for example Part VI (Collection and Recovery of Tax) of the Income Tax Assessment Act 1936 (Cth.). An interesting element of which is a link between a director’s remittance obligation and the external administration rules contained in the Corporations Act 2001 - s 222AOB (Directors to cause company to remit or to go into voluntary administration or liquidation – deductions and amounts withheld).
107 (1988) 11 University of New South Wales Law Journal 66. In the two decades since the publication of “The Melting Down of the Remedial Trust” the High Court of Australia,
law of trusts was, and arguably is still, in turmoil. He uses this phenomenon as a basis for exploring the changing nature of jurisprudential influences on rule development. This discussion provides background to the subsequent analysis in the thesis concerning the identification of principles of creditor entitlement recognition within a framework of bankruptcy distribution.

The uncertainty surrounding the law of imposed trusts is further identified by Professor Patrick Parkinson in his review of the second edition of Ford and Lee's *Principles of the Law of Trusts*:

"- - - the constructive trust in particular is difficult to expound as a coherent conceptual unity, and its doctrinal boundaries are at present incapable of precise definition."110

And again,

"The fact of disorder, that is the breakdown of the classical model and the turbulence of disorder within the law of resulting and constructive trusts over the last few years, needs to be acknowledged."111

Austin's analysis is based on some basic propositions concerning the interplay between theoretical principles and precedent-based inductive judicial methodology. Within the realm of trusts law Austin observes that changing remedial demands had been met in the nineteenth century by the endeavours of text writers to organise and distil case law into formalised and defined legal propositions. Similarly, Professor Parkinson provides a brief description of this process of systemisation within the common law. Degrees of coherence were progressively imposed upon the case-by-case inchoate state of English law through theoretical resolution derived from continental traditions – the case law resolution coming from the common law itself. The thesis draws upon some of these philosophical foundations and their more recent reinterpretations – particularly that of natural law theory. That the state of the common law continues to be neither settled nor immune from upheaval is particularly after Sir Anthony Mason’s period as Chief Justice (1987-95), has tended towards a more formal and ‘black letter’ application of legal principle.

109 Sydney, Law Book Company, 1990
111 Ibid at 237.
112 See for example Laurence Boulle, “Precedent and Legal Reasoning” in J Corkery (ed) *The Study of Law* (1988), which provides some insightful comment concerning the effects on legal development in England of a comparative absence of a tradition of academic analysis of the law and the historical aversion amongst the English judiciary to theoretical analysis.
acknowledged in Parkinson’s remarks, applied to the present development of the law of trusts:

“It is the notion that all trusts can be explained by the same rules which must be abandoned, but not to the seas of uncertainty.”114

Applying this perspective to the problem of understanding the development of the law of trusts, Austin regards the present formal rules, on the one hand, as having provided judges with a valid basis for dealing with evolving remedial problems but on the other hand, over time has led to a tendency to disregard the utility of potentially better targeted equitable remedies.115 More generally, Austin asserts that formal tendencies have detracted from the recognition of a more flexible equitable analysis116. He goes on to argue that judicial conformity with classical English doctrine has over many years led to the acceptance of the ‘monolithic trust’ in applying English approaches to equitable remedies. This is in contrast to an adherence to the application of more discretionary principles in the United States. Austin maintains that in Australia, as in England, the practical manifestation of a rigid trust approach has been to cause either the distortion of cases in order to bring them within existing trust principles, or has necessitated further ad hoc adaptation of the traditional trust in order to meet changing circumstances. Part III of Austin’s paper is devoted to examining the relevance of the principle against unjust enrichment as an explanation of the outcome of five categories of cases which are seen as examples of ‘melting down’, that is, instances of a conceptual unbundling of the parts which in totality form the traditional trust concept. In this endeavour, Austin expressed a preference for the unjust enrichment principle to become:

“- - - a true legal principle in the sense that the neighbour principle117 is a principle of torts, providing guidance in the development of legal rules and itself available to be converted into a rule.”118

116 Ibid at p 69.
117 This principle is contained in (and developed from) the much analysed passage from Donoghue (or McAlister) v Stevenson [1932] All ER Rep 1; [1932] AC 562 where at 580 Lord Atkin stated; “The rule that you are to love your neighbour becomes in law, you must not injure your neighbour; and the lawyer’s question, Who is my neighbour? receives a restricted reply. You must take reasonable care to avoid acts or omissions which you can reasonably foresee would be likely to injure your neighbour.”
Arguing for a more deductive approach, Austin urges that the number of cases which cannot be satisfactorily fitted into the “monolithic trust” indicates that a different conceptual framework for their resolution is required. Austin urges acceptance of:

“- - - relevant propositions which are relatively general, desirable, and with explanatory and justificatory force – explanatory and justificatory in a way which can be taken into account by judges and which will provide generative norms for legal development.”¹¹⁹

This remark is drawn by Austin from the writings of Professor Neil MacCormick. It is worth quoting here the related passage which follows in MacCormick’s text as it bears directly on the critical issues examined in the following chapters of the thesis. These remarks can be applied to the identification of the normative nature of the rules which go to make up a division of law, such as a bankruptcy regime. MacCormick states that:

“Working out the principles of a legal system to which one is committed involves an attempt to give it coherence in terms of a set of general norms which express the justifying and explanatory values of the system. This engages one both in trying to understand the values which legislation and case law rules in the intendment of legislators and judges are supposed to serve, and in imposing what to oneself appears an acceptable value basis of rules.”¹²⁰

The complex nature of a bankruptcy regime itself and the manner in which it deals with competing interests are sourced from both legislation and judicial decision. These sources in turn are based both on private and public law concepts, and promote the interaction of the concepts. It is by an appropriate understanding of this interaction that the ‘justificatory force’ of bankruptcy law can be understood. The types of complexity examined in the next chapter can be analysed, and in some instances reconciled, from the perspective of how they might reflect the principles of corrective and distributive justice.

¹¹⁹ Ibid at p 85.
CHAPTER 2
CURRENT PROBLEMS IN BANKRUPTCY DISTRIBUTION
EXAMPLES DRAWN FROM ‘HARD CASES’: THE CHALLENGE TO ORTHODOXY AND THE NEED FOR ALTERNATIVE EXPLANATION

Introduction
In this chapter I develop further the themes of complexity and interconnection in bankruptcy law's processes of recognising and distributing creditor entitlements. Significant themes are how bankruptcy law responds to a variety of private law claims, and how it responds to uncertainty in private law. Practical examples are drawn from Australian and English law which highlight the stresses and uncertainty that can arise in bankruptcy distribution. These form a justification for the presentation of a normative model of bankruptcy law grounded in natural law.

The first major area of consideration is the law's treatment of the dominant tort of negligence in which the timing and extent of damage may be hard to quantify because of the latency of some types of conditions created by negligent conduct. Two problems require consideration. The first concerns the law's present treatment of both non-consensual tort claimants and consensual, predominantly contract, claimants within the same distributive framework. The second problem is the extent to which limited liability prevents the achievement of a just outcome. The thesis challenges the rationality and justice of the identical treatment of tort and contract claimants, and doubts whether insolvency law on its own can solve problems created by the concept of limited liability. The latter may in fact suggest limits to a normative non-economic model.

The second major area of consideration also deals in part with the contrasting treatment of non-consensual versus consensual claimants, this time in the context of the law's recognition of proprietary interests and remedies. The discussion commences with an outline of the principle that pre-existing property entitlements are not to be altered on bankruptcy. The discussion then focuses on a limited number of types of dealing between debtor and creditor where this expectation might be subject to challenge. Again, rather than proposing definitive outcomes, the objective is to illustrate both the value and the limits of a normative model of entitlement recognition in explaining how the law responds to equitable claims and property entitlements.
2.1 The limitations of insolvency law in the contexts of mass tort liability and corporate personality

2.1.1 Tort claimants and problems of inter-creditor competition

In recognition of the fact that a bankrupt will ultimately be discharged from liability to creditors, most bankruptcy schemes enable “future creditors [to be brought] into the debtor’s distributional plan and require participation by anticipated claimants”.\(^{121}\) This is achieved by the process of defining and quantifying claims. In Australian corporate insolvency law this process is established by s 554A of the Corporations Act 2001.\(^{122}\) The CCH *Australian Corporations Commentary* on this section describes the circumstances and manner of its operation:

“The value of a debt or claim may be uncertain for a variety of reasons. It may be that the claim relates to proceedings for a breach of contract where unliquidated damages are being sought or a claim based in tort where, again, the value of the claim cannot be determined until the proceedings are finalised by the courts considering the matter.”

Warren takes a favourable view of this kind of uncertainty in the bankruptcy system. It reflects the law’s capacity to apply policy considerations additional to that of mere distribution of a maximum possible pool of assets amongst creditors.\(^{123}\) A major theme of this thesis is to describe how these policy considerations are brought to bear in a manner which achieves justice without derogating from optimal economic efficiency and predictability – positive characteristics particularly relevant in the context of a corporate insolvency scheme. And later chapters will examine how these claims ought to be balanced.

One of the more significant issues that needs to be explored is how statutory and judge-made bankruptcy law interacts with the law of obligations. As already noted, contract claims in the main are more easily handled by a system which is premised on the notion of the “creditors’ bargain”.\(^{124}\) However, a more critical appreciation of the nature of the various branches of the law with which bankruptcy interacts is required in cases, first, of mass tort liability and, secondly, where the corporate legal

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\(^{122}\) Debts and claims of uncertain value. The key sub-section is s 554A(2) which states that the “liquidator must make an estimate of the value of the debt or claim as at the relevant date; or refer the question of value of the debt or claim to the Court.”

\(^{123}\) E. Warren, “Bankruptcy Policy” (1987) 54 *University of Chicago Law Review* 775 at p 778, where the author describes bankruptcy “as a more complex and ultimately less confined process” than the model advocated by Baird.

\(^{124}\) Refer Chapter 1 section 1.1.3.
personality of the debtor presents an opportunity for strategic behaviour. In essence, the latter concerns the “motivation for conducting business through a separate subsidiary [so as to] circumscribe the group’s exposure to the risks of the business.” Mass tort liability typically arises in relation to injuries caused by industrial or pharmaceutical products. The litigation is complex both because the plaintiffs are numerous and because the damage is often ongoing. In this context the following questions have to be considered:

1. Whether bankruptcy schemes should give preferential treatment to tort claimants, entitling them to priority over other private law claims.
2. The extent to which the current equal ranking of consensual contract and non-consensual tort claimants operates as an incentive to corporate controllers to avoid solutions that would prevent or minimise harm to unidentified plaintiffs.

These two questions have been debated amongst American law academics over an extended period of time – though without apparent result in terms of prompting law reform. Christopher Painter, writing in 1984, asserted that “[f]orcing tort claimants to share equally with voluntary, unsecured creditors and subordinating them to the interests of secured creditors is unfair.” He therefore proposed elevating tort creditors to the highest level of the secured priority system as an efficient basis for compelling increased monitoring, remarking that such a system would be “fair to voluntary creditors, who can bargain to be compensated for their extra risk.” My thesis focuses less on the economic efficiency element and substantially more on the notion of fairness as between non-consenting tort claimants and voluntary creditors. Charles Elson and Robert Rasmussen have proposed elevation of the payment of tort claims in bankruptcy based on an analysis of the “interaction between bankruptcy distribution rules and tort deterrence objectives [so as to] develop a proposal for reordering bankruptcy payout priorities.” The approach taken in this thesis is distinguishable. It focuses less on the deterrent functions of tort law, concentrating instead on its corrective objective within a rationale of the nature of private law obligations. In doing so it introduces a natural law-based concept of virtuous debtor conduct towards single and multiple claimants. As such, the emphasis is on tort’s

127 Ibid at p. 1084.
128 Ibid at p 1085.
130 Ibid at 2542.
interaction with bankruptcy distribution rules. A re-examination of the contrasting treatment of voluntary creditors and discrete categories of non-consensual claimant may be a valuable precursor to achieving better approaches to the treatment of the impact of corporate limited liability which has prompted arguments such as the need for veil piercing discussed below in 2.1.3. The thesis concentrates on developing a normative model for understanding priority in bankruptcy. Whilst therefore not delving further into the complexities of corporate personality, the model may at least form the basis for identifying the limits to which the distributive scheme can logically be applied. Beyond this, responses might demand application of more directly interventionist instruments of public policy. What matters more than the complications caused by strategic use of corporate personality, discussed in the next section, are the normative positions of debtor and creditor, as applied to both tort and contract. On the debtor’s side, the critical question concerns the debtor’s power to pay his debts as they fall due. This notion underlies the concept of the ‘virtuous debtor’, discussed in chapter 4. On the creditor’s side, an important consideration is the extent to which the creditor could have protected his own position, for example by taking security or other precautions.

2.1.2 The Jackson QC Report of the Special Inquiry into the Medical and Research and Compensation Foundation (the Report); James Hardie Industries; tort claimants and bankruptcy policy – the need for a wider perspective in resolving complexity

The Jackson Report of the Special Inquiry into the Medical and Research and Compensation Foundation (the Report, September 2004) is used to introduce the topic of insolvency and mass tort liability. An examination of the conduct of James Hardies Industries discussed in the Report, and in particular the commentary in Chapter 30 ‘The Future’, provides a context for examining what has been argued, are inadequacies of the Australian bankruptcy schemes of distribution and the abuse of limited liability. The Report is extensive and far reaching, amounting to more than 550 pages of text. The recommendations of the Special Inquiry were the subject of a Corporations and Markets Advisory Committee (CAMAC) ministerial referral “Proposal for the treatment of future unascertained personal injury claimants”\(^\text{131}\), whose report was released in May 2008.\(^\text{132}\)


For the purpose of this thesis, the following brief description is drawn from the Report’s principal conclusions on the second of the Inquiry’s Terms of Reference. The Reference is as follows:

“The circumstances in which MRCF [Medical Research and Compensation Foundation] was separated from the James Hardie Group and whether this may have resulted in or contributed to a possible insufficiency of assets to meet its future asbestos-related liabilities.”

This potential for a deficiency of assets to meet the claims of potential plaintiffs raises ethical concerns as to the validity of strategic corporate restructuring, as well as highlighting uncertainty as to the manner in which corporate insolvency rules will be applied to deal fairly with such an eventuality. The MRCF had been established to control two former companies of the James Hardies Group, Amaca Pty Ltd and Amaba Pty Ltd, which had previously been manufacturers of asbestos-based products. These companies have acquired, and will continue to acquire, legal liabilities to identified and as yet unidentified victims of Hardie’s asbestos products. In his conclusions Jackson states the motive for the reorganisation, an essential part of which was also the relocation of the Group’s control to the Netherlands.133

“The principal purpose of separation was to enable the Group thereafter to obtain capital or loan funding or to use its own share capital for future acquisitions without the stigma of possible future asbestos liabilities.”134

Another conclusion was that the Foundation’s funds would “be exhausted in the first half of 2007 and it had no prospect of meeting the liabilities of Amaca and Amaba in either the medium or long term.” Without some form of intervention these companies would become insolvent. Clearly to allow these companies to reach this point would result in a significant injustice to future claimants. The ‘nub’ of the problem here was:

“The negligence of the James Hardies companies occurred in the past, but the liabilities flowing from that negligence only arise day to day, now and in the future, as the diseases are acquired or manifest themselves.”135

Jackson remarks that “the causes of action now arising are by reason of negligent conduct which took place during the period when profits were being made from asbestos”136 - it is thus possible to conjecture that a basis might be identified which enables such ‘causes of action’ to survive the effect of the reorganisation. The

133 JHI NV
134 1.6 p 8.
135 1.25 p 13.
136 30.14 p 555.
incomplete nature of the causes of action themselves constitute to a large degree the basis for Jackson’s conclusion that “none of the external administration mechanisms under the [Corporations] Act recognises the position of persons in the category of unascertained - - - future claimants.”

Jackson acknowledges that the attempt to operate in the future “without the stigma of future asbestos liability” is not of itself objectionable. What, however, is regarded as objectionable are the actions and pattern of behaviour by which the under-funding of the Foundation was allowed to arise and systematically denied. Specifically, Jackson drew upon the following comments of Hardie’s own legal counsel based upon United States experience:

“- - - any attempt at reorganisation that does not leave sufficient assets for asbestos claims will, at a minimum, spawn lengthy and costly litigation at the plaintiff’s bar, and may ultimately be unsuccessful.”

Jackson’s concluding remarks about the consequences of the reorganisation clearly point to the need for identification of alternative approaches:

“- - - any ultimate recovery would depend on the claims to the intra-group payments and asset transfers, - - - together with any additional remedy that might be obtained in respect to the events related to separation.”

These comments, along with the subsequent discussion of possible law reform concerning the corporate veil, serve as the practical background to the theoretical model developed later in the thesis. Under the heading ‘Reform of the Law Concerning the Corporate Veil’, Jackson makes the following comment:

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137 30.3 p 551.
138 See 1.14 p 10.
139 See variously 1.23, 1.25 and 1.26 pp 12 – 13. The dual features of under-funding and systematic denial were ultimately played out in a series of cases commencing with Australian Securities and Investments Commission v Macdonald and Others (No 11) [2009] NSWSC 287, (2009) 256 ALR 199 and finally concluding in the High Court with ASIC v Hellicar [2012] HCA 17 which was decided concurrently with ASIC appeals in relation to a further seven former directors and officers of James Hardie Industries. The course of the litigation is extensively drawn out and complex, a substantial element of the High Court decision dealing with matters around “the duty of fairness” involved in the manner in which ASIC had conducted the litigation. Although a number of matters concerning relief from liability and disqualification were remitted to the NSW Court of Appeal, the essential elements of the decision of Justice Gzell in the NSW Supreme Court were restored. Much of the litigation centred on an announcement to the Australian Stock Exchange and accompanying media release concerning the funding sufficiency of MRCF. Amongst the numerous matters decided by Gzell J, was the fact that the “ASX announcement was false and misleading - - - JHIL [had therefore] engaged in conduct that was misleading and deceptive, or likely to mislead or deceive, contrary to section 995(2) of the Corporations Act.” ((2009) 256 ALR 199 at 388)
140 1.23 p 13.
141 30.8 p 553.
“(T)he circumstances that have been considered by this Inquiry suggest there are significant deficiencies in Australian corporate law. In particular, it has been made clear that current laws do not make adequate provisions for commercial insolvency where there are substantial long-tail liabilities. In addition, circumstances have raised in a pointed way the question whether existing laws concerning the operation of limited liability or the “corporate veil” within corporate groups adequately reflect contemporary public expectations and standards.”142

Continuing this theme of legal principle lagging behind public expectations, Edwina Dunn in her comment on the Jackson Inquiry Report noted that:

“While there were economic arguments in favour of the separate entity principle and the related doctrine of limited liability, public sentiment suggests that allowing further exceptions to be made to the principle of limited liability in corporate groups may be timely and appropriate.”143

The challenge for public policy is to determine the limits of the concept of corporate personality while avoiding any vagueness in setting these limits.

Proponents of an expansion of the legal principle of corporate veil piercing would probably not gain comfort from recent English judicial considerations in Prest v Petrodel Resources Ltd.144 Lord Neuberger identified two specific circumstances for corporate veil piercing absent specific statutory authority; “namely those [cases] concerned with concealment and those concerned with evasion”145, in so doing endorsing146 Lord Sumption's more detailed analysis of the case law addressing the meaning and scope of the principle. Firstly, the rule itself:

“ - - - when we speak of piercing the corporate veil, we are - - - speaking - - - only of those cases which are true exceptions to the rule in Salomon v A

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142 30.67 pp 571 – 572.
143 “James Hardie: No Soul to be Damned and No Body to be Kicked” (2005) 27 Sydney Law Review 339 at 344. The complete phrase used in the title of this paper is “Did you ever expect a corporation to have a conscience, when it has no soul to be damned, and no body to be kicked?” and is attributed to Edward, First Baron Thurlow 1731 – 1806. The phrase is used also in the title of John C. Coffee’s paper “No soul to damn: no body to kick: An unscandalized inquiry into the problems of corporate punishment” (1981) 79 Michigan Law Review 386.
144 [2013] UKSC 34. The case concerns the seeking of ancillary relief by the appellant, Yasmin Prest, in relation to property settlement pursuant to her divorce from Michael Prest. The legal question pertains specifically to whether the court has power to order the transfer of particular residential properties (none of which were the matrimonial home) to Yasmin Prest given that they belong not to Michael Prest but to his companies within the Petrodel Resources Group.
145 Ibid at [60].
146 Ibid at [81].
Salomon and Co Ltd [1897] AC 22, i.e. where a person who owns and controls a company is said in certain circumstances to be identified with it in law by virtue of that ownership and control.”

Set then in its modern context of a targeted and narrow application, the principle applies:

“- - - when a person is under an existing legal obligation or liability or subject to an existing legal restriction which he deliberately evades or whose enforcement he deliberately frustrates by interposing a company under his control.”

The restricted nature of the principle’s application is emphasised in the following short passage from Lord Sumption’s summation of the modern context:

“The principle is - - - limited - - - because in almost every case where the test is satisfied, the facts will - - - disclose a legal relationship between the company and its controllers which will make it unnecessary to pierce the corporate veil.”

Concluding thus that:

“- - - the principle has been recognised far more often than it has been applied.”

Applied to the challenge of finding a satisfactory treatment of mass tort claimants in the corporate insolvency context, it is reasonable to suggest, though without analysing further, that the solution may be found in recognition of joint tortfeasors, though more likely, by way of statutory development. Lord Sumption’s specific remarks concerning existing legal obligations and deliberate evasion go to the heart of what can be inferred, at least by a court, as to an incorporator’s deliberate intentions in adopting a particular group structure or corporate re-organisation.

The process of ‘proving’ debts described by Warren, which facilitates recognition of future debts and contingent claims within the bankruptcy process, suggests that there already exist adequate and workable principles governing bankruptcy, tort law and the specific treatment of a corporate debtor’s involuntary creditors. Professor Roe introduces his paper “Bankruptcy and Mass Tort” with a similar assumption of the general adequacy of tort law. Significantly, however, he concludes that:

147 Ibid at [35].
148 Ibid.
149 Ibid.
150 Potentially directors and group company members.
“- - - under circumstances of massive enterprise liability after multiple trials and settlements - - - financial clarity and simplicity is quickly obliterated. Questions arise that the tort system does not explicitly answer”. 152

Neither corporate law nor insolvency law have provided adequate solutions to ‘long tail’ claims. Such shortcomings are critical where the extent of the liability threatens to exceed the net worth of the debtor. While bankruptcy law recognises the possibility of contingent claims it is ineffective in cases where the damage, and thus the cause of action, has not yet been manifested. Jackson153 discusses the problem by reference to Young CJ in Eq’s remarks in Edwards v Attorney General (NSW):

“Accordingly, the choice between continuing to pay claims at present and going into liquidation will not advantage the future claimants one whit. Moreover, going into liquidation would preclude any possibility of further funds being injected into the pool to meet future claims.”154

In examining the complexity of these issues the “legal system faces as yet unresolved problems of managing vague but possibly enormous future liabilities.”155 Additionally, Hansmann and Kraakman identify strong empirical evidence which shows that increasing exposure to tort liability has led to the widespread reorganisation of business firms so as to exploit limited liability in order to avoid exposure to damage claims.156 Against the background of legal uncertainty and manipulation of corporate entities, there are specific issues which have to be addressed.

First, there is an urgent need to develop novel mechanisms within bankruptcy processes in order to deal with this complexity. These must including exploring alternatives to legal liability. The type of law reform suggested here can be found in the implementation in 2007 of pooling of group assets in external administration157 and recommendations that account be taken of ‘unascertained future claimants’ in both share capital reductions158 and in the structuring, or conduct, of deeds of company arrangement arising out of voluntary administration.159

152 Ibid.
153 The Report 30.5 p 552.
159 Ibid at pp. 61-68.
Secondly, returning to the primary purpose of the thesis, the arguments to vary the current distributive scheme’s equal ranking of involuntary tort claimants with unsecured contract creditors need to be considered - either generally or in specific instances.

Any solution to these questions must take account of the incidence of ‘mass tort’ liability and the likelihood of abuse of limited liability. Proposals of a comprehensive solution to these questions is beyond the scope of this thesis. A more measured approach is argued for in the following section, in which the thesis focuses on the fundamental aspects of creditor entitlement recognition without reference to the distortions and complexity created by limited liability within corporate groups. That is the second issue identified above. Reforms of the doctrine or corporate personality, and its exceptions, may well be rendered unnecessary if the place of tort victims in the pari passu scheme of distribution is reconsidered.

Certainly, however, much of the academic focus has been on the corporate legal personality aspects of the problem, as will be shown in 2.1.3 below. There the evident absence of settled principle is emphasised. To reconcile these arguments is not an objective of this thesis. The contrasts in academic opinion are presented rather to establish context and, in particular, to support the need for a more principled approach to bankruptcy distribution. The structure of such an approach is suggested in the immediately following section which briefly considers some of the academic comment on the Jackson Special Inquiry itself, along with some of the public policy analysis\textsuperscript{160} and reform generated.\textsuperscript{161} But it is only after the rational treatment of consensual and non-consensual claims in bankruptcy has been established that any remaining problems created by corporate structures become amenable to reform.

\textsuperscript{160} Corporations and Markets Advisory Committee, Parliament of Australia \textit{Long-tail Liabilities in the Treatment of Unascertained Future Personal Injury Claims} Discussion Paper (June 2007). More generally, the circumstances of James Hardie Industries were a stimulus leading to two inquiries into corporate social responsibility (Parliamentary Joint Committee on Corporations and Financial Services June 2006 and Corporations and Markets Advisory Committee December 2006).

\textsuperscript{161} Corporations Act 2001 – Pt 5.6 - Winding Up Generally – Div 8 – Pooling. The pooling provisions were introduced as part of Corporations Amendments (Insolvency) Act 2007 (Cth) which gave effect to recommendations contained in Parliamentary Joint Committee on Corporations and Financial Services Report \textit{Corporate Insolvency Laws: A Stocktake (2006-07)}. Pooling was also a theme in the Companies & Securities Advisory Committee \textit{Corporate Groups Final Report} (May 2000) Chapter 6 Liquidation of Group Companies.
2.1.2.1 A brief review of the academic literature on the Jackson Special Inquiry

The dilemma for mass tort claimants, and the related implications for any eventual policy response, goes to the heart of one of the landmark decisions of English company law development. The legacy of this case permeates common law-based company law. The case is of course *Salomon v Salomon & Co. Ltd.* \(^{162}\) which “is more than just a decisive turning point in corporate legal evolution, [additionally] their Lordship’s decision - - - treated as the source of the “separate entity” doctrine of company law."\(^{163}\) Thus, as Helen Anderson observes:

“In accordance with the principles laid down in *Salomon v Salomon & Co Ltd*, an act committed in the name of the company is regarded as its own act by virtue of the company’s separate personality as a distinct legal entity.”\(^{164}\)

The translation of this principle into the basis of external relationships, specifically those of unsecured creditors in the context of insolvency, is well captured in the following remarks of Rogers AJA in *Briggs v James Hardie & Co Pty Ltd* \(^{165}\):

“Generally speaking, a person suffering an injury as a result of the tortious act of a corporation has no choice in the selection of the tortfeasor. The victim of the negligent act has no choice as to the corporation which will do him harm. In contrast, a contracting party may readily choose not to enter into a contract with a subsidiary of a wealthy parent.”\(^{166}\)

Anderson observes that:

“The conclusion will be drawn that the case law [dealing with directors’ duties in tort] is not based on a sound theoretical foundation, because of unresolved conflicts between principles of company law and tort law.”\(^{167}\)

Continuing this idea of an absence of settled principle, Anderson further observed in 2011\(^ {168}\), in relation to the law reform and reviews undertaken in relation to the Jackson Special Inquiry, that these were “inadequate for the proper protection of tort

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162 [1897] AC 22.
165 (1989) 7 ACLC 841.
166 Ibid at 863.
creditors of insolvent subsidiaries.” One of the criticisms made by Anderson is that the more recent and major CAMAC report dealt too narrowly with long-tail liability rather than with what she regards as the “more significant issue of the protection of tort creditors of insolvent group companies.” Underlying the latter, broader issue, I suggest that there are two related elements; first, the nature of bankruptcy distribution and how as a matter of principle it deals with non-consensual as opposed to consensual claimants; and secondly, the effect of overlaying these relationships with the separate legal personality of corporate debtors. The current absence of settled principle as to the first precludes achieving clarity and certainty as to the second. Hence, the objective of this thesis is foremost to establish a theoretical justification for the principle of collectivism and the basis for relaxing the principle in dealing with particular classes of creditor. For this reason, except for the following passages dealing with corporate legal personality, no further technical analysis is applied to veil piercing in the context of corporate tortfeasors. Reference to veil piercing is however made when considering public policy options ancillary to understanding the limits of possible reform of non-consensual claimant recognition within the ordering of priorities.

2.1.3 Mass tort liability and corporate legal personality

2.1.3.1 Economic explanations of the inter-creditor standing of tort entitlements
In this section I consider economic arguments, similar to Jackson’s “creditors’ bargain” theory, which are presented as a normative justification for recognising limited liability as a restriction on full recovery of tort claims. These arguments, which adopt a risk-bearing perspective, are contrasted to other perspectives which emphasise the complexity of predicting and adjusting to ‘bad incentives’ and the associated need for development of a deeper principle-based explanation of distribution.

A full investigation of the contrasting contractarian (nexus of contracts) and state concession theories of limited liability is not within the scope of this thesis. A ‘state privilege’ perspective may arguably be the most convincing method of justifying the

169 Ibid at p 547.
170 Ibid at p 552.
piercing of the veil – the state in granting the concession of limited liability is justified in controlling the privileges enjoyed within the concession. Similarly, the associated organic theory of the company\textsuperscript{173}, with its notion of separate legal persona, might offer a useful way of examining the more specific Australian aspects of joint tortfeasorship and piercing within corporate groups.

2.1.3.2 Tort and the corporate veil
The issues of veil piercing and tort claimant priority are interrelated. While, at least in the United States, “courts are more willing to disregard the corporate veil in tort than in contract cases,”\textsuperscript{174} there is compelling reason in Australia to likewise regard the claims of tort creditors as being distinct from, and superior to, those of contract and other private law creditors. Aside from subjective notions of justice, there is, as Easterbrook and Fischel note, a sound economic basis for such protection in terms of ‘moral hazard’. Contract creditors retain a capacity to adjust \textit{ex ante} for corporate default risk which, in turn, encourages a degree of measured risk aversion on the part of the debtor in relation to this group of creditors. In contrast, the very nature of involuntary tort creditors is that they are non-adjusting:

“- - - unable to assess the risk of default accurately and thus the probability that the firm will engage in excessively risky activities is increased”.\textsuperscript{175}

Priority in bankruptcy should, on this view, be determined by the ability to adjust for risk, not by the legal classification of the claim.

Some Law and economics writers are less convinced that tort creditors are disadvantaged compared to other creditors. Professor Ribstein\textsuperscript{176} has argued that the risks attaching to contract and involuntary creditors are not readily distinguishable. The compulsion to monitor activities\textsuperscript{177} ensuing from the ‘contractual’ nature of limited liability enables risks, broadly defined, to be internalised within acceptable bounds of efficiency and utility. The alternative stance, which is supported by the model developed in this thesis, is encapsulated in the following observations of Robert Austin made with reference to Rogers AJA’s analysis in \textit{Briggs v James Hardie & Co. Pty Ltd}:

\textsuperscript{174} F. Easterbrook and D. Fischel, “Limited Liability and the Corporation” (1985) 52 University of Chicago Law Review 89 at p 112.
\textsuperscript{175} Ibid.
\textsuperscript{177} Ibid at p 127.
“The difficulty for tort claimants is that they cannot bargain through any contractual process to share the externalities of the enterprise risk with shareholders of the entity against which they claim.”

Whilst Austin’s observations are expressed in predominantly economic terms, the theory developed in the thesis seeks a deeper justification for the differential treatment of consensual and non-consensual claimants based on the ethical underpinnings of private law obligations.

Law and economics writers also emphasise the wider gains of limited liability outweighing the cost of elevating the position of tort creditors. They suggest that as part of a wider ‘societal choice’ the rule which should be adopted is one which would see the whole community better off - though the consequence of applying such a rule will be that some creditors will suffer an uncompensated detriment. Professor Ribstein justifies the argument in terms of a Kaldor-Hicks concept of efficiency. This compensation principle of welfare economics establishes that if a change in policy would result in some persons being better off and others worse off, compensation between gainer and loser must ensure that society is better off. The challenge, of course, in a contentious area such as mass tort liability is to translate this abstract explanation of policy preferences into satisfactory and justifiable applied outcomes. An alternative Pareto optimality, which assesses alternatives from the perspective of ‘welfare gains’ whereby one individual might be better off without making another worse off, arguably constitutes a more rigorous test of this proposition. In subsequent chapters of this thesis, a philosophical approach is adopted which, whilst not wholly rejecting economic explanations of major bodies of legal rules, may offer a clearer justification of the principles of bankruptcy law.

179 Market efficiency, separation of management and control, and risk diversification – to which there might be added the associated gains of corporate perpetual existence and the free transferability of securities.
181 Ibid at fn. 212
183 At some risk of over-simplification, welfare economics is concerned with the study of the well-being of members of a society as a group rather than adopting a perspective on individual consumer behaviour or behaviour of the firm. It thus addresses economic activity and the generating of wealth from the perspective of the objectives of society as a whole.
A similar stance in relation to limited liability is adopted by Professors Meiners, Mofsky and Tollison who, under the heading ‘Limited Liability and Involuntary Creditors’, highlight a degree of inconsistency in the judicial treatment in the United States of closely-held corporations and tort liability. These academics note that the \textit{ex ante} assessment of risk dictates that there will periodically occur mismatches with \textit{ex post facto} outcomes. The contingent nature of these outcomes are such that competitive choices are made around insurance and capital adequacy. In these terms, they argue, the notion of limited liability should apply to tort liability as a consequence of wider society choice as to where risk will be borne.

Elsewhere in this section an assessment of the contrasting legal treatment of publicly-traded and closely-held corporations will be provided. What the economic analyses outlined above do not purport to do, however, is to address the practicalities and merits of conflicting inter-creditor claims that arise upon bankruptcy. Nor do they adequately address the presence of a ‘bad incentive’ caused by the nature of limited liability in the more specific circumstances of mass tort claims. These conditions are ones of uncertain identification of claimants and extended duration of liability. These matters are discussed, initially in the context of primarily United States-based academic comment.

\textbf{2.1.3.3 The complexity of mass tort claims}

Incentive arguments are considered by Professor Roe who stresses that dissipation and diversion of assets will occur where future claims are scattered amongst unknown tort victims. The overlaying of corporate limited liability compounds the potential for adverse and unjust outcomes.

Limited liability may “create incentives for excessive risk-taking by permitting corporations to avoid the full cost of their activities.” The exercise of this ‘freedom’ is by no means unfettered. At a relatively general level, while corporate law through the granting of limited liability facilitates valid commercially based risk-taking behaviour, it is “with a reservoir of suspicion and a threat of constraint.” More specifically, corporate shareholders have a strong incentive and retain a capacity, in

\footnotesize{\textsuperscript{184} “Piercing the Veil of Limited Liability” (1979) 4 \textit{Delaware Journal of Corporate Law} 351 at pp 364-367.}
\footnotesize{\textsuperscript{186} H. Hansmann and R. Kraakman, “Towards Unlimited Shareholder Liability for Corporate Torts” (1991) 100 \textit{Yale Law Journal} 1879.}
many instances reinforced by statute,\textsuperscript{188} to restrain management from engaging in highly opportunistic behaviour, including strategies initiated to deprive the company of its assets. Nonetheless, as Austin observes “shareholders - - - have all the upside of the externalities of business risk which arises through limited liability - - - and are able to make an uncompensated transfer of business risk to the tort claimants.”\textsuperscript{189} Contrastingly, some, although by no means all, contract creditors are in a relatively strong position to assess the creditworthiness of a corporation, by comparison with tort victims, and are, by virtue of the contractual relationship, often by agreement able to monitor and restrain debtor behaviour directed at diverting assets.\textsuperscript{190} Again, problems of subjectivity in identifying incentives to monitor behaviour are less relevant to the non-economic natural law approach adopted in this thesis.

The related incentive for companies is the avoidance of exposure of assets to emerging tort claims through the avenue of ownership structuring. This may possibly “involve[s] a large number of subsidiaries and perhaps also a partitioning of functions among them, as the firm tries to segregate its riskiest activities into separate corporations.”\textsuperscript{191} The corollary of this is the holding of valuable assets within separate subsidiaries, kept beyond the reach of future tort claimants.

Before addressing mass tort in the context of the more immediate insolvency issues of priority and distribution, it is appropriate to examine briefly the rationale for allowing the interests of creditors as a justification for piercing the corporate veil. The approach here may serve as a useful basis for identifying the relative merits of tort claims within inter-creditor competition. Referring again to Easterbook and Fischel’s discussion of corporate veil piercing, the authors observe that courts have tended to allow creditors to “reach the assets of shareholders where limited liability - - - [has created] - - - a high probability that a firm will engage in a socially excessive level of

\textsuperscript{188} Corporations Act 2001 Part 2.F1 Oppressive conduct of affairs and Part 2F.1A Proceedings on behalf of the company by members or others. Whilst they are relatively powerful provisions, it is unclear whether they have been used in response to the very specific type of director conduct considered in this thesis.


\textsuperscript{190} This obviously depends on strength of bargaining power. In some cases where contract creditors are unable to assess risk equity may impose fiduciary obligations of disclosure on the debtor: Robert Cooter & Bradley J Freedman, “The Fiduciary Relationship: Its Economic Character and Legal Consequences” (1991) 66 New York University Law Review 1045

risk taking.” As we have seen, the liability of a debtor to a negligence claimant may arise from the excessive risk taking of the former. Against this, the claimant is usually unable to adjust either by monitoring or by achieving a degree of price protection, the latter of which depends on the practical possibility of insurance against risk. Furthermore, there is also the likelihood in extreme circumstances that the creditor’s entitlement might be adversely affected by the precise legal structure of limited liability adopted by the corporate debtor.

There is therefore at least a tentative basis for arguing that in such circumstances negligence claimants should receive preferential treatment. A justification for such an outcome might be found in terms of the nature of the right, and the consequent need for preservation in the context of a bankruptcy distribution. Additionally, an economic justification may be found in negating the abuse of limited liability which in some instances gives rise to incentives for excessive risk taking. How this could be achieved is nonetheless highly problematic, posing complex questions about the interaction of insolvency with corporate law. Moreover, bankruptcy law does not have the capacity to deal with the complexity of mass tort liability. The incapacity is both institutional and legal. The first is that claims have to be brought within the distributive scheme of statutory bankruptcy procedures. The second relates to the ranking of claims within bankruptcy, and is the primary focus of this thesis. These limitations mean that alternative methods of resolving these claims equitably will need to be developed.

2.1.3.4 Distributive alternatives – Two American models for solving the problems of mass tort liability

While the two proposals discussed here are presented in the context of United States bankruptcy law, they are nonetheless useful in assisting in formulating an appropriate model for Australian law. More broadly the two frameworks – unlimited liability for corporate torts and the institutional facilitation of corporate reorganisation – are examples of attempts to redress the type of indeterminacy in bankruptcy caused by mass tort liability. They attempt to resolve, first, conflicts between company law and tort law and, secondly, conflicts between rights in tort and other private law claims.

Hansmann and Kraakman insist that “limited liability should be retained as the background rule for contract creditors”. A critical question is how to distinguish claims arising in tort from contract claims, noting that contractual relationships can give rise to tort claims, for instance in cases of product liability. More problematic, though, is to determine a basis of priority that is not only just, but also demonstrates the necessary characteristic of predictability. In discussing priorities in bankruptcy Hansmann and Kraakman present a radical proposal. Consistent with their theme of unlimited liability for corporate torts, they propose a rule which would give priority to unsecured contract creditors whilst granting tort creditors the capacity “to proceed against shareholders when the firm's remaining assets [are] insufficient to satisfy their claims.” The rationale, and possible shortcomings, of this distributive framework are best understood from the authors’ perspective on the nature of the incentive to abuse limited liability, as between closely held and publicly traded corporations.

In arguing for unlimited liability for corporate torts, Hansmann and Kraakman start from a base scenario of a single shareholder company undertaking an investment the risk of which potentially creates tort liability exceeding both the overall corporate value and the shareholder’s personal assets. The nature of limited liability, which facilitates the externalisation of costs, is then regarded as intervening to create perverse incentives “to spend too little on precautions to avoid accidents” whilst at the same time encouraging “overinvestment in hazardous industries.” The expectation around the hypothetical single shareholder is that the wider community will bear such costs. The risks of adverse outcomes are further compounded, in the authors’ view, by a tendency in the main for undercapitalisation so as to reduce risk of exposure of the owner’s assets to tort damages. The fact that in publicly-trading corporations managers are ‘substituted’ for shareholders as the party subject to an incentive to assume too much risk, does not of itself justify the notion of unlimited liability. Hansmann and Kraakman, however, see as compelling the scale and reach of the modern company, and the capacity therefore to cause widespread harm. These factors warrant the relinquishing of long held assumptions as to the sanctity of limited liability. Commonality of treatment is also suggested as warranted in order to

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194 Ibid at p 1902.
195 Ibid at p 1882.
196 Ibid at p 1883.
counter the incentive that would be created to shift investment from closely-held to publicly-traded enterprises.

In contrast, Professor Roe proposes the facilitating of corporate reorganisation as a strategy for resolving problems of mass tort liability. Briefly, the rationale is based on an understanding that:

“- - - to refrain from an early reorganisation could seriously and deleteriously affect the firm’s operations, lowering the firm’s value and thus impairing the value of future claims”.197

As Roe further indicates, existing bankruptcy policy needs to be examined in order to determine how best to accommodate future tort claims and whether the circumstances “dictate a special distributional result.”198 The aspect of future claims presents its own complexities – present pro rata ranking with unsecured creditors is clearly inadequate in dealing with the uncertainty surrounding both valuation and identification in the circumstances of ‘long-tail’ mass tort liability. This level of contingency thus “makes any effort at current compensation of future claimants [seem] unwieldy, perhaps impossible”199 – hence, the rationale for an early corporate reorganisation. Of more significance is the recognition that the notion of ‘debtor rehabilitation’ which underlies a mass tort-induced reorganisation, does not of itself suggest a preferred distributive outcome. Reorganisation and insolvent company rehabilitation, whilst being essential practical responses, do not of themselves address the problems of competition between consensual and non-consensual creditors. In these terms, the limitation of the bankruptcy norm fundamental to Jackson’s theory is most apparent, namely that of respect for pre-bankruptcy bargaining. Roe’s most significant remarks in this context are that:

“Presumptions in favour of honouring the bargain or providing equality of distribution, however, are not necessarily conclusive.”

and

“- - - respect for the bargain is misplaced when the reorganisation turns on what to do with involuntary, non-bargain creditors such as present and future tort claimants”.200

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198 Ibid at p 851.
199 Ibid.
200 Ibid at p 854.
Without promoting any particular distributive framework, Roe nonetheless places significant weight on the supervisory capabilities of the courts to balance the ongoing tort claims against the decision to allow the discharging of the firm’s liability from insolvency. Guidance, Roe suggests, might be drawn from:

“- - - fairness and risk-allocation values derived from tort law, and second, though more equivocally, on the sense of fairness-as-equality that in part underlies bankruptcy’s equal treatment of most creditors.”

A further significant contribution to the debate concerning the interaction of tort, limited liability, and bankruptcy is provided by David Leebron. Leebron, whilst sympathetic to the analysis and insights provided by Hansmann and Kraakman, offers a less radical and more measured approach falling short of the wholesale abandonment of limited liability in circumstances of tort. He urges a more context-specific approach in which attributes of “diversification opportunities, risk bearing, and transaction costs” are brought to the fore as elements in disentangling structural and legal features which lead to the externalisation of tort risk. A critical objective in Leebron’s analysis is to separate arguments against joint liability from those against limited liability enabling a more focused approach to the perverse incentives that might be at play in management’s actions. He concludes identifying thus that “where individual shareholders use multiple corporations for purposes other than investment diversification, particularly where the corporations are in related lines of business, all the assets of such related corporations should be available to satisfy the claims of tort victims” – a significant foreshadowing of the dilemma played out in Australia around the circumstances of the James Hardie Industries’ restructure.

201 Australian policy-makers have rejected US Chapter 11 ‘debtor in possession’ type arrangements which can entail significant specialist court supervisory roles. See for example Corporations and Markets Advisory Committee (CAMAC) October 2004 Report “Rehabilitating large and complex enterprises in financial difficulties“ page 5 of conclusions: “The Advisory Committee finds no compelling need, or intrinsic shortcoming in the VA [Voluntary Administration] procedure, which requires or justifies adopting Chapter 11 as an additional or substitute corporate recovery procedure for large and complex, or other, enterprises.”


204 Ibid at p 1568.

205 Ibid at p 1650.
2.1.4 An evaluation of these approaches
Assumptions about the pervasiveness of limited liability in public companies remain deeply entrenched, and it would seem likely that concerns about investor confidence would preclude adoption of the radical proposals favoured by Professors Hansmann and Kraakman. From a policy perspective that seeks to integrate tort law effectively with bankruptcy procedures, the associated priority framework they describe would also be difficult to sustain for public companies. As for private companies, the notion of allowing tort claimants to proceed against shareholders would not survive the various tests such as proximity and vulnerability which have evolved to control the scope of reasonable foreseeability in the tort of negligence. This objection assumes that the legislature would be unwilling to overturn decades of case law on the duty of care decided since *Donoghue v Stevenson*. However, at least in the circumstances of mass tort liability caused by a public corporation in financial difficulties, the type of discretionary approach identified by Professor Roe might be more practicable.

Such an approach must, if it is to be of predictive value, involve a hierarchical ordering of legal rules of which bankruptcy is a part. From this ordering, principles could be developed for the rational prioritising of claims. The imperative for such principles is neatly encapsulated by Hansmann and Kraakman’s comment that:

“- - - for involuntary creditors, tort law rather than contract law must determine the appropriate allocation of costs among actors, and limited liability prevents tort law from fulfilling this function.”

These ideas of determining the priority which should be given to particular interests, is also alluded to in the Jackson QC Report, with reference to the 2000 CASAC Report on Corporate Groups where it was stated:

“The existing principles of tort liability should not be changed for corporate groups. The imposition of additional tort liability on parent companies of corporate groups should be left to specific statutes and general common law principles.”

206 See for example *Woolcock Street Investments Pty Ltd v CDG Pty Ltd* [2004] HCA 16: “Proximity is not now accepted as a sole criterion for explaining when a duty of care exists at law, any more than other attempted short verbal formulae can do that job.” per Kirby J at para. 148.
207 See for example *Perre v Apand Pty Ltd* (1991) 198 CLR 180 at 220-228 per HcHugh J.
209 Ibid at p 1920.
210 30.70 at p 572.
In terms of the scope and objectives of the thesis, these remarks raise the issue as to how statute should remove defects caused by the operation of established legal principles. The CASAC 2000 report goes on to say, with reference to the introduction of a general tort liability for parent companies in corporate groups, that this “should be dealt with by specific legislation where the extension of liability beyond the tortfeasor company is desirable in the public interest.” It is argued in this thesis that, first and foremost, it is necessary to determine the criteria of desirability. The source of such criteria can only be found in the ethical foundations of private law liability viewed in the contexts of corrective and distributive justice.

In arguing for this type of development, I make no direct assessment of the merits of the legal concepts, such as remoteness of damage, used to determine liability in negligence, as these concepts apply to mass tort liability. Instead, my concern is to explore the underlying moral and ethical nature of the liability itself. My particular concern is how types of obligation sit in relation to each other where, as in bankruptcy, the debtor’s capacity to satisfy his full liability is severely impaired. No coherent model dealing with private law obligations can be developed without identifying the ethical basis upon which it depends. This is the vital assumption on which this thesis rests.

2.2 Proprietary interests and remedies

This part considers the objections to enforcing proprietary remedies in bankruptcy, as well as examining some responses to these objections. Clearly the consequences of recognising a proprietary interest impacts upon the notion of the creditors’ bargain described in Chapter 1, enabling the successful claimant of such an interest to stand outside the collective procedure. Particularly germane to any analysis of the statutory and general law rules for recognising and making distributions in relation to creditor entitlements, is the propensity for “equity to convert personal obligations into proprietary remedies.” In contrast, the proliferation of personal remedies, though

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212 Ibid. CAMAC rejected such an approach stating in its report that “this liability would undermine the separate entity principle and could have negative consequences for the economy”. This is a view illustrative of a still strong degree of adherence to the Salomon principle amongst key influencers of public policy development. It is also one which sits in contrast to some of the more reform minded academic views mentioned in this thesis (see Edwina Dunn; fn reference 143).

213 Ibid.

dramatic, merely reduces the proportionate share of equally ranking unsecured creditors unless of course, as proposed above, a sound basis for granting priority to tort and other non-consensual claimants of a particular character can be identified.

The treatment of proprietary interests and remedies, and their recognition in the context of a defendant debtor’s insolvency, is an area of uncertain and unsettled principle. The following observation of Richard Calnan made in the context of the law’s treatment of proprietary claims for mistaken payments is typical of the pessimistic conclusions expressed by modern commentators:

“In spite of a great deal of academic writing on the subject, there is little case law; and that which there is is contradictory.”

He goes on remark that:

“English law has not always clearly distinguished between the law of property and the law of obligations”.

These uncertainties inevitably affect the prioritising of claims in bankruptcy which tends strongly towards collective pari passu treatment of unsecured creditors in “acknowledge[ment] [of] the problems inherent in establishing a pecking order of classes of creditor which meets with general approval.” Professor Jonathan Hill has remarked in this connection:

“Although one can find comprehensive accounts of the law of priorities in the textbooks and there is debate surrounding specific aspects of the system, there appears to have been little attempt to reconsider the foundations of the system.”

This thesis adopts a perspective on the foundations of the law of priorities based on natural law explanations of the law of obligations, the objective being to explore the extent to which bankruptcy’s distributive system could and should accommodate different categories of claimant. The principle should apply to restitutionary claimants who have not “voluntarily put themselves in the position of being unsecured

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215 “Proprietary Claims for Mistaken Payments” in F. Rose (ed), Restitution and Insolvency (2000) Mansfield Press, London at p 168. Three English cases are examined by Richard Calnan, two of which also form the basis of analysis in this part of Chapter 2 of the thesis; Chase Manhattan NA v Israel-British Bank (London) (2.2.2.1) and Westdeutsche Landesbank Girozentrale v Islington London Borough Council (2.2.2.2). A third English Privy Council case Re Goldcorp Exchange Ltd is examined in 2.2.2.3.

216 Ibid at p 169.

217 Ibid.

creditors\textsuperscript{219}, or who assert a proprietary claim over moneys or assets that would otherwise form part of the pool of funds available for distribution to the general body of unsecured creditors.

There is, however, a difference in how restitutionary claims are analysed in a bankruptcy context. Personal claims, for example for the value of a mistaken payment, are additional claim on the debtor’s pool of assets. The principal question these claims raise is whether they are consensual, so that they are analysed and ranked alongside contract claims, or whether they are non-consensual, so that they are treated analogously to negligence claims. Proprietary restitution claims, on the other hand, if successful reduce the pool of assets available to all personal claimants. The policy question here is whether, analogously to a creditor’s mortgage created before bankruptcy supervened, a restitutionary proprietary remedy should be allowed to deplete the debtor’s pool of assets.

It is important to caution against a too ambitious objective, and it is in these terms that Hill’s further remarks are highly pertinent:

\textquotequote{“Though not inconceivable, it is intuitively unlikely that satisfactory solutions to all priority problems can be provided by a single principle.”\textsuperscript{220}}

In the context of this thesis, these words do not so much provide a reason not to have to force all problems into a neat explanation, but rather emphasise the need to accept that there is a boundary beyond which priorities and bankruptcy distribution cannot provide solutions. Some of the issues legitimately belong in the domain of public policy. The thesis’s focus on the threshold between public and private law is presented in order to assist in better identification of these limits to bankruptcy law.

Similar cautionary remarks are made by Professor Craig Rotherham with respect to proprietary remedies and bankruptcy:

\textquotequote{“The most fundamental source of confusion in the law of proprietary remedies results from a disagreement as to whether it is legitimate to try to explain, justify or develop proprietary remedies by reference to policy arguments that focus on the effects such relief have in insolvency.”\textsuperscript{221}}


\textsuperscript{221} “Policy and Proprietary Remedies: Are We All Formalists Now?” (2012) \textit{Current Legal Problems} 65 (1) 529-564 at 529.
This thesis does not seek to resolve this disagreement. Restitutionary remedies are, however, examined in order to illustrate the possible analytical benefit that may arise from a non-instrumental (in other words non-economic) model of bankruptcy distribution.

The following section provides a more detailed account of the tension between collectivism in bankruptcy and the enforcement of restitutionary proprietary rights. This is followed by a longer section looking at some of the case law developments that demonstrate encroachment upon both the rationale and sanctity of strict collectivism. The objective is not to provide a detailed treatise on the judicial reasoning in these cases, but rather to highlight the nature of unresolved developments in the law which create stress within bankruptcy law’s distributive objectives and mechanisms.

2.2.1 Safeguarding the interests of unsecured creditors – problems of predictability and proliferation of claims

The assets available for distribution to creditors upon bankruptcy or liquidation are limited to those beneficially owned by the insolvent debtor. The valid assertion of an equitable proprietary right therefore directly impacts upon the size of the estate available for distribution to creditors. The event of insolvency crystallizes the identification of proprietary rights in others. In many such instances "equity is merely defining rights which are said to pre-exist the insolvency."\textsuperscript{222} Maxton and Rickett make the important point that courts in applying equitable doctrines do not in a strict sense grant priorities ahead of the general body of creditors. They deal rather with the narrower relationship and transactions between the insolvent and the claimant, often "as if other interested parties did not exist or at the most were irrelevant."\textsuperscript{223} Nonetheless, the incentive this presents to individual creditors is to argue for the existence of an equitable relationship that gives rise to a right to a specific asset, rather than for an obligation which can only be satisfied from a pool of assets upon bankruptcy or liquidation.

Courts have shown a reluctance to allow remedial devices, such as the constructive trust, to vary existing, or to create new, property rights with resultant adverse

\textsuperscript{223} Ibid at p 209.
consequences for unsecured creditor priorities. Statements such as those of Gibbs CJ in the High Court judgment in *Daly v Sydney Stock Exchange* are typical and show sensitivity to the nature of the equitable remedy that would flow from such recognition:

“One consequence of recognizing the constructive trust would be that the money, and any property acquired with it, would on the firm’s bankruptcy, be withdrawn from the general body of creditors; another would be that the appellant [Daly] could require the firm [Patrick Partners] to account for any profits made with the use of the money”.

A similar perspective is provided by Professor Rickett:

“As the remedial constructive trust involves the court in varying existing property rights or creating new ones - - - the court’s ability to grant such a remedy, especially in the crucial context of insolvency, must necessarily be limited by the existence of a statutory insolvency regime and the policy objectives inherent in both the adoption and structure of that regime.”

A more recent affirmation of judicial reluctance to give recognition to a constructive trust where other remedial devices might be available is provided in a joint decision of the High Court in *John Alexander’s Clubs Pty Ltd v White City Tennis Club Ltd; Walker Corp Pty Ltd v White City Tennis Club Ltd*. The theme of impact on existing rights is reflected in their Honours’ statement rejecting the relief granted by the New South Wales Court of Appeal:

“ - - - it [the granting of a constructive trust] failed to take into account a crucial factor – the impact of such a trust upon the then existing rights of third parties - - -.”

Likewise the emphasis on pursuing alternative, more targeted remedies is reflected in the view:

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224 (1985) 160 CLR 371
225 (1985) 160 CLR 371 at 379. Those instances where a constructive trust is recognised are couched in similar terms: “A full proprietary remedy is not always necessary or appropriate and is not always automatic. Sometimes the interests of innocent third parties such as creditors mean that the plaintiff will be confined to a personal remedy or the narrower remedial constructive charge.” - - - “A remedial constructive trust is entirely appropriate in the present case in the light of the absence of third parties such as creditors having a legitimate claim on the assets of Coldwick.” per Mason P in *Robins v Incentive Dynamics Pty Ltd* (2003) 21 ACLC 1,030 at 1043.

228 *White City Tennis Club Ltd v John Alexander’s Clubs Pty Ltd* [2009] NSWCA 114.
229 [2010] HCA 19 at [75].
“A constructive trust ought not be imposed if there are other orders capable of doing full justice.”\(^{230}\)

In this part of the reasoning, their Honours raise some concerns about how the case was conducted in the lower courts remarking that:

“The resolution of controversy is something which ought to have taken place in the courts below had the proceedings been properly constituted.”\(^{231}\)

And further:

“- - - it may be that an order of equitable compensation or an account of profits could have been made - - -.”\(^{232}\)

These remarks add weight to the views of Richard Calnan and Professors Jonathan Hill and Craig Rotherham concerning the unsettled nature of the law in the area of proprietary remedies in bankruptcy and the corresponding difficulty in proposing a unified principle.

More generally, debate highlights the state of flux and an absence of settled principle in determining when personal obligations can be converted into proprietary remedies. This thesis considers whether a natural law explanation of bankruptcy can justify, or at least, explain, the priority given to equitable proprietary interests in bankruptcy. If such an explanation can be found, it could be invoked in order to justify some of the most difficult and complex cases in proprietary restitution. The challenge of finding such a theory should not, however, be underestimated. It is worth noting that a justification of proprietary restitution in terms of economic analysis has never been advanced. Any theory of bankruptcy which purports to explain proprietary restitution has to confront several difficulties which are irrelevant to explaining the position of tort claimants in bankruptcy. First, whereas the basic contours of the relevant torts, such as negligence, are well understood, the same cannot be said of the grounds of restitution. It is unsettled, for example, when a constructive trust can be imposed over money paid upon a failure of consideration. Secondly, the borderline between the recognition of existing property interests and the creation of new interests is somewhat blurred, and some might argue non-existent. Is an equitable interest enforced on the basis of the principle “equity considers as done that which ought to be done” a new interest or an interest that in theory subsisted prior to the judicial application of the maxim? It is important in this connection to draw a line between judicial enforcement of existing proprietary interests and the creation of new

\(^{230}\) Ibid at [128].

\(^{231}\) Ibid.

\(^{232}\) Ibid.
interests. The former can be justified in terms of corrective justice, much as the enforcement of consensual interests, or interests created by recognised wrongdoing, such as breach of fiduciary duty, can be justified. The latter requires a court to engage, more or less openly, with distributive justice, since it entails the redistribution by judicial order of existing property rights. For both these reasons it may not be possible to develop any holistic theory of equitable proprietary restitution, although some partial explanation may be possible.

Attention at this point should be drawn briefly to the salient aspects of the various critiques of equity’s supposedly disruptive infiltration into commercial dealings. The objective here is to emphasise differences in judicial and academic approaches to these issues.

According to Maxton and Rickett\textsuperscript{233} the sources of difficulty are multi-faceted. First, the present doctrinal confusion that has arisen between equity’s and restitution’s respective roles in the context of bankruptcy, which is aggravated by the fact that equity and restitution are not distinct categories for organising legal doctrine. Maxton and Rickett suggest that this uncertainty may well continue to persist while the tensions between equity and restitution remain unresolved. Any resolution nevertheless must be found as part of an endeavour to determine how both forms of right are treated in bankruptcy distribution. The practicalities of bankruptcy will necessitate a resolution even if that resolution cannot be theoretically justified.

Additionally, it is worth noting Worthington’s view that “the equitable rules which define and limit these options are still in a state of development.”\textsuperscript{234} It is impossible in a theoretical thesis of this kind to chart all the developments, and the thesis will only highlight a few leading, and in some cases, controversial cases, examined in this chapter, as well as pursuing some of the taxonomical implications of these cases in chapter 4.

There is of course an obvious risk in recognising proprietary entitlements in relation to what are primarily relationships of debtor and creditor. To do so is said to “confound ownership with obligation.”\textsuperscript{235} It is thus proposed in this thesis that a

\textsuperscript{233} Maxton and Rickett, “The Effects of Equitable Doctrines on Priorities in Insolvencies” in Essays on Corporate Restructuring and Insolvency C. Rickett (editor) (Brooker’s Ltd, Wellington NZ, 1996).
\textsuperscript{235} Daly v Sydney Stock Exchange (1985) 160 CLR 371 at 379 per Gibbs CJ, remark repeating the dicta of Lindley L.J. in Lister & Co v Stubbs (1890) 45 Ch D 1.
clearer understanding of the character of private law obligations in the context of the intervention of debtor insolvency, presents an important element in resolving this confusion.

A further source of difficulty is the recognition of personal remedies where they had not previously been recognised which can "increase the number of an insolvent's general creditors"²⁳⁶, some of whom can make far-reaching claims, thus dramatically depleting sums otherwise available to unsecured creditors. For example, the last twenty years have seen a considerable expansion in the circumstances in which equitable compensation can be awarded, as a restitutio as well as a compensatory remedy.²³⁷ It is suggested that restitutio personal remedies do not raise the same considerations as restitutio proprietary remedies, and that in many cases the justification for prioritising some classes of tort claimant will also extend to some classes of personal restitutio claimant.

Returning to a more practical focus, Professor Goode has emphasised the potentially adverse impact on the interests of the broader body of unsecured creditors that will be caused by further expansion of proprietary remedies. In expressing his aversion to the notion of recognition of a proprietary priority in instances of a partial failure of consideration Goode suggests that the insolvency regime would "move rapidly towards a situation in which we have no unsecured creditors at all."²³⁸ In order to avoid this spectre, an informed understanding of the underlying obligations should drive the process of admitting claims. The impact on unsecured creditors as a body, though fundamental, must not lead to bland acceptance that all claims outside of valid secured interests should invariably be treated as alike. Remarks such as those cited above extracted from the High Court in John Alexander's Clubs Pty Ltd, point at least to a willingness on the part of the judiciary to entertain the use of targeted remedial devices such as equitable compensation and the award of an account of profits as a substitute for proprietary relief.

²³⁶ Ibid at p 210.
²³⁷ See for example Commonwealth Bank of Australia and R Dungan v Robert Smith and Marie Smith [1991] FCA 375 and The Bell Group Ltd (in Liq) v Westpac Banking Corporation [No 9] [2008] WASC 239. Aside from its immense length, the latter landmark decision of Justice Owen is significant from a number of insolvency law perspectives including the consideration which directors should give to the interests of individual companies under circumstances of actual or impending insolvency and the position of financiers with knowledge of the directors' breach of fiduciary duties. Concerning the latter case, see also Court of Appeal (Lee, Drummond and Carr AJJA) [2012] WASCA 157.
Similar concerns for equity's encroachment upon commercial law are evident in Goodhart and Jones's 1980 review of the two main streams of development to that time in this area; the *Quistclose* Trust and the *Romalpa* retention of title clause. The authors note a degree of judicial ambivalence toward the wider issue of extensive adaptation of equity to commercial dealings. Whilst Goodhart and Jones approve of both decisions, in particular *Quistclose*, stating it "on its own facts - - - [to be] a just and commendable decision", they are concerned with subsequent developments. Particularly germane to this thesis is *Re Kayford Ltd* in which Megarry J found an express trust protecting a group of customers, identifiable by virtue of the company placing their mail order monies in a separate account. Such an agreement, given impending insolvency, on its face would constitute a fraudulent preference; "it is very difficult to accept that the customers never became 'creditors' of Kayford." This is all the more so given the absence of customer knowledge of, and concurrence in the creation of, the trust. This type of outcome is contrary to the collectivisation objective of bankruptcy law described Chapter 1, at least if the trust is analysed as a new trust created by the company.

Goodhart and Jones are similarly sympathetic towards the concerns raised by Lord Templeman's conclusion regarding the wider adaptation of the Romalpa clause. Aside from problems of ascertainment of such interests:

"- - - proprietary claims of this kind were objectionable, since they derogated from the principle that the property of a company in liquidation should be applied in satisfaction of its liabilities pari passu." 

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240 *Quistclose Investments Ltd v Rolls Razor Ltd* [1970] AC 567.
241 *Aluminium Industrie Vassen BV v Romalpa Aluminium Ltd* [1976] 1 WLR 676.
243 Ibid at p 494.
244 [1975] 1 WLR 279.
245 Customers' trust deposit account
247 *Borden (UK) Ltd v Scottish Timber Products Ltd* [1979] 3 WLR 672. This case is of further note in that it was referenced by way of footnote (numbers 72 and 114) in Kirby J's dissenting judgment in *Associated Alloys Pty Ltd v Metropolitan Engineering and Fabrications Pty Ltd (in liq)* (2000) 171 ALR 568. There in relation to the question posed (that would be answered in the affirmative by the majority Gaudron, McHugh, Gummow and Hayne JJ) at [61] as to whether the retention of title clause "without registration - - - [would] - - - defeat the priorities which the Law enacts in cases of corporate insolvency and afford an effective preference to itself over unsecured creditors of the insolvent company?" Retention of title clauses are registable security interests under *the Personal Property Securities Act* 2009 (Cth) section 8.
A thorough exploration of the development and use in commercial sale of goods transactions of retention of title clauses is beyond the scope of this thesis. The strategies adopted by vendors in these cases might be regarded as indicative of the development of inappropriate commercial doctrine or practice when considered in the context of the law’s strong preference towards *pari passu* ranking. ‘Inappropriate’, insomuch as there is an anticipation on the part of the vendor of the potential sequestration of debtor property upon bankruptcy. The cases, at least prior to the coming into force of the *Personal Property Securities Act 2009* (Cth), also show how equitable concepts can be fashioned so as to avoid the application of company charges legislation, one of whose aims is to protect potential creditors of the chargor.

The fact that there is a significant degree of fluidity in the application of equitable doctrine to commercial activity in a more general context outside of insolvency is evidenced by the inclusion in Professor Worthington's *Proprietary Interests in Commercial Transactions* of an Addendum specifically addressing the decision of the House of Lords in *Westdeutsche Landesbank Girozentrale v Islington London Borough Council*. This case, which is analysed later in this chapter, is significant in light of the dramatic shift between the initial Court of Appeal decision and the reasoning ultimately applied by the House of Lords.

Under the heading 'General arguments against the wholesale importing of equitable doctrines into commercial law', Worthington suggests a need to step back from what might be seen as an evolving ‘paternalistic’ restraint on equity’s encroachment upon commercial dealings:

" - - - the stated aim of the decision in *Westdeutsche* [being] to dramatically reduce the scope for proprietary intervention in the commercial arena."

The apparent motivation in this decision, as stated by Lord Browne-Wilkinson, is to negate the risk of:

" - - - the wholesale importation into commercial law of equitable principles inconsistent with the certainty and speed which are essential requirements for the orderly conduct of business affairs."

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249 [1996] AC 669. A fuller examination of the *Westdeutsche* is provided is section 2.2.2.2 of the thesis.
252 Ibid at xxiv.
In Worthington's view such a stance fails to do justice to the inherent existence of risk and imperfect information within commercial transactions irrespective of any damaging impact that equity is assumed to have on commercial certainty. Moreover, she suggests that the *Westdeutsche* decision pays insufficient regard to sophisticated commercial dealings having complex proprietary implications which cannot be wound back, concluding in a manner consistent with Maxton and Rickett, that the more likely source of "dramatically alter[ed] economic balance in relationship[s]"\(^{254}\) to be that of developments in personal liability. The risk-based perspective on creditor entitlements was outlined in Chapter 1 as one of the major economic explanations of the nature of bankruptcy distribution.

Worthington provides further valuable insight into the possible limitations of registration as a panacea for overcoming uncertainty concerning the existence of property interests. The complexities and range being such that:

"- - - there is no way to register these latter interests\(^{255}\) in advance of the dispute which brings them to light."\(^{256}\)

Worthington's suggests that insolvency legislation could be amended to recognise such latent property interests, "though subject to the overriding - or equal - interests of unsecured creditors"\(^{257}\). It has merit, as it puts on the public record the existence of such entitlements. Nonetheless, the novelty, complexity and therefore unpredictability of the underlying fact situations brought before courts would, I suspect, present significant legislative drafting difficulties, as Worthington indicates elsewhere, requiring a careful balancing so as not to unduly enrich the general body of creditors "at the expense of justice to the plaintiff property owner."\(^{258}\) As such, the principle-based approach described in the following chapters of this thesis might be more realistic in terms of both justice-based merit and promoting commercial predictability.

Professor Worthington prefaces her analysis of retaining and regaining ownership interests with a number of important remarks concerning the objective of equitable intervention and the manner of its application.

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\(^{255}\) Resulting and constructive trusts


\(^{257}\) *Ibid.*

\(^{258}\) *Ibid.*
First, she stresses that in a strict sense equitable intervention correctly eschews consideration of a defendant’s insolvency and the impact on the general body of unsecured creditors. Like Maxton and Rickett, she recognises that equitable proprietary interests are directed to the relationship between the plaintiff and defendant. Failure to adopt such an approach would unjustly enrich the defendant’s general creditors.

Secondly, she observes that the identification and protection of proprietary interests by operation of law arises by means of the application of established principle rather than by way of arbitrary judicial discretion. But the principles themselves are targeted at redressing the unconscionable conduct of the defendant rather than promoting broader conceptions of justice. The removal of current uncertainties suggests the need for development of a structured approach to judicial discretion in bankruptcy distribution.

Finally, Worthington states that equitable jurisprudence in applying the maxim that ‘equity regards as done that which ought to be done’ in determining the existence of an equitable ownership interest, addresses the circumstances of when an obligation to transfer property _in specie_ arises. The significance of this maxim was noted earlier; it tends in constructive trust cases to obscure the distinction between enforcing pre-existing interests, which is an exercise in corrective justice, and creating new interests which involves the assertion of a claim engaged in distributive justice.

2.2.2 Proprietary Interests and Remedies – the basis of equity’s intervention in bankruptcy outcomes

The discussion here also draws on the analysis applied by Professor Sarah Worthington, a central part of which is an examination of the nature and circumstances of proprietary interests arising by operation of law. The thesis eschews detailed consideration of proprietary interests arising by agreement as this category of interest is less likely to undermine expectations of pari pasu treatment than interests imposed by operation of law.

Proprietary interests arising by operation of law are categorised by Worthington into retaining or regaining interests, and newly acquired interests. The latter category is
divisible between equitable ownership and equitable security interests. This division is important in distinguishing between the constructive trust and the equitable lien.\(^{259}\)

The grouping of cases and associated rules derived from Worthington’s analysis forms a useful parallel to the analysis of negligence claims. Neither tortious liability nor those proprietary interests arising by operation of law as new interests are based on the agreement of the parties. Both provide a useful basis for critiquing the limitations of the notion of bargaining central to creditor collectivism as described in Chapter 1, and hence, emphasise the need for a clear basis for the identification and treatment of non-consensual claimants. The focus of this thesis is on equitable ownership since it inevitably introduces the aspect of judicial discretion as a potential source for creating or altering creditor entitlements in bankruptcy. Moreover, all proprietary remedies are equitable, apart from actions to recover land and a statutory action of “specific restitution” awarded in some cases of detinue.\(^{260}\)

The following categories and the associated cases are selected for examination of ‘regained’ or ‘new’. Where relevant, specific reference is made to Australian cases in which these English authorities have been considered.

<table>
<thead>
<tr>
<th>Payments of money made in the absence of a contract(^ {261})</th>
<th>Chase Manhattan NA v Israel-British Bank (London) [1981] Ch 105</th>
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<tr>
<td>Payments arising out of void contracts(^ {262})</td>
<td>Westdeutsche Landesbank Girozentrale v Islington London Borough Council [1996] AC 669 (HL)</td>
</tr>
<tr>
<td>Payments arising out of terminated contracts(^ {263})</td>
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\(^{259}\) This distinction is encapsulated in the remarks of Crennan J in Jones (as trustee of the property of Heather Macneil-Brown, a bankrupt) v Southhall & Bourke Pty Ltd [2004] FCA 539: “ - - - the term ‘constructive trust’ covers both trusts arising by operation of law and remedial trusts. Furthermore, a constructive trust may give rise to either an equitable proprietary remedy based on tracing or - - - an equitable personal remedy to redress unconscionable conduct. The equitable personal remedies include equitable lien or charge or liability to account. The difference between an equitable proprietary remedy and an equitable personal remedy, is that a constructive trust giving rise to an equitable proprietary remedy gives the beneficiary an ‘ownership’ interest in the property whereas personal remedies, such as an equitable lien or charge, gives the beneficiary a ‘security interest’.” (Emphasis added) Perhaps symptomatic of the absence of settled rules in relation to such distinctions, Justice Crennan’s inference of an equitable lien or charge having the nature of personal remedy is controversial.

\(^{260}\) The wrongful detention of goods after the plaintiff’s lawful request for their return.

\(^{261}\) Ibid Chapter 7 at 7.2.1 Transfers of property in the absence of a contract or according to the terms of a void contract.

\(^{262}\) Ibid Chapter 7 at 7.2.1 and Addendum
The objective in adopting this structure is twofold. First, it is to identify problems in the application of existing equitable principle to these cases. Secondly, it might provide the basis for a system of natural law based jurisprudential principles which, as later chapters will show, could be applied to determine the outcome of bankruptcy disputes.

2.2.2.1 Payments of money made in the absence of a contract
Professor Worthington's discussion under this heading covers both common law and equitable remedies. She emphasises that property transfers made in the absence of a contract, whether by mistake or under the terms of a void or voidable contract, nonetheless in most cases transfer legal title. The common law restitutionary remedy will thus clearly be personal, being the action for money had and received; equitable remedies may however be proprietary, though they may also include personal equitable remedies by way of equitable compensation and an account of profits.

Aside from the obvious advantage that it affords to a plaintiff to assert a recovery of property in specie, Worthington stresses that such an outcome in equity is fully justified on the basis that the transferee's legal title was acquired without providing valuable consideration and "where a gift was clearly not intended."264 Worthington goes on to assert that the traditional equitable response is to recognise the transferee as holding the property on resulting trust for the transferor.

More problematic and directly relevant to the issue of mistaken payments is the rationale applied by Goulding J in Chase Manhattan NA v Israel-British Bank (London)265. The essential facts of this case are that the plaintiff, a New York bank, was instructed to pay USD 2million to another New York bank for the account of the defendant, a bank in England. These instructions were carried out on 3 July 1974, though through clerical error a second payment in the same amount was also made. Subsequently on 2 August the defendant bank presented a petition to be wound up compulsorily, with the order made on 2 December given the defendant’s insolvency. The plaintiff sought a declaration that the defendant had become a trustee in relation

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263 Ibid Chapter 7 at 7.2.3 Transfers of property in accordance with a contract which remains uncompleted because of breach .
265 [1979] 3 All ER 1025
to the second mistaken payment, thus avoiding the adverse consequences of having to prove as an unsecured creditor. The case was decided in favour of the plaintiff, the ratio of which is captured in part by Goulding J’s statement that:

“... a person who pays money to another under a factual mistake retains an equitable property in it and the conscience of the other is subject to a fiduciary duty in respect of his property right.”266

In his decision Goulding J made the following critical remarks in relation to *Sinclair v Brougham*267 and the interaction between the common law and equitable remedy:

“Lord Haldane LC ([1914] AC 398 at 419-420) (who spoke for Lord Atkinson as well as himself) includes money paid under mistake of fact among the cases where money could be followed at common law, and he proceeds to the auxiliary tracing remedy, available (as he said) wherever money was held to belong in equity to the plaintiff, without making any relevant exception.”268

and further

“... I hold that the equitable remedy of tracing is in principle available, on the ground of continuing proprietary interest, to a party who has paid money under a mistake of fact. On that prime question, I see no relevant difference between the law of England and New York and there is no conflict of law to be resolved.”269

Lord Browne-Wilkinson, however, in *Westdeutsche* rejected the conclusion that the second payment mistakenly made by the plaintiff bank could be traced to the insolvent’s assets on a proprietary basis to which the recipient trustee was subject to a fiduciary duty. Critical to Lord Browne-Wilkinson’s conclusion is the view that where money is paid without an awareness or intent to make the payment, an equitable interest cannot subsequently spring into being. Further, his Lordship sought to distinguish the English model of constructive trust from the New York version. On this point, Lord Browne-Wilkinson largely rejected the development of a remedial constructive trust, holding rather to the institutional concept necessarily “arising by

266 [1979] 3 All ER 1025 at 1032. It is noted here that *Sinclair v Brougham* is overruled in the *Westdeutsche* decision.


268 [1979] 3 All ER 1025 at 1032.

269 [1979] 3 All ER 1025 at 1033.
operation of the law as from the date of the circumstance which gave rise to it.”

The court's role was thus passive and declaratory.

Worthington's commentary on Lord Browne-Wilkinson's analysis of *Chase Manhattan* deserves further consideration. First, she indicates that his Lordship's approach misstates orthodox equity. The fallacy to which she refers is the notion that a full range of fiduciary responsibilities are to be brought to bear on the making of a mistaken payment, whereas equity imposes such responsibilities on the basis of the overall commercial relationship. Similarly, the idea that the existence of a trust must be occasioned by the "recipient's conscience as affected only when there is some appropriate degree of knowledge" denies, in Worthington’s view, equity's overarching consideration, which is to ensure "that a recipient cannot unconscionably retain property" - and, it is principally on this basis that the trust, be it resulting or constructive, can contribute to resolving problems of priority.

The authors of Meagher, Gummow & Lehane are similarly sceptical of the reasoning applied in *Chase Manhattan*. In their view, it is entirely unclear how the overpayment arising from a mistake of fact could of itself give rise to a fiduciary relationship either before or after the event. More significantly, Meagher, Heydon and Leeming go on to question Lord Browne-Wilkinson’s remarks to the effect that *Chase Manhattan* could be rationalised in terms of a constructive trust arising “once the recipient bank became aware of the overpayment.”

A related influential authority in Australia is *Bathurst City Council v PWC Properties Pty Ltd*, where the High Court states:

270 [1996] AC 669 at 714, Lord Browne-Wilkinson conceded, however, the case to be correctly decided, the critical fact in his view being the knowledge of the mistake by the defendant bank.
273 Ibid.
274 Ibid.
276 Ibid at p 484.
“- - - it [the court] should first decide whether, having regard to the issues in the litigation, there are other means available to quell the controversy. An equitable remedy which falls short of the imposition of a trust may assist in avoiding a result whereby the plaintiff gains beneficial **proprietary interest** which gives an unfair priority over other equally deserving creditors of the defendant.”

(Emphasis added)

Notwithstanding the clearly technical correct position that the rules concerning recognition of proprietary interests can, and indeed perhaps should always, operate in isolation from concerns about inter-creditor competition, the practicalities of the cases dictate otherwise. Specifically, amongst the objectives of this thesis is the determination of whether a corrective justice analysis can assist in resolving discordance between equitable remedies and the competing claims of unsecured creditors.

An Australian case applying Lord Browne-Wilkinson’s approach is *Wambo Coal Pty Ltd v Stuart Karim Ariff & 1 Or.*

The first defendant was liquidator of the second defendant, Singleton Earthmoving Pty Ltd (In Liquidation). The plaintiff had mistakenly made two payments to Singleton Earthmoving after the time at which Mr Ariff had become liquidator, Ariff subsequently causing most of these moneys to be transferred a company he controlled (S Ariff Nominees Pty Ltd) in purported reimbursement for disbursements paid at Ariff’s direction as part of the liquidation of Singleton. The legal issue concerned the basis upon which Ariff should be compelled to disgorge all or some of the moneys paid.

The case is of interest in terms of the consideration given to the treatment of moneys in the hands of a recipient under contrasting circumstances of theft, fraud and mistaken payment. Justice White in *Wambo Coal*, after first reiterating that the remedial constructive trust was part of Australian law, addressed the nature of the trust applicable to instances of theft stating that “[t]he property is trust property in the hands of the thief because the thief is bound in conscience to hold the property on

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278 (1998) 195 CLR 566 at [42].
280 *Wambo Coal Pty Ltd v Stuart Karim Ariff & 1 Or* [2007] NSWSC 589 at para 39 “- - - it still remained to be decided whether English law should follow the United States - - - in adopting the remedial constructive trust.” and at para. 40 “The remedial constructive trust is part of the law in Australia.” per White J.
behalf of its true owner.”281 Turning specifically to the character of the trust itself, White J stated that “the trust is of an institutional rather than a remedial character.”282 Addressing then both the timing of the trust and the extension of the principle to acquisitions of property either by way of fraud or other forms of total failure of consideration, White J stated that “the trust arises immediately on the receipt of the property.”283 Concerning then the treatment in bankruptcy of mistaken payments, White J approved Lord Browne-Wilkinson’s analysis in Westdeutsche, noting that “[t]he recipient’s conscience is bound only upon being aware of the mistake.”284 Significant also are White J’s remarks concerning the application of a proprietary remedy, particularly in the context of a recipient’s insolvency so as to guard against “an unwarranted windfall for - - - creditors to share in the payment”285, and equally significant, was his conclusion that this did not interfere “with the statutory scheme for the ordering of priority of debts recoverable from the company.”286

The Australian High Court’s dictum in Bathurst City Council and the more recent consideration to the question of proprietary interests imposed over mistaken payments given by the New South Wales Supreme Court in Wambo Coal, when taken together, suggest that the knowledge of the payee will be an important, but not necessarily the exclusive, consideration to be taken into account.

2.2.2.2 Payments arising out of void contracts

Building upon her analysis of equity’s treatment of mistaken payments, Worthington then applies the rationale for a resulting trust to transfers for which there is no consideration. Worthington make the important observation that the:

“- - - distinction between ‘no consideration’ and a ‘failure of consideration’ is vitally important - - - [f]ailures of consideration are unquestionably more common, but they do not attract the resulting trust analysis.”287

Resulting trust analysis is appropriate in circumstances where a recipient provides no consideration for a transfer and no gift was intended, whereas failure entails the recipient failing to execute the bargained consideration – thus, in a commercial

281 Ibid at para. 40.
282 Ibid.
283 Ibid at para. 41.
284 Ibid at para 43. White J went on in para. 44 to state the current understanding of the rules of constructive knowledge based around the decision in Barnes v Addy (1874) LR 9 Ch App 244.
285 Ibid.
286 Ibid.
setting, the more likely to occur. According to this distinction, the failure to perform does not attract the intervention of equity as “the relationship between the parties remain[s] purely contractual.”

I return to the decision in *Westdeutsche*, this time from the perspective of the wider consideration given by Lord Browne-Wilkinson to the resulting trust and resitutionary arguments. This serves as a useful basis for identifying different circumstances of contracts void for mistake or ultra vires, failure of contractual performance and total failure of consideration. Confusion and controversy as to the remedy which each respectively attracts is used in this thesis as a basis for examining the transformation of creditor entitlements brought about by debtor bankruptcy. *Westdeutsche* also provides a convenient illustration of a failure of consideration in a commercial context.

The fact of *Westdeutsche* concern parties entering into a ten year interest rate swap agreement. The agreement stipulated that the plaintiff bank, as fixed rate payer, pay to the defendant council, as floating rate payer, a lump sum of £2.5m against which the council would make interest payments. The arrangement progressed with the council paying four periods of interest. However, around two years into the agreement it was determined in an unrelated case that such swap agreements were ultra vires the statutory borrowing powers of local authorities. The council made no further interest payments, upon which the plaintiff claimed recovery of the balance of the £2.5m plus interest calculated back to the commencement date of the agreement. At first instance the bank obtained judgment, including an award of compound interest. The Court of Appeal dismissed an appeal from the council and allowed the bank’s cross-appeal concerning the compound interest calculation. The award of compound interest depended on whether the money lent to the council constituted trust money.

The fundamental principle of trust law at issue was whether “the recipient of money under a contract subsequently found to be void for mistake or as being ultra vires hold the moneys on trust even where he had no knowledge at any relevant time that the contract was void.” The House of Lords allowed recovery only on a common

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288 Ibid at p 157.
law basis in an action for money had and received with consequent simple interest calculation, holding:

“ - - - that in the absence of fraud equity had never awarded compound interest - - - [and] that the recipient of moneys under a contract subsequently held to be void for mistake or as being ultra vires did not hold those moneys on a resulting trust and it would be undesirable so to develop the law of resulting trusts since to do so would give the claimant a proprietary interest in the moneys and produce injustice to third parties and commercial uncertainty.”

It is appropriate briefly to identify some of the key aspects of the lower courts’ reasons in the Westdeutsche litigation rejected by Lord Browne-Wilkinson since the repudiation of these reasons presents major challenges to the resulting trust rationale proposed by Worthington. A significant feature of the argument for an equitable proprietary interest derives from equity’s treatment of non-contractual transfers in which the transfer is set aside because of a flaw in either the transferor’s intention to give or motivation for giving. Consistent with the principle that equity will intervene only in the former circumstance of flawed intention, Worthington concludes that “[i]t is no less appropriate with contractual transfers, where because a contract is void, a transfer is made for no consideration and with no intention to give.” Support for this principle is drawn from Hobhouse J’s decision at first instance in Westdeutsche:

“ - - - any payments made under a contract which is void ab initio, in the way that an ultra vires contract is void, are not contractual payments at all.”

The Court of Appeal applying as authority the principle established in Sinclair v Brougham, concluded in agreement with Hobhouse J, that the swap transaction was ultra vires upon being entered into by the defendant local authority. The money received by the council "has from the time the council receives it - - - been held on a
resulting trust for the bank."297 The implication stemming from such an approach is that "[p]ayees of money under a void transaction are, from the moment of receipt, trustees of the money",298 and that this is so, "even where [they] had no knowledge at any relevant time that the contract was void."299 The Court of Appeal’s dictum disregards a reasonable assumption that the intention of the payer bank was to become no more than a general creditor upon entering into the transaction. The Court of Appeal’s analysis is of some interest as it does not directly address the situation of an insolvent payee, and Maxton and Rickett regard Dillon LJ’s resulting trust analysis as not being dependent on an insolvency context.300 In contrast, Lord Browne-Wilkinson does consider insolvency to be a crucial matter, stating that “the creation of an equitable proprietary interest under the trust can have unfortunate, and adverse, effects if the original recipient of the moneys becomes insolvent”.301

On the specific aspect of intention, Professor Goode302 is strongly of the view that a revesting of property could only arise where it is specifically contemplated by the parties or where such intent might be presumed. On this analysis failure of consideration is not sufficient to give rise to an equitable proprietary interest unless the contract provides for the consequences of such failure. But in such a case the security interest will obviously be consensual and will not arise by operation of law.

The House of Lords majority judgments, attempt to resolve some of these issues. That Lord Browne-Wilkinson is prepared to apply to the analysis an insolvency policy perspective is evident in the initial presentation of two consequences303 that would follow were the bank to succeed in its argument, both of which would derogate from the certainty and speed of commercial dealings. First, were the payee to become insolvent such traceable trust monies would not be available for distribution to unsecured creditors. Secondly regardless of insolvency, the unknown proprietary

297 [1994] 1 WLR 938 per Dillon LJ at 947.
298 J. Maxton and C. Rickett "The Effects of Equitable Doctrines on Priorities in Insolvencies" in Essays on Corporate Restructuring and Insolvency C. Rickett (editor) (Brooker’s Ltd, Wellington NZ, 1996); “Dillon LJ’s resulting trust analysis does not, it would appear, allow for a distinction to be made between solvent and insolvent defendants” at p 237.
300 "The Effects of Equitable Doctrines on Priorities in Insolvencies" in Essays on Corporate Restructuring and Insolvency C. Rickett (editor) (Brooker’s Ltd, Wellington NZ, 1996) at p 237.
interest would be enforceable against any subsequent recipient except for the good faith purchaser for value without notice.

More particularly, the rejection on principle of a resulting trust applicable to the \textit{Westdeutsche} facts derives from what Lord Browne-Wilkinson acknowledged as a conventional and conservative approach.\footnote{Lord Browne-Wilkinson provided the following definition: “A resulting trust is not imposed by law against the intentions of the trustee (as is a constructive trust) but gives effect to the presumed intention.” [1996] AC 669 at 708.} He held that a resulting trust will be imposed on the basis of either a presumed intention of the parties where an express trust does not exhaustively declare the whole beneficial interest, or where a proportionate payment is made in reasonable anticipation of another's share or contribution.\footnote{[1996] AC 669 at 708.} The facts of \textit{Westdeutsche} did not fall into either of these categories.

Additionally, the bank advanced a restitutionary argument based on the argument proposed by Professor Birks\footnote{“Restitution and Resulting Trusts” \textit{Equity: Contemporary Legal Developments} (S. Goldstein (ed.) Sacher Institute Hebrew University, Jerusalem (1992)), critiqued by Lord Browne-Wilkinson [1996] AC 669 at 708-709.} that the resulting trust is a remedy for the payee's 'subtractive unjust enrichment' in cases where the payment is still traceable. The view adopted by Lord Browne-Wilkinson was that the overlaying of trust principles with proprietary restitutionary considerations distorts the former. More specifically, he considered it contrary to the basic tenet of trust law that there must be present on the part of the alleged trustee knowledge that he is not entitled to the property, to which his conscience can be affected. He objected to the unjust enrichment analysis for conceptual and practical reasons. Conceptually, liability in unjust enrichment is strict and has no regard to the payee's knowledge of the circumstances in which the payment was made. The practical objection to unjust enrichment analysis was that the imposition of a resulting trust to every case of failure of consideration would distort priorities in insolvency. On the other hand, Lord Browne-Wilkinson found no objection to personal restitution for a total failure of consideration, awarding this remedy in \textit{Westdeutsche}. This nonetheless defeated the bank's purpose in the litigation of seeking compound interest.

In his analysis of the restitutionary model of the resulting trust Goode makes the following remark:
“- - - this neat equation of failure of consideration with failure of purpose is most beguiling; it sounds so obviously right.”

In his view the simplicity of this equation is dangerous. It leads to the misallocation of commercial risk.

Lord Browne-Wilkinson’s analysis of the criteria for the imposition of a trust, which as we have seen was applied by White J in Ariff, places emphasis on the recipient’s knowledge that he has assumed the obligations of a trustee. This may be an appropriate corrective justice consideration when applied to a dispute between payer and the unintended recipient of a mistaken payment. But is it also appropriate to the resolution of a dispute between the payer and creditors of a bankrupt payee, represented by the latter’s trustee in bankruptcy, who have no possibility of knowing the circumstances under which the recipient came to receive the payment, including the state of the recipient’s knowledge? Is it sufficient answer to say that the recipient’s creditors can be in no better position than the recipient himself? Is it a principle that can be applied at all outside cases of vitiated consent, to instances of failure of consideration? These are not questions which has so far been answered by appellate courts in Australia.

It will be argued that the payer’s entitlement to proprietary restitution cannot be determined solely by reference to the relationship between the payer and payee, given that any constructive trust will have the practical consequence of reducing the payee’s estate available for distribution to all of his creditors. The applicable legal principle must be based on a normative principle that will be accepted by all the creditors, and not just by the parties to the constructive trust. The natural law framework proposed in later chapters, grounded in the concepts of “virtuous debtor” and “meritorious creditor” recognised by all parties to the bankruptcy process, attempts to distil just such a principle.

The areas of controversy discussed thus far are complex. Nonetheless even greater difficulties are experienced in discussing Worthington’s other categories: transfers of property in accordance with a contract which remains uncompleted because of the disability or fault of one of the parties and equitable security interests: retained and

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new interests\(^\text{309}\). These categories are to a degree interrelated, stemming from contracts which are not void or voidable. A purchaser’s proprietary or other equitable remedy in circumstances of vendor contractual failure depends upon whether the purchaser acquired an equitable interest in the subject matter of the contract or retained an interest in the purchase monies.

### 2.2.2.3 Payments arising out of terminated contracts

As described above, the failure of a valid contractual bargain in circumstances where a transfer of property is supported by valuable consideration presents its own unique challenges to possible equitable proprietary intervention. Worthington emphasises that, whilst complexity in this area is most apparent in circumstances of transferee insolvency\(^\text{310}\), neither the common law nor equity will intervene to grant restitutionary proprietary relief. Significantly, in her analysis of both common law and equity recourse is made to issues of risk allocation. Specifically, in relation to the absence of scope for equitable intervention Worthington concludes:

> “- - - risk of breach (whether caused by insolvency or not) is a commercial risk presumed to be provided for, at least impliedly, by the agreement between the parties.”\(^\text{311}\)

In consequence the thesis examines the extent to which risk allocation and capacity for adjustment, amongst other factors, provides a rational explanation of the rules of creditor entitlements in bankruptcy distribution. For the purpose of the thesis, explanations of the imposition of proprietary remedies in terms of risk are economic explanations.

Entry into a contract for the sale of goods does not confer any specifically equitable proprietary rights in either vendor or purchaser, although sale of goods legislation in common law countries typically provides that title to the goods sold will pass upon entry into the contract. Equitable rights will be recognised, however, if the purchaser pays the price for specific land or goods having unique value without receiving the goods. He will be entitled to a constructive trust after payment provided that the property is identifiable.\(^\text{312}\) Similarly, if the vendor transfers the goods without payment, he will be entitled to an equitable lien over the goods to secure payment.

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\(^{309}\) Ibid at Chapter 9 p 222.
\(^{310}\) Ibid.
\(^{311}\) Ibid at p 172.
\(^{312}\) See *Tanwar Enterprises v Cauchi* [2003] HCA 57.
It has been argued that the award of equitable interests goes further than these classic examples of proprietary interests awarded in cases of non-performance of obligations arising under specifically performable contracts. The argument was that, even where a contract for sale is not specifically performable, payment of the purchase price may entitle the payer to a constructive trust over the subject-matter of the contract in the event of non-delivery by the seller. This argument was considered in *Re Goldcorp Exchange Ltd*\(^{313}\) in connection with the common law principles of passing title to property established in *Re Wait*\(^{314}\) but was rejected.

*Goldcorp* dealt with the affairs of an insolvent gold merchant. The general nature of the business was to sell unascertained bullion for future delivery, with each customer receiving an invoice or certificate verifying ownership of the bullion each had bought. On failure to deliver the bullion upon Goldcorp’s bankruptcy, the purchasers brought claims against the liquidator of the insolvent Goldcorp Exchange Ltd for either their share of the bullion or the return of their purchase money. Three categories of claimant were involved. Firstly, there were non-allocated claimants to whom the company’s employees had given an undertaking that a sufficient stock would be maintained to meet their demands. This undertaking could not be fulfilled by reason of Goldcorp’s insolvency. A second claimant, Mr Liggett, was distinguishable in that his dealing initially involved sufficient ascertainment and allocation (52 coins) followed by an additional contract (1000 coins), the acquisition of which by Goldcorp was not specifically appropriated to Mr Liggett’s contract. The third category of claimant had dealt initially with Walker & Hall Commodities whose business was acquired by Goldcorp. The nature of the dealings had involved sufficient ascertainment and appropriation to enable title in a pooled store of bullion, though after acquisition by Goldcorp this practice was suspended with Goldcorp unlawfully mixing the respective stocks of bullion. Against this background Goldcorp had issued a debenture to the Bank of New Zealand such that upon the company getting into financial difficulties a receiver was appointed and the bank’s floating charge over Goldcorp’s assets crystallised.

The Privy Council opinion delivered by Lord Mustill is not only noteworthy for an appreciation of the context of insolvency, but more significantly, recognises the need to reconcile conflicting claims of parties having different commercial relationships with the insolvent gold merchant. As this case dealt extensively with the notion of

\(^{313}\) [1995] 1 AC 74.
\(^{314}\) [1927] 1 Ch 606.
subsistence of proprietary rights, it is worth identifying the basis for the rejection of these claims before turning specifically to the equitable lien claimed by the separate ‘Walker & Hall’ claimants.

Their Lordships did not wholly rule out recognition of a remedial constructive trust, alternatively described as a restitutionary proprietary interest. However, the facts presented did not give rise to this remedy. The telling comment was made:

"The company's stock of bullion had no connection with the claimant's purchases, and to enable the claimant's to reach out and not only abstract from the assets available to the body of creditors as a whole, but also to afford a priority over a secured creditor, would give them an adventitious benefit devoid of the foundation of logic and justice which underlies this important new branch of the law." (Emphasis added)

The above remarks illustrate awareness on the part of their Lordships of a need to adhere closely to the fundamental objectives of insolvency law. First, the Privy Council recognised the need to negate pre-emptive creditor behaviour. Secondly, and more significantly, the decision also recognises the need to preserve the paramountcy of valid consensually created secured claims which are expressly created prior to any claim arising by operation of law.

Three particular elements of Lord Mustill's speech concerning the position of the Bank of New Zealand as the holder of a floating charge over Goldcorp's assets illustrate this sensitivity. First, the judgment considered the argument that a claim could be brought in proprietary estoppel because of the representations as to the separate holding of stock made to the non-allocated claimants. His Lordship considered whether the bank upon crystallisation of its floating charge stood 'in the shoes of the company'. The argument, though conceded attractive, was rejected:

"- - - the chargee becomes entitled to a proprietary interest which he asserts adversely to the company, personified by the liquidator and all those general creditors who share in the assets of the company."  

Thus, estoppel cannot create any new right in this area. Secondly, in the separate consideration given to the position of the bank, reference was made to the

316 Ibid at 94. Similar Australian judicial statements confirming a secured creditors' rights can be found in such cases as Chant v Deputy Commissioner of Taxation (1994) 15 ACSR 184, per Priestley, Handley and Sheller JJA of the NSW Court of Appeal it stated at 189: "The bank therefore had a legal entitlement to the proceeds of the realisation of its security and in the first instance received such proceeds directly or through its agents as its own property and for its own benefit."
argument that an equitable right arose out of wrongful dealing founded in the bank's level of awareness of Goldcorp's trading difficulty. Consistent with the New Zealand Court of Appeal, Lord Mustill did not regard such knowledge as decisive in precluding "the bank from claiming the normal benefits of security". Finally, in the brief consideration given to the prospect of the court extending its discretion to recognize a remedial restitutionary right that would retrospectively create a proprietary interest in competition with the bank's, their Lordships rejected the argument. The necessity "to strike directly at the heart of the problem to conclude that there was such an imbalance between the positions of the parties that if orthodox methods fail a new equity should intervene"318, was rejected. The bank's proprietary claim was based on its floating charge whereas the customers' proprietary claim was based on an expectation of delivery and holding of separate stock. These were fundamental aspects of the parties' separate dealings. The Privy Council could identify no authority or doctrine which would enable the latter to prevail over the former.

That their Lordships on this third point might have in very tentative terms contemplated the possible development of a remedial restitutionary right to operate in competition with the claims of other creditors (indeed some of whom may have secured interests), is viewed by Worthington with a degree of apparent incredulity:

"This development is disputed and, if it does exist, is decried. - - - The court's only discretion is to deny a proprietary remedy when the basis for one can be established, not to grant one in the absence of such a basis."319

Additionally, their Lordships rejected the claim the unallocated claimants made to a pre-existing proprietary interest in either the bullion or derived from the purchase price. Three arguments were examined. First, the notion that "the purchase moneys were from the outset impressed with a trust in favour of the payers"320 was rejected as being inconsistent with the Quistclose line of cases, there being no indication of a mutual intention to create a trust. Similarly, the second, namely the submission that the company was a fiduciary, failed for the absence of intention or any specification of what the content of the fiduciary duty might be. An evident rigidity stemming from Re Goldcorp concerns the presumed impossibility of a fiduciary relationship in sales.

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317 Ibid at 105.
318 Ibid at 104.
320 [1995] 1 AC 74 at 100.
contracts. Professor Bridge considers \textsuperscript{321} Re Goldcorp in his analysis of the Romalpa decision and the tendency for the making of such a presumption of a fiduciary status to be increasingly doubtful, concluding that “it is not for the parties to deem their relationship to be a fiduciary one - - - if in objective commercial terms they are conducting an arm’s length sale.”\textsuperscript{322} There is a critical distinction between relationships by which fiduciaries act in the interests of their principals and sales contracts in which the parties act in their own interest.

The third reason for rejecting the claim to a pre-existing equitable interest was based on an argument that the contracts for sale of the bullion were legally ineffective. It could have led to the existence of a "proprietary interest in the purchase money or its fruit superior to that of the bank."\textsuperscript{323} Such an interest would either be subsisting or re-vesting, or alternatively, created by judgment to "reflect the justice of the case."\textsuperscript{324} The rejection of each of three vitiating factors relied upon - misrepresentation, mistake and total failure of consideration - can again be seen to have some foundation in the underpinning of bankruptcy law objectives of predictability and preservation of legal rights pre- and post-liquidation. Both the misrepresentation and mistake arguments failed because the purchase moneys were paid by the customers in the belief that they had entered into a binding contractual obligation\textsuperscript{325} under which the money became the unencumbered property of the company.\textsuperscript{326} A personal right to recover an equivalent sum was not denied by their Lordships. But it "would not by operation of the law have carried with it a proprietary interest."\textsuperscript{327} Similarly, with the contracts for the sale of unascertained goods, a residuary proprietary interest cannot be enlivened merely by one party's non-performance of the bargain.\textsuperscript{328}

At this juncture it is relevant to consider in more detail the related sale of goods case of Re Wait because the Privy Council’s decision in Re Goldcorp relied on this case in rejecting the claim for rejecting the imposition of constructive trusteeship. The manner in which the rule established in Re Wait, and the rule contained in Holroyd v Marshall\textsuperscript{329}, affect inter-creditor competition is introduced in order to demonstrate

\begin{itemize}
\item \textsuperscript{322} Ibid at p 110.
\item \textsuperscript{323} [1995] 1 AC 74 at 101.
\item \textsuperscript{324} Ibid at 102.
\item \textsuperscript{325} Ibid at 103.
\item \textsuperscript{326} Ibid at 102.
\item \textsuperscript{327} Ibid at 103, the facts noted as clearly distinguishable from those considered in Chase Manhattan Bank.
\item \textsuperscript{328} Ibid, see also similar considerations in Westdeutsche.
\item \textsuperscript{329} (1862) 10 HLC 191.
\end{itemize}
how a corrective justice account of bankruptcy law can take into account developments in private law. The two cases are distinguishable and deal with different issues. The older Holroyd case, decided in equity, recognises that a contract for the sale of future property is specifically enforceable once the consideration has been paid as soon as the property has been received by the seller. The seller holds the property on constructive trust for the buyer until legal title passes to the buyer. The more recent authority in Re Wait, decided by a majority of common law judges over a dissent by the equity member of the Court of Appeal, deals with sales of goods by description, holds that title to property under the contract only passes once the property has been appropriated to the contract. At first sight, the decisions might appear to conflict, since Re Wait denies the possibility of title passing in equity under sales contracts by description until the property has been appropriated to the contract while Holroyd v Marshall recognises that possibility. If there were indeed a conflict of authority, it would create difficulties for the practical administration of bankruptcy law, as well as its theory. In fact there is no such conflict since the cases deal with different kinds of sales contracts.

The facts of Re Wait were that Wait, prior to shipping, purchased 1000 tons of wheat, on-selling 500 tons to a sub-purchaser. Prior to the ship sailing the sub-purchaser was provisionally invoiced and paid the price for the wheat, after which Wait was declared bankrupt. On delivery to port of the 1000 tons of wheat, the question was whether the sub-purchaser was entitled to specific performance of the contract, or alternatively to an equitable lien over part of the remaining 1000 tons to satisfy the claim to receive 500 tons. No part of the 1000 tons bulk was specifically identified and attached to the sub-purchaser’s contract.

The judgment of Atkin LJ in Re Wait is authority for the proposition that the applicable Sale of Goods legislation is a complete code for determining the rights and duties of the parties to a sale of goods contract, though the wider issue of whether equity was excluded from influencing the outcome of the passing of property under sales of

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331 See for example Goods Act 1958 (Vic) s 21 Sale of unascertained goods: “Where there is a contract for the sale of unascertained goods no property in the goods is transferred to the buyer unless and until the goods are ascertained”. “Ascertained as contrasted with specific probably means identified in accordance with the agreement after the contract of sale is made.” J Davis & N Seddon, The Law of Australian Contracts (3rd edition) (Lawbook Co. 2003) p 1116.
goods contracts was arguably not conclusively determined.\textsuperscript{332} This reluctance to allow the equitable remedy of specific performance\textsuperscript{333} to encroach upon the transfer of property under sale of goods contracts, where the character of the goods is not unique, is illustrated by the statement that:

"... specific enforceability may sometimes produce undesirable side-effects: for example, by giving the plaintiff an equitable interest in the subject matter of the contract, it may result in his getting an undeserved priority over other creditors." \textsuperscript{334}

Whilst not determinative of the outcome in \textit{Re Goldcorp Exchange Ltd}\textsuperscript{335}, their Lordships emphasise the weight of authority from \textit{Re Wait} which “points unequivocally to the conclusion that under a simple contract for the sale of unascertained goods no equitable title can pass merely by virtue of the sale.”\textsuperscript{336} Commenting on \textit{Holroyd v Marshall}\textsuperscript{337} Meagher, Heydon and Leeming note that it is not immediately apparent how the rule in this case, which is clearly more favourable to purchasers in that it confers a constructive trust for their benefit, “works any particular inconvenience” in an insolvency context.\textsuperscript{338} For this reason the authors argue that \textit{Re Wait} may have excluded equitable principles too rigorously from contracts for the sale of goods.\textsuperscript{339} Nonetheless, Meagher, Heydon and Leeming conclude that the authority in \textit{Re Wait} is formidable not having been subject to recent judicial challenge or analysis\textsuperscript{340}, and it is perhaps on this basis that Worthington proposes the rule that:

\begin{itemize}
\item \textsuperscript{332} G Pearson, “The transfer of property in unascertained goods: who owns the wine bottles?” (1997) 71 ALJ 137 at p 140.
\item \textsuperscript{333} S Worthington, “Proprietary remedies: The Nexus between Specific Performance and Constructive Trusts” (1996) 11 JCL 1.
\item \textsuperscript{335} [1995] 1 AC 74: “It is unnecessary to examine in detail the decision of the Court of Appeal in \textit{In re Wait} [1927] 1 Ch. 606 for the facts were crucially different.” at 90 per Lord Mustill.
\item \textsuperscript{336} Ibid at 91.
\item \textsuperscript{337} The rule in \textit{Holroyd} can be summarized as “authority for the following proposition: (a) when A for valuable consideration agrees to assign, or purports presently to assign, an expectancy, or future property, to B, and (b) the consideration has been paid or executed, and (c) A acquires property which falls within the description of that which was agreed to be assigned or purportedly was assigned, then the property vests in equity in B as soon as it is acquired by A.” The Hon. Justice Meagher, “The Kitto Lecture: Sir Fredrick Jordan's Footnote”, University of New England, Armidale NSW, 27 May 1999.
\item \textsuperscript{338} R Meagher, D Heydon and M Leeming, \textit{Meagher Gummow & Lehane’s Equity Doctrines & Remedies} (4th edition) (Butterworth’s, Australia 2002) at p 259.
\item \textsuperscript{339} Ibid at p 260.
\item \textsuperscript{340} Kearney J’s comment in \textit{Electrical Enterprises Retail Pty Ltd v Rodgers} (1988) 15 NSWLR 473 is noted as a significant exception, his Honour stating at 493: “In the context of the growing application of equitable principles to commercial relationships especially in Australia, the view expressed in \textit{Re Wait} (but not decided) on this point is ripe for review: see generally
\end{itemize}
“- - - one party will only become the equitable owner of property belonging to another if that other party is under a mandatory and unconditional personal obligation to transfer identifiable property to the first party.”

One of the objectives of this thesis is to develop a basis for testing the universality of this type of rule. A natural law perspective has potential application in the context of the different creditor dealings with an insolvent debtor as occurred in Re Goldcorp. It is from this perspective that some description of the nature and outcome of the separate claims of Walker & Hall is warranted.

Lord Mustill acknowledged that the Walker & Hall claimants’ position was distinct, in that their interests were separate and ascertainable compared to the interests of other contributors to the shared pool. What, however, proved critical was the determination of the appropriate relief, given the intermingling which incorrectly took place after the acquisition of the Walker & Hall operations by Goldcorp. Meagher, Heydon and Leeming note that in relation to a contract under which the seller agrees to sell goods presently in stock, English and New Zealand authority would seem settled with reference to Re Wait. They go on to remark, however, that “[t]he question remains open as far as Australian authority is concerned: it was deliberately left open by the High Court in Hewitt v Court.”

Moving to the different circumstances of the contract for the sale of future goods, which are subsequently acquired and clearly identifiable as such, Meagher, Heydon and Leeming assert that:

“- - - the point has never been decided and, it is submitted, there is no good reason to suppose that Holroyd v Marshall does not apply to such a case.”

The position therefore is that contracts for the sale of goods by description differs from the principles applicable to the sale of future property. Title will not pass to the purchaser under the former type of contract until specific goods have been appropriated to the contract. A contract for the sale of future property, on the other hand, is specifically enforceable and entitles the purchaser to the benefit of a constructive trust over the property once the purchaser has paid the price and the

Finn, *Equity and Commercial Relationships* (1987). As pointed out in Meagher, Gummow & Lehan in a detailed analysis of the authorities, the argument for excluding equitable principles from sales of goods is really an argument based on commercial convenience.

Additionally, both Meagher, Gummow & Lehan and Professor Worthington cite a range of academic comment dating back to the 1930s criticising both the strictness of the rule and its presumed embodiment in Sale of Goods statutes.


343 Ibid.
property has been received by the seller. In Australia there is some uncertainty as to whether the principle of Holroyd v Marshall subsumes the principle of Re Wait on the ground that the sale of goods legislation should not be taken to have covered the whole field of sales contracts.

Has a theory of bankruptcy law anything to contribute to a doctrinal dispute of this kind relating to the passing of title to property? It is certainly true that rules about passing of title cannot be sourced from a natural theory, any more than they can be directly sourced from economic theory. But theory can provide critical standards against which the existing rules can be assessed. In the case of natural law theory, conceptions of the virtuous debtor and the meritorious creditor, to be explained later in the thesis, can assist in assessing the merits of rules which either entitle purchasers to constructive trusts (as Holroyd v Marshall does) or denies them proprietary relief (as is the case with Re Wait which denies the purchaser either legal or equitable title).

A relatively brief examination was made by Lord Mustill of the proposition that an equitable lien could be asserted over all the company property at the time of receivership. His Lordship acknowledged the existence of authority which might support such tracing. He was however also mindful of the limitation imposed by In re Diplock, citing with evident approval analysis by Professor Goode, to the effect that the award of a lien presupposed continuity of existence of the plaintiff’s property in an actual or notional form. With reference to Lord Napier and Ettrick v Hunter, his Lordship made specific reference to the award of damages secured by the equitable lien in that case being directly traceable to an identifiable fund. Such amount of property that might be traced would nevertheless be very small through application of the ‘lowest intermediate balance’ rule. What is unequivocal is the conclusion that "it would be inequitable to impose a lien in favour of the Walker & Hall claimants."

344 Space Investments Ltd v Canadian Imperial Bank of Commerce Trust (Bahamas) Ltd. [1986] 1 WLR 1072.
345 [1948] Ch. 465.
346 [1993] AC 713.
348 The lowest intermediate balance rule is a tracing rule applicable to comingled funds. The rule prevents earlier investors in a trust from benefiting from the contribution of later investors, particularly where an earlier beneficiary’s money has unquestionably left the fund. It can be explained by the idea that ‘he who suffers last, suffers less’. Its most recent and comprehensive judicial analysis comes from Canada. See Law Society of Upper Canada v Toronto Dominion Bank (1998) 169 D.L.R (4th) 353 and Boughtner v Greyhawk Equity Partners Ltd (2012) ONSC 3165.
What, in turn, seem determinative are the facts which pointed to the Walker & Hall claimants’ commercial dealings as being largely indistinguishable from those of other customers.

**Concluding comments**

The above inter-creditor competition which had to be resolved in *Re Goldcorp* illustrates the controversies and complexity that can occur when equitable proprietary claims are made to the property of failed companies. Doctrine inevitably, to some extent, has to respond to social and economic policy. That the judiciary are, and indeed should be, drawn into consideration of policy is emphasised by the following observation made by Professor Gerard McCormack:

“Failure to take on board policy considerations is - - - the gravamen of the charge of living in an unreal region.”350

This remark is made in the context of a critiquing of particular aspects of the extensive scholarship of Professor Peter Birks. Whilst it is neither practical nor appropriate to explore the underlying controversies, it is important to draw upon one assertion of Professor Birks which has attracted particular criticism from McCormack, this being that:

“Lawyers have no special competence in distributive justice. They cannot be expected to say who deserves what.”351

The following chapters, it will be seen, tend far more towards the views of McCormack in which it is acknowledged that judges are compelled to “descend into the litigious marketplace where appeals to policy hold sway.”352 If we accept McCormack’s idea that “policy considerations should be accorded more overt recognition”353, this should ideally occur within a coherent framework which gives some certainty of predicting when bankruptcy’s norms of collective treatment and pari passu ranking should be relaxed. A model of creditor entitlement recognition and bankruptcy distribution which addresses attributes of both corrective and distributive justice has merit in that it provides an intellectually intelligible structure within which policy questions can be evaluated. Such an understanding has the potential to assist in avoiding McCormack’s related concern of “extending the categories of recognised security interests which will - - - work to the disadvantage of unsecured creditors.”354

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352 Ibid.
353 Ibid at p 263.
354 Ibid.
Bankruptcy schemes impose policies extending beyond those covered by a contractual allocation of risk. Whilst these policies are desirable in themselves, complexity is inevitable when bankruptcy interacts with other branches of law – in the context of this thesis, equitable interests and remedies, and the tort of negligence. Moreover, there needs to be an understanding of the limitations and capacity of bankruptcy law to deal with wider economic and social issues falling outside the immediate concerns of a debtor/creditor relationship. This can be assisted by an appreciation of the extent that corrective and distributive justice reasoning play in formulating and understanding the relevant policies. The emphasis is placed on determining how ideas of corrective and distributive justice can guide policy decisions in different branches of the law. Clearly for the bankruptcy system to be required to recognise and reconcile an ever increasing number and diversity of claims tends to inefficiency and injustice. Arguments based on corrective and distributive justice may assist us in understanding those claims which are recognised or given distributive priority.

The pari passu principle and the associated notion of creditor collectivism are justifiably entrenched in both judicial and legislative approaches to the resolution of the affairs of an insolvent debtor. The rationale for these principles can be justified from a number of theoretical standpoints. Given what is being dealt with in the main are arm’s-length dealings between individuals, the recognition and treatment of creditor entitlements naturally attracts analysis from an economic perspective. This is particularly relevant when considering the incentives of parties, the need to regulate behaviours towards mutually understood ends, and not least the fair allocation of risk. But the central argument of this thesis is that economic analysis does not provide the only perspective on the application of the bankruptcy system – at least as it applies to tort and equitable proprietary claims. A natural law perspective, premised on determining the proper scope of corrective and distributive justice, is at least as equally convincing. The natural law perspective may in fact be preferred on the grounds that it is internally coherent because it succeeds in justifying the law in its own terms, and not in terms of external aims and policies.
CHAPTER 3

A CORRECTIVE AND DISTRIBUTIVE JUSTICE FRAMEWORK – A RIGHTS-BASED ANALYSIS OF OBLIGATIONS AND THEIR TREATMENT IN THE TRANSITION FROM SOLVENCY TO INSOLVENCY

Introduction

The most basic theoretical, as opposed to practical, question which can be asked of a system of distributing entitlements on bankruptcy is whether the system is internally intelligible or whether it can only be explained in terms of values and policies which lie outside the system. Any examination of the present system of bankruptcy administration, as it applies in common law countries, is based on certain assumptions. The system itself is part of what is conventionally understood in legal categories as public law. The trustees, liquidators, administrators and other officials are subject to public law review and their powers are defined by statute. But the entitlements which have to be distributed, because of the scarcity of resources, are private law entitlements, with the exception of statutory entitlements for which bankruptcy law makes express provision. It is in satisfaction of private claims, whether by the ‘pari passu’ or other principle, within a public law framework which is the principal task of bankruptcy law administration. Whether the claim ought to be satisfied by an application of the ‘pari passu’ principle, which is bankruptcy law’s own version of corrective justice, is precisely the matter which this thesis considers. But it is considered within the assumption of public law institutions managing what are for the most part private law entitlements. The following is therefore very much an exploration of the nature of obligations within a private law setting and how they are impacted by debtor insolvency.

3.1 An analysis of the nature of private law

Although no part of the purpose of his book, Ernest Weinrib’s analysis of private law in terms of corrective justice provides a potentially useful and intellectually coherent method of examining bankruptcy administration. The formulation of a rights-based model of bankruptcy, according to which entitlements are based on natural law principles, is premised on acceptance of particular theoretical explanations of the nature of law, particularly that of private law. In this section I both present and explain a particular normative account of private law and identify its essential underpinning in terms of corrective justice. The objective is to briefly outline a theoretical framework.

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within which a normative model of bankruptcy distribution can be developed and to present some of the fundamental components of such a model.

3.1.1 Private law understood as intelligible from within its own structure and ends

Weinrib’s exploration of private law is a quest to establish that private law is an “internally intelligible phenomenon” and rests on a secure ideological basis – hence, his book’s title *The Idea of Private Law*. His approach is avowedly normative and sits, he observes, in stark contrast to most current streams of legal scholarship whose mode of understanding law is in terms of the law’s purposes. Thus, he states, “[t]hat one comprehends law through its goals – a notion we may call functionalism”. Predominant amongst functionalist approaches is that of economic analysis with its focus on the goals of wealth maximization and market deterrence whereas other functionalist approaches may emphasise societal or community goals. Within these types of inquiry the nature of private law is relegated to a subservient or secondary consideration such that - and this is perhaps the greatest challenge Weinrib presents to functionalism - the theories explored or promulgated are not ones of private law but rather the pursuit of social goals. A further related distinction is drawn by Weinrib; this is between instrumentalism and non-instrumentalism.

Weinrib’s theorising is of course highly controversial and subject to accusations of ‘selective explanatory modelling’. These are not only doctrinal objections to formalism, but also objections to the scope of his analysis. Selectiveness is asserted by Weinrib’s critics at a number of levels. Kenneth Simons in his review of Weinrib’s *Idea of Private Law* remarks at the outset on Weinrib’s “extremely narrow conception of acceptable justifications in private law”. He goes on to analyse in greater depth Weinrib’s notion of corrective justice applied to negligence liability. Here the strict adherence to the correlativity applicable equally to injurer and victim is said to be “far too drastic and excludes too many legitimate justifications.” Similar expressions of alleged narrowness of Weinrib’s correlativity concept, argue that it is a corrective justice theory that cannot “claim to be just when it operates in total

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356 Ibid p 2.
357 Ibid p 3.
358 This alludes to the use of market based mechanisms (be they highly prescriptive ‘sticks’ or incentive-focused ‘carrots’) to direct behaviours towards desired ends.
361 Ibid at p 700.
362 Ibid at p 714.
ignorance of injustice in initial distributional allocation of resources.”\textsuperscript{363} Again, selective modelling can be seen as an aspect of Weinrib’s Hegelian-based theory of property which is said to deal too narrowly in terms of “perceived - - - embodiment of the agent’s free will” thus denying other accounts of interactions and attachment.\textsuperscript{364} It is beyond the scope of this thesis to analyse and rebut these criticisms. It is appropriate though to foreshadow how I draw on Weinrib’s doctrinal stance, where I depart from it without compromising my essentially non-functionalist stance. My thesis is, on the one hand, unapologetically doctrine-based, but adopts a stance seemingly preferred by Hanoch Dagan in which I pay close “attention to policies and values [as] a necessary component of the task of understanding, criticizing, and improving the law”\textsuperscript{365}. It is sufficient to point out that the natural law model I develop in chapter 5 does in fact take into account in a structured framework, the principles and policies which Dagan identifies.

Instrumentalist analysis, Weinrib states, views private law in terms of its contribution to the aggregate of community welfare. Instrumentalism is therefore closely allied with functionalism and, as Weinrib observes, is often expressed in terms of economic goals and outcomes. Perhaps the most significant aspect of Weinrib’s distinction between instrumentalism and non-instrumentalism concerns the latter’s relationship to moral ideas. The essence of non-instrumental private law is built around “reflect[ing] the unity, character, and distinctiveness of the - - - relationship.”\textsuperscript{366} This idea of internal intelligibility renders it necessary for private law’s distinctive morality to be sought from within private law’s framework of rights and obligations, and it is on this point that Weinrib is most dogmatic. This of course is not to say that morals have no role to play. Weinrib acknowledges that “[m]oral inquiry can be directed towards a wide variety of issues (motive, virtues of character, discrete acts, human interactions, and so on)”.\textsuperscript{367} This remark supports my argument that moral reasoning can, and should, support an internally intelligible system of legal principles. Firstly, moral theory can inform a critique of private law obligations which are recognised and enforced in the bankruptcy process.\textsuperscript{368} Secondly, it permits analysis of natural law

\textsuperscript{365} Ibid at p 4.
\textsuperscript{367} Ibid at p 50.
\textsuperscript{368} This task is undertaken in this chapter at 3.2 with reference to juridical (distinctive moral rationality) classification and in 3.3 where consideration is given to corrective justice and correlativity which Weinrib views as essential in creating private law’s internal intelligibility.
jurisprudence that can serve in developing an understanding of the objectives and limitations of bankruptcy law's distributive principles.369

Necessary therefore for my purpose of establishing a natural law based theoretical framework of bankruptcy distribution is some application, albeit modified, of Weinrib's idea of private law. Private law obligations which are affected by the intervention of debtor insolvency are resolved by a formal set of statutory arrangements. Bankruptcy distribution is instrumental in nature, concerning itself with goals of collective welfare as it affects the collective interests of unsecured creditors. A principal concern of this thesis is how a legal system defines its concept of collective welfare. Private law's relationship with both distributive justice and public law form important elements in understanding the distributive structure and limitations of bankruptcy law. Bankruptcy distribution, of its very nature, is not capable of the type of strict internal intelligibility which Weinrib ascribes to private law. Nonetheless, it is internally intelligible within a normative framework which, to revert to Neil MacCormick's words cited in Chapter 1, provides "coherence in terms of a set of general norms which express justifying and explanatory values of the system."370 To understand how this is achieved, it is necessary to identify how instrumental theories and policies operate within private law.

In his book Law as a Means to an End371, Brian Tamanaha provides a concise summary of the instrumentalist theories of the law. He notes the common feature, aside from that evident in the title of the book, as "scepticism about the capacity to achieve objectivity", and thus, a sense that theories and knowledge about the law "are inevitably colored by politics."372 Non-instrumentalists – of whom John Finnis373 and Ernest Weinrib374 are prominent - are said by Tamanaha "to hang on against the [instrumentalist] tide."375 With respect to our understanding of the objectives, logic and limits of bankruptcy law, one might ask: what is at risk or what is to be gained from succumbing to this 'tide'? Viewed dispassionately, one might treat bankruptcy distribution as a useful legal framework for testing the cogency of instrumental and non-instrumental theories of private law. My approach is to argue the merits of a non-
instrumental perspective applied to those aspects of bankruptcy law which deal with the recognition of creditor entitlements and the distribution of residual debtor funds although the systemic features of the bankruptcy system – its administrative structure and judicial processes – reflect distributive choices made on essentially instrumental grounds. The argument is that the bankruptcy system is only intelligible in terms of a system of natural law values. This chapter focuses on the internal intelligibility discernible in private law and how this perspective can be extended to an understanding of the distributive aspects of bankruptcy. Chapter 4, in turn, develops a natural law-based value system appropriate to entitlement recognition and distributive processes.

The extended title of Tamanaha’s book is noteworthy – *Law as a Means to an End Threat to the Rule of Law*. It is appropriate to briefly address here both the character of the rule of law to which he alludes and the nature of the threat. Dealing specifically with the contrast between instrumental and non-instrumental views on the law, Tamanaha presents, with reference to Lon Fuller and Joseph Raz, the formal theoretical version of the rule of law:

“ - - - the essence of which is that the government must abide by legal rules set out publicly in advance.”

Fundamental to this formality are the characteristics of legal rules and the attributes of legal officials, so that so long as such criteria are adhered to “the law can consist of any content whatsoever.” My thesis disagrees with this last proposition, namely that the content of legal rules is irrelevant to its internal intelligibility. In contrast to Tamanaha, however, the external ends which I identify the law as seeking rest on natural law theory, not on economic or social considerations.

Tamanaha further elaborates on the instrumental and non-instrumental attributes of natural law scholarship. Again with reference to Finnis and Weinrib whose natural law scholarship have respectively emphasised revival of Catholic Thomistic thought and classic Aristotelian natural law, Tamanaha remarks that:

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379 Noted are characteristics that law be clear, certain, public and stable.
380 Emphasised are ideas that legal officials act so that rules cannot be retroactive, contain contradictions or compel the impossible.
“Although each of these theorists elaborates a non-instrumental approach to the law - - - [neither] would deny that law should advance the ends of society.”\textsuperscript{382}

Significantly, Tamahana continues:

“Using law instrumentally to deal with mundane and complex issues is a fact of modern life, which these [natural law] theories acknowledge.”\textsuperscript{383}

Insolvency signifies a critical moment when the expectations of parties with legal claims are no longer capable of being fulfilled. In the remainder of this thesis I elaborate an understanding of the principles of bankruptcy distribution as being based on both corrective and distributive justice. In summary, bankruptcy procedures draw upon non-instrumental insights in terms of the admitting of claims, whilst supporting an instrumental approach to resolving an insolvent debtor’s affairs. This approach, I argue, attracts application of a form of the rule of law distinguishable from that described by Tamahana as the ‘formal’ version. The form which is considered in the following chapter (4.2.2) is essentially an Aristotelian conception developed as a basis for understanding legitimacy in the exercise of particular forms of authoritative power. This perspective is relevant to the objectives of the thesis because it explains how ideas of natural law can be incorporated into a legal system. More specifically, it explains the basis of the assumption of collective sharing of loss, as well as departures from that assumption, authorised by bankruptcy law. At this juncture it is worth briefly noting what Weinrib regards as the relevance of the Rule of Law in establishing the internal intelligibility of systems of law:

“The appeal of the Rule of Law is an appeal to the generality and impersonality of law.”\textsuperscript{384}

Significantly for bankruptcy law, its distributive processes rely on principles of generality centred on collectivism and pari passu ranking which are applied impersonally through the process of orderly admitting of claims.

Bankruptcy law might seem best suited to analysis in terms of law and economics, particularly in its corporate context of reward and risk where mis-assessment of the latter leads to failure. But can economic analysis completely explain bankruptcy? If

\textsuperscript{382} Ibid at p 131.
\textsuperscript{383} Ibid.
\textsuperscript{384} The Rule of Law; Ideal or Ideology, Hutchinson and Monahan (Editors) (1987) p 59. Specifically in relation to the attribute of intelligibility, Weinrib states in the context of a positivist instrumental conception of the Rule of Law that “this [positivist] conception of the Rule of Law is intelligible only instrumentally; it has value only in so far as it forwards the values favoured by the reformer, and its status is hostage to his assessment of its usefulness.” Ibid at p 67.
we adopt Weinrib’s analysis, we should instead seek to understand bankruptcy law as a reflection of private law in which obligations are both suspended and to varying degrees adversely affected by the misfortune of bankruptcy. Weinrib’s thesis provides indirect support of the observations of Elizabeth Warren that the reality of bankruptcy is “more complex” and is an “ultimately less confined process”\textsuperscript{385} than economic analysis recognises. A brief- law- and- economics-based explanation of bankruptcy distribution contrasted with Warren’s more expansive view, was provided at 1.1.4 of Chapter 1. My remarks here should not be taken as saying that economic method cannot be brought to bear on the analysis of bankruptcy law. But it is certainly not the only possible theoretical framework which can explain the principles on which the bankruptcy process rests.

A theory of corrective justice of the kind proposed by Weinrib allows bankruptcy law to be analysed from the perspective of private law rights, liabilities and remedies. From this perspective its private law character is more strongly emphasised and differentiated from the public law aspects of bankruptcy distribution.

In a similar manner, the corporate form fits very neatly into a functional analysis, given its clear wealth-generating orientation, which in turn attracts criticism from alternative, for example, social or communitarian based perspectives.\textsuperscript{386} But given the nature of the claims made on a liquidated corporation, which are principally private law claims, there is no reason to exclude a private law and corrective justice analysis based on the reasoning Weinrib articulates.

\begin{footnotesize}
\begin{enumerate}
\item Various theories have emerged to explain or provide a context for corporate regulation and the behaviour of participants. These serve as a useful basis to consider the contrasting demands or stresses being placed on the assumed role and function of the corporation in the economy and wider community. These include ‘nexus of contract’ theory, ‘state-conferring concession’, and associated with the latter, the ‘doctrine of separate legal entity’. While not pursued in this thesis, the comparatively radical ‘communitarian’ perspective would deny the presumed primacy of shareholder interests and further disregard the notion of corporate legal personality central to the development of the company in common law jurisdictions: “Grounded in sociology and notions of the corporation as community, communitarianism focuses on vulnerability of non-shareholder constituencies and challenges the contractual theory of the corporation.” J Hill ‘Public Beginnings, Private Ends – Should Corporate Law Privilege the Interests of Shareholders?’ (1998) 9 Australian Journal of Corporate Law 21 at p 24.
\end{enumerate}
\end{footnotesize}
3.1.2 The rejection of functionalism in the context of the applied nature of bankruptcy distribution

Weinrib identifies four assumptions of functionalism; functionalism being a mode of critiquing the law which rejects the possibility of explaining legal principles in non-instrumental terms. All four functional assumptions are germane to the application of bankruptcy law. They are, first, a denial of law as an autonomous body of learning so that "the study of law becomes parasitic on the study of nonlegal disciplines"\(^\text{387}\), and secondly "that law and politics are inextricably mixed."\(^\text{388}\) This idea of a subservience or interdependence of private law to predominately economic or political considerations when applied to bankruptcy law as a distinctive body of rules, obscures understanding of the latter’s critical function of managing the transition of legal obligations from solvency to insolvency. Nonetheless, it would be foolish and naïve to suggest that the operation and development of insolvency law can be wholly explained without reference to its economic and political context – this is particularly so when viewed from the perspective of regulating corporate failure. The statutory priorities given to certain claims on bankruptcy reflect political realities. But my central argument is that bankruptcy distribution is first and foremost a legal mechanism for ordering private law entitlements in the event of the debtor’s inability to pay debts as and when due. That this has economic consequences and is played out in the political context of legislative-based mechanisms, is a second order consideration. This is not to deny in bankruptcy law any propensity to have imposed on it economic and political criteria. Again, these are reflected in the structuring and ordering of statutory entitlements. But they are essentially modifications of the processes for ordering private law entitlements – processes which can be explained in non-functional terms.

The third functionalist assumption pertaining to the character of private law is that it has evolved its own ritually invoked “terms and concepts”\(^\text{389}\) which create a veil that is prone to piercing\(^\text{390}\) upon external rational (functional) analysis. I hope to demonstrate in this and the next chapter that the elaboration of a non-instrumental model of bankruptcy does not involve the creation of veils. In Chapter 4 I give extensive consideration to the evolution of natural law jurisprudence as a basis for informing a contemporary understanding of the ethical aspects of the event of bankruptcy and the moral issues at play in the resolving of inter-creditor disputes.

\(^{388}\) Ibid p 7.
\(^{389}\) Ibid.
\(^{390}\) Ibid.
The terms and concepts of bankruptcy distribution can be examined in their own right without reference to functional outcomes.

The fourth functionalist assumption highlighted by Weinrib is that there exists no distinction between public and private law, so that all law is public in nature, varying only in the means - legislation, adjudication, administrative instrument – through which a community's purposes are manifested.\textsuperscript{391} Again, in Chapter 4, I reject this assumption, arguing that the distinction between private and public law is essential to understanding the nature of judicial intervention on bankruptcy.

I add one further related observation concerning these assumptions of functionalism. Social and economic theories overlook or minimise the accumulated history of moral and philosophical contemplation of the nature of the law within human relations and endeavours. The centuries of development in the law's treatment of an individual debtor's insolvency is an important source for understanding the moral, as well as economic, principles which inform bankruptcy.

3.1.3 Normative explanations of private law connections and interaction

Weinrib concludes his description of the assumptions of private law with the following statement of purpose:

“\textit{I will argue the private law construes the litigating parties as immediately connected to each other. Interaction so conceived is categorically distinct from that of public law, which related persons only indirectly through the collective goals determined by state authority. The different mechanisms for enunciating legal norms – adjudication and legislation – broadly reflect the different contours of these two modes of interaction.}”\textsuperscript{392}

It is worthwhile examining elements of this statement because it justifies an analysis of the private law character of bankruptcy. Three aspects deserve attention.

First, I consider the idea that private law deals with parties immediately connected through litigation. This idea of an immediacy of connection is explored in the discussion below of corrective justice and correlativity (3.3), and how this might inform the process of granting priority as between different classes of creditor relationship. Here, however, I consider the more immediate and specific context of

\textsuperscript{391} Ibid.
\textsuperscript{392} Ibid p 8.
how bankruptcy law is structured in order to deal with the admitting of claims. It can be observed that the process of connecting the parties through litigation is central to an understanding the private law character of bankruptcy. The bankruptcy process itself in certain instances translates what would otherwise be a litigation-based connection between parties into an entitlement in bankruptcy distribution. This is illustrated by the manner in which corporate insolvency law has evolved to deal with contingent claims, in particular the category of unliquidated damages. Whilst there is some variation in the definition of unliquidated debt393, what is common is the certainty of the existence of a loss, the monetary quantum yet to be determined either by a jury or by a court ruling on the elements to be calculated. In Weinrib’s terms there is a litigation-based connection between two parties. As described in Chapter 1, within the Corporations Act 2001 an expansive approach is taken in the admission of creditor claims. Professor Keay has remarked that:

“The general rule as regards proof in winding up is that any debt is provable which might have been enforced against the company immediately prior to winding up.”394

The statutory provisions for both personal bankruptcy395 and corporate insolvency396 make specific reference to the admissibility of debtor claims where the amount is uncertain. An important distinction, however, is that personal bankruptcy law specifically excludes from proof claims for unliquidated damages in respect of personal torts.397 Professor Keay’s discussion of the rationale for this distinction between personal bankruptcy and corporate insolvency law is convincing. He states that, with respect to natural persons, the law has always permitted such claims to be enforced against the bankrupt after discharge. In contrast, the eventual deregistration of the insolvent398 corporate entity makes impossible the re-enlivening of such actions. Keay adds further that:

“- - - the only grounds on which the bankruptcy rule can be justified in its application to winding up is that corporate liability for torts is necessarily

393 See for example Ex parte Ruffle (1873) 8 Ch App 997 and Alexander v Ajax Insurance Co Ltd [1956] VLR 436. 
395 Bankruptcy Act 1966 s 82.
396 Corporations Act 2001 s 553.
397 Bankruptcy Act 1966 s 82(2) states that: “Demands in the nature of unliquidated damages arising otherwise than by reason of a contract, promise, or breach of trust are not provable in bankruptcy.”
398 It is noted that the rules of proving contained in s 553 are applicable to both solvent and insolvent companies.
vicarious, so that the injured person always retains the right to proceed against the individual tortfeasor.”

This anomaly was removed as a result of the Harmer Report reforms so that the current treatment of uncertainty in the value of a debt will include:

“... claim[s] relating to proceedings for a breach of a contract where unliquidated damages are being sought or a claim based in tort where, again, the value of the claim cannot be determined until the proceedings are finalised by the Court considering the matter.”

What we have here is a contemporary example of a formalised distributive principle which, immediately prior to insolvency, is based on a litigation-based connection between parties, the law having now intervened to convert a cause of action into a component in the collective claims against the debtor. That this level of formality has evolved is a reflection of the need for bankruptcy law to deal rationally with corrective justice-based claims, albeit in a distributive based framework. Moreover, such treatment is a reflection of what justice dictates and is fully explainable within its own terms. Resort to an economic or social justifications is unnecessary to this, one of the most critical distinctions between bankruptcy and insolvency law.

I turn, secondly, to Weinrib’s notion that private law and public law are categorically distinct. The coercive authority of the State has been critical to the long history of the development of bankruptcy law towards its present highly formalised approach to the orderly resolution of a debtor’s affairs. In this process the particular attribute whereby creditors surrender their rights is one by which individuals cease potentially to be immediately connected by litigation and instead are connected through the application of pari passu sharing – this being a collective goal. Again, this process can be understood as a feature of bankruptcy law functioning at the threshold between corrective and distributive justice. Whilst Weinrib’s insistence on a categorical distinction between public law and private law holds true, in the context of bankruptcy distribution it is the character of private law rights which informs the recognition of entitlements while the separate public law process of enforcing pari passu distribution enforces the entitlements to the extent that the debtor’s scarcity of resources permits.

401 Australian Corporations Commentary, CCH Australia Ltd 2009, [162-510] Debts and claims of uncertain value: sec 554A.
Finally, Weinrib’s assertion that adjudication and legislation reflect contrasting modes of legal application requires analysis. In the next chapter consideration is given to the development and application of legal rules, or more precisely higher order deductive norms, which adhere to what Professor Neil MacCormick describes as “value-coherence within the legal system” and have what Robert Austin terms explanatory and justificatory force. The chapter considers the justification and limits of judicial discretion in imposing a reordering of entitlements. Suffice to say that whilst bankruptcy law signifies a demarcation between developments in adjudication-based norms governing private obligations and legislative rules directed at the orderly resolution of an insolvent debtor’s affairs, it would be erroneous to insist on a complete separation between adjudication and legislation in this context. The interaction is reflected in the scheme for distributing private rights in bankruptcy, as well as in handling tort claims in a corporate context, and in the role of discretionary equitable considerations in applying the pari passu principle.

An understanding of the function of adjudication in bankruptcy is vital to the development of normative propositions as to how bankruptcy law should function. Applying the notion of ‘coherence’ in a manner slightly different from Weinrib’s usage, MacCormick maintains that coherence is that characteristic of the law whereby “multitudinous rules of a developed legal system should ‘make sense’ when taken together.” Notwithstanding its complexity, bankruptcy law generally adheres to this ideal. MacCormick’s further proposition is that the ideal of coherence promotes an understanding “delimiting the field within which judicial law-making is legitimate.”

The challenge for the development of bankruptcy rules when viewed in the context of Weinrib’s idea that adjudication and legislation broadly reflect respective private law and public law interaction, is the scope for judicial law-making in allowing continuity of pre-bankruptcy rights in the recognition of distributive entitlements. Too great a reliance on legislatively prescribed distributive outcomes might come at the cost of targeted flexibility applied by adjudication.

So far I have argued that the distributive features of bankruptcy law, whilst not inseparable from private law, must be closely informed in the admission and ordering

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405 Ibid at p 153.
of entitlements by the nature of private law obligations. The manner of this informing is more fully explored in section 3.3 below. Here it is appropriate to more fully examine Weinrib's propositions as to how the question 'what private law is?' might be answered and thus made internally intelligible. In so doing I will demonstrate how bankruptcy conforms to the ideal of internal intelligibility.

3.1.4 Bankruptcy's institutional and conceptual features explained through private law's internal intelligibility

Essential to Weinrib's inquiry into the nature of private law, as with most intellectual inquiries, is the assumption that the basis of one's theorising about the nature of a thing depends on how it is experienced. Whilst there are a multiplicity of issues and characteristics in play within a particular field of experience, it is only those features – the salient features - which are essential to our understanding of the character of a thing, and upon which a theory can be founded. With respect to the law, these essential features explain 'what law is' and inform our idea of the internal coherence of the law. It is this idea of coherence that is fundamental to the rejection of functionalism and its central need to inquire into external goals. Weinrib's elaboration of the phenomenon of private law identifies some minimal features without any of which private law's distinctiveness would be lost. These features are both institutional and conceptual. Private law's institutional features include the recognition of actions and the processes of adjudication and judgment. The latter includes the enforcement of judgments.

If we were to adopt the view that bankruptcy law might be so distinctive as to warrant development of its own non-functionalist theory, we would recognise its institutional features as those of the moratorium against individual creditor actions, the sequestration of the debtor's property, the liquidation of such assets, and finally, the distribution amongst creditors after the recognition of proprietary and priority claims.

It is, however, the conceptual features of Weinrib's notion of a non-functionalist private law theory that are most distinctive and to which he gives greatest prominence. He states that:
“- - - private law embodies a regime of correlative rights and duties that
highlights, among other things, the centrality of the causation of harm and the
distinction between misfeasance and nonfeasance.”406

Continuing this idea of a non-functional theory, we can validly conjecture that the
conceptual features of bankruptcy law are those of collectivism, pari passu ranking
and the setting aside of antecedent transactions and fraudulent dispositions.
Recognition of these, along with the above institutional features, facilitates further
elaboration of bankruptcy law doctrine. The greater challenge however, is to explain
how Weinrib’s exposition of the conceptual features of private law informs what I
have identified as the basic conceptual features of bankruptcy law and its prioritising
of different interests. Speculation on the nature of bankruptcy law doctrine cannot
take place in isolation from analysis of underlying private law doctrine. This is so
notwithstanding the legislative character of private law.

In Weinrib’s pursuit of a non-functional theory of private law the following is
acknowledged as fundamental:

“- - - the master feature characterising private law [is] the direct connection
between the particular plaintiff and the particular defendant.”407

Bankruptcy law is distinct in the sense that, in the main, debtor and creditor are no
longer directly connected. Instead they are represented through the intervention of a
trustee, for personal bankruptcy, or a liquidator, for corporate insolvency. This does
not necessarily prove that bankruptcy law is fundamentally different from private law.
The broader focus of private law informs the conceptual features of bankruptcy law.
Moreover, the event of bankruptcy creates a challenge to private law’s conceptual
attribute of “correlative rights and duties”. A theory of bankruptcy law can to a
significant degree be constructed in non-functionalist terms if one puts to one side its
institutional features. What is crucial is the perspective taken on how claims are
admitted and on how the conflict between claimants resolved. These aspects of the
bankruptcy system are most convincingly explained in terms of corrective justice
(refer below discussion in 3.1.3). Weinrib recognises this explanation when he states
that the central task of private law theory is to “illuminate the directness of the

between misfeasance (doing something badly or improperly in relation to a duty) and
nonfeasance (non-performance or refusal to perform in relation to a contact) is dealt with by
Weinrib in his earlier writing “Right and Advantage in Private Law” (1989) 10 Cardozo Law
Review 1283 at p 1298. The overarching distinction between right and advantages is
considered in 3.4 of my thesis.
407 Ibid.
connection between the parties.” The fundamental task in the admission of creditor
claims is, in a non-litigious setting, to assess the directness of claims between
creditor and debtor. Many of these claims will be relatively uncomplicated so as to
attract ordinary pari passu treatment, whereas others will have additional features
which warrant treatment by way of exception to the pari passu principle in the form of
proprietary remedy or priority ranking.

Weinrib’s explanation of private law as internally intelligible is a precise one. It is
therefore appropriate to apply his analysis to determine whether bankruptcy law
conforms to the ideal of internal rationality. He states “that private law is
simultaneously explanandum and explanans.” The matter sought to be understood
and the means of understanding are internal to themselves – the content and the
means of understanding being one and the same. Hence the concept of correlative
ity as the relationship between the doer and sufferer of an injury is the essential
component of Weinrib’s idea of private law. Bankruptcy, however, clearly differs from
this model as there are a multiplicity of parties affected by the event of bankruptcy.
Nonetheless, it is by this type of inquiry that we are better able to understand the
wider community of interests in bankruptcy law’s resolution of insolvent debtors’
affairs.

So far I have emphasised that bankruptcy law differs from Weinrib’s conception of
private law in that it necessarily deals collectively with the interests of creditors. But it
is important to keep in mind that its manner of dealing is directly informed by the
character of private law obligations. In addition, bankruptcy law has characteristics of
a social phenomenon in which there are considerations of deterrence and
rehabilitation. In this regard a perspective of bankruptcy law addressed exclusively
through the notion of private law as a self-understood enterprise allows a better
defining of the bankruptcy law’s primary objectives. This will be in contrast to
bankruptcy’s ancillary, though significant, purposes which are collectively achieved
through a complex interaction of statutory and judicial mechanisms – namely the
institutional features described above. Bankruptcy law should primarily be regarded
as a distributive mechanism to which there can be added secondary objectives of
deterrence and rehabilitation. Significantly however, bankruptcy distribution gives

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408 Ibid at p 11.
409 Ibid at p 14. The components of an explanation. Explanandum and explanans are two
forms of the same Latin word; explanans is the means of ‘making plain’ whilst explanandum is
effect to corrective justice principles by virtue of its seeking to return to creditors as much as they are owed, allowing for the fact that the debtor cannot satisfy everything that is owed.

Weinrib’s model of private law as a self-understanding enterprise\footnote{Ibid.} comprises several aspects. Each of these can be analysed as a challenge to our understanding of bankruptcy law. Developments in bankruptcy law are only acceptable if they are consistent with the internal intelligibility of private law that he identifies.

First, Weinrib maintains that private law is derived through the engagement of thought and intelligence as distinct from being deduced through the observation of regularities. It is a logical consequence of this insight that bankruptcy as disruption of expectations of parties to a legally recognised relationship might be understood by observation of the specifics of its causes and impacts. Drawing instead on Weinrib’s approach, this thesis argues that any analysis of bankruptcy law must be based on the essential character of private law obligations. The rational explanation of private law is also, in part, the source for explaining the prioritising of different interests in bankruptcy. The nature of private law as a mode of intelligent inquiry causes Weinrib to conclude that:

“- - - [t]o regard law in this light is to take seriously the ancient commitment of natural law theorizing to the possibility that law resides in the reason.”\footnote{Ibid.}

In the following chapter I develop further the idea of natural law reasoning as a basis for understanding the relationship between debtor and creditor, particularly in the transition from solvency to insolvency.

The second element of private law as a self-understanding enterprise is the idea that the resolution of private law controversy is undertaken within its own framework – thus the notion of coherence. To reiterate, Weinrib presents the idea of self-understanding as one in which the solution to understanding comes from within the subject matter itself. Whilst I have observed above that bankruptcy law may contain a discrete set of conceptual features, these can function only in terms of their interaction with other bodies of law – be they the different forms of personal obligations, property law, or the complex body of rules which go to make up corporate law. Rather than undermining the notion of bankruptcy law’s own discrete intelligibility, the nature of bankruptcy law’s essential elements which enable the
proving, admitting and ranking of claims, along with the resolution of conflicting claims, is based on a perspective of private law’s own intelligibility and coherence. This is an important source for understanding the limits of bankruptcy law and what can reasonably be expected of it within societal and economic contexts without damaging its own coherence.

Finally, Weinrib observes that self-understanding of private law is a dynamic process “exhibit[ing] human intelligence rather than - - - divine omniscience.”412 This distinction is relevant to the possible application of contemporary perspectives on natural law jurisprudence to an understanding of bankruptcy law’s recognition and treatment of creditor entitlements.413 He also notes that the dynamics of self-understanding does not deny the possibility of other disciplines “yielding useful insights.”414 Essentially what Weinrib concedes in his theory of private law, is that legal development in its dynamic may include a consideration of these insights. Nonetheless, these other disciplines cannot “claim primacy in the interpretation”415 of what private law is. This would contradict the essential intelligibility and coherence. Bankruptcy is prone to social and economic controversy given its inherent need to examine, interpret and reconcile competing demands. Such exploration clarifies our understanding of bankruptcy law. Social and economic factors do not explain bankruptcy law but they can explain the dynamic of development and modification of the law.

To sum up, the theory of private law presented by Weinrib is constituted of “three mutually reinforcing theses”.416 First, the framework itself is seen as self-contained and self-sustaining (immanently intelligible) requiring no reference to external functional justification. The internal intelligibility is the source of private law itself and is the basis for understanding legal relationships.

The second essential thesis in Weinrib’s theory of private law is that of Aristotle’s conception of corrective justice as the foundation of private law relationships. These relationships are uniquely bipolar or reciprocal. Weinrib remarks that:

412 Ibid at p 15.
413 See Chapter 3.2.1
414 Ibid at p 17.
415 Ibid.
416 Ibid at p 18.
“And by decisively distinguishing between corrective and distributive justice, Aristotle established the categorical difference between private law and other legal orderings.”\(^{417}\)

The third and final vital component of Weinrib’s theory of private law is that the normative basis of corrective justice is to be found in Immanuel Kant’s philosophy of right and his foundation of rights and obligations in ideas of individual autonomy and freedom of interaction with others. I argue that it is unnecessary to consider the objectives and rationale of bankruptcy law in terms other than the moral or ethical explanations of the character of legal relationships. These explanations of bankruptcy are discussed in the next section of this chapter where I consider the applicability to bankruptcy law of a concept of moral rationality of private law obligations, and again in Chapter 4 – there in terms of the insights gained from natural law jurisprudence.

Weinrib recognises the challenge of moral reasoning to his Aristotelian conception of private law:

“Because the negligent defendant’s culpability seems morally detachable from the fortuity of injury, liability for negligence poses a particularly severe challenge to the stringent notion of coherence that I shall be developing.”\(^{418}\)

In a similar vein, it is fair to conjecture that my particular analysis with its emphasis on the basis of bankruptcy law in morality might be thought to undermine the cohesion of private law. But there is no necessary contradiction between internal coherence and morality. With reference to Weinrib’s concluding remark in his introductory chapter to The Idea of Private Law that “the purpose of private law is simply to be private law”\(^{419}\), it can be stated that recognition of the positive law aspects of bankruptcy need not signify the surrendering of internal consistency. Rather, it creates the necessity to clearly identify and understand the relationship between private law’s objectives and those of bankruptcy distribution. In the case of bankruptcy, its rationale must both recognise Weinrib’s insistence on internal coherence and be based on a morality that explains its collective principles. Natural law provides both the basis for bankruptcy in morality and the source of its internal intelligibility.

\(^{417}\) Ibid at p 19.  
\(^{418}\) Ibid at p 20.  
\(^{419}\) Ibid at p 21.
3.2 A juridical formulation of private law obligations

Continuing the idea of building a model of bankruptcy distribution on a theory of private law, this section introduces the first element in developing ethical attributes essential to a normative explanation of the dealings between debtors and creditors for the purpose of ensuring orderly and rational distribution. The perspective is drawn from the moral rationality of private law – this, being an essential premise upon which a more detailed natural law-based explanation is founded. The discussion introduces the dilemma created by different types of pre-existing relationship: how they are differently impacted by supervening debtor insolvency, and how understanding can be achieved by applying a perspective based on the correlativity essential to corrective justice? The notion of correlativity is more fully explored in subsequent sections of this chapter.

3.2.1 Moral rationality in the ordering of private law

Analysed in this section is the application of an approach to the classification of obligations. It is proposed as an initial, though incomplete, basis for the better understanding of creditor entitlements in bankruptcy. Ernest Weinrib in Chapter 2 of Peter Birks’s edited *The Classification of Obligations* sets out his objective in the following terms:

“The theme [of] juridical classification, lies at the juncture of the theory of private law and the classification of the obligations of private law. A classification is ‘juridical’ (as I shall use the term) if it reflects the distinctive moral rationality that is implicit in private law and that animates it from within.”

It is of significance that Weinrib extends the meaning of ‘juridical’ beyond its relatively neutral expression of things, issues or events pertaining to the law and its administration. Consistent with his previous analysis, Weinrib argues from a standpoint by which the law is reconcilable from its own “distinctive” rationality. It is this rationality that gives normative underpinning to the common law to which its application may not necessarily conform. The challenge in applying these principle-based ideals to bankruptcy rules, which of their very nature are heavily outcomes-oriented, is to identify how to translate abstract explanations of human interrelationships into guiding principles which, to use Robert Austin’s terminology, have ‘justificatory force’. It is to these ends that analysis from the perspective of an

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421 Ibid.
appropriate classificatory framework plays a significant function. The following analysis of Weinrib’s juridical classification in terms of bankruptcy distribution will in a number of respects fall short of describing how the law in this critical area actually functions. But an important theme of my analysis is to present a robust basis for identifying, and potentially reconciling, gaps between the normative justification of bankruptcy and its realisation in practice.

The themes of ‘moral rationality’ are considered in this and the following section in the context of philosophical concepts of right as a source for informing the nature of private law. In Chapter 4 moral and ethical theories are considered in the context of analysis of natural law jurisprudence and the Rule of Law. There the emphasis is on identifying how abstract normative principles might be seen as ideally convertible into a coherent and authoritative body of legal rules. The objective also is to overcome some of the challenges in applying Weinrib’s predominant theoretical orientation on private law relationships to the practicalities of bankruptcy administration.

Weinrib’s account of a coherent classification of obligations derived from the implicit moral rationality of private law has its basis in a criticism of Roman law’s categorising of contract.422 The deficiency relates to an absence of unifying principle which is overcome in Weinrib’s scheme by reference to the nature of legal right as being “inherent in the interaction of self-determining agents.”423 Moreover, the source of confusion in Roman law classification is said by Weinrib424 to be its tendency to mix that element which is implicit and rational in the interaction of ‘self-determining agents’, with the necessary attributes of positive law. Positive law, nonetheless, promotes the enforcement of such rights. Weinrib’s states that he is not concerned with assessing the various criticisms of Roman law classification. Deficiencies in classification of legal entitlements are, however, an issue to which I return in considering the internal coherence of private law.

Weinrib’s approach to the classification of private law is based on three underlying ideas.425 First, the distinction between different kinds of obligation should form a unified conception. It is necessary at this point to provide a simple definition of

422 The criticism referred to by Weinrib derives from Georg Hegel’s The Philosophy of Right (originally published in 1820). Hegel identified a tendency of Roman Law to treat various kinds of contract as separate autonomous categories without having found any unifying contractual principles.
423 Ibid at p 39.
424 Ibid.
425 Ibid at p 40.
‘obligation’. To this end it appropriate to rely on a well known Roman Law definition set out in J. Inst. 3.13:

“An obligation is a legal tie which binds us to the necessity of making some performance in accordance with the laws of our state.”

The ideas of ‘legal tie’ and ‘performance’ are critical, so that in a bankruptcy context we are dealing with how legal ties are created, and the consequences of breaches of these ties with the additional feature, not adverted to by Weinrib, that the liabilities imposed by these ties are collectivised.

The second element is that described above concerning the non-mixing of normative and institutional aspects of private law. The third classificatory element concerns the notion that the distinctive inner rationality identified between obligations is based on juridical norms – that is, those of moral rationality. This constitutes the non-functional mode of understanding private law. This rather abstract, and perhaps even somewhat circular, description of classification of private law is justified by Weinrib in terms of the principles of corrective justice. Corrective justice provides the bridge to classifying obligations. Both the coherence and juridical norms urged by Weinrib have their source in corrective justice. Corrective justice is considered firstly here as the basis of a classificatory framework. Secondly, in the next section, corrective justice is considered in terms of its particular Aristotelian mathematical expression.

Weinrib observes, in relation to his posited classificatory framework, that it will either exclude or will not be applicable to ‘contextual categories’ – these being a body of rules which “bring together the miscellany of law relevant to a given social context.” Applied to the subject matter of this thesis, both bankruptcy law and corporate law are highly contextually based, particularly in terms of both the social conditions within which they are applied and their economic ramifications. Moreover, contextual elements may be apparent in terms of their drawing together elements of different bodies of legal rules. But even though bankruptcy operates within the economic context of financial failure, it does not have to be justified in terms of this context. The appropriate framework within which to assess the norms of bankruptcy law is one which recognises its basis in both corrective and distributive justice. Corrective justice helps to explain the application of the basic pari passu rule, and, even though distributive justice explains exceptions to that rule, the starting point for

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426 Ibid. An example would be family law.
inquiry is to examine the extent to which the bankruptcy process gives effect to principles of corrective justice.

Essential to Weinrib’s description of corrective justice as a basis for classifying private law obligations is corrective justice’s explanation of the idea of correlativeity. It is appropriate to explore here how correlativeity assists our understanding of the objectives of bankruptcy distribution, particularly where a multiplicity of creditors in different categories are involved. Corrective justice’s explanation of liability centres on the identification between two parties of an injustice in which one person is the active correlate of the passive other person. First, dealing with this idea of a connection between two parties, corrective justice, as Weinrib conceives it, has the character of determining within an exclusively bipolar relationship, to whom and from whom liability is recognised. The determination involves no question of need or virtue. Bankruptcy law does not reallocate resources on the basis of need. Rather, bankruptcy supplies an institutional framework for reconciling claims based on corrective justice. Indeed, not to apply corrective justice would undermine the rational, just and predictable resolution of an insolvent debtor’s affairs and may attract the type of opportunistic behaviour described by Baird and Jackson⁴²⁷. Secondly, what a corrective justice perspective does not admit is the notion of deterrence as a basis for imposing liability, particularly in instances of tortious wrongdoing – the main area of private law considered by Weinrib in The Idea of Private Law. Without stretching Weinrib’s rationale beyond reasonable bounds, his explanation of the role of deterrence in tort can be applied to the objectives of bankruptcy law. Weinrib remarks that:

“Under corrective justice - - - deterrence cannot count as [a] reason for repairing tortious wrongs: deterrence applies to the defendant without giving a reason for awarding damages to the particular plaintiff.”⁴²⁸

While the role of deterrence in the law cannot be denied, it is consequential on the need to repair the loss – corrective justice which focuses on rectifying the inequality created by the wrong. The fact that private law deters is merely a side effect of achieving corrective justice. Bankruptcy law, when considered in terms of its institutional attributes, has what might be considered deterrent features. These include rules directed at attacking antecedent transactions and dispositions of property and, in the more specific circumstances of corporate insolvency, the

⁴²⁷ Refer Chapter 1 discussion in section 1.1.3.
attaching to directors of personal liability for corporate debt incurred whilst trading insolvent. Although the rules appear to be deterrent, and therefore distributive in character, their function is to actually promote corrective justice by maximising the assets available for creditors in giving effect to the pari passu process.

3.2.2 Private law remedial responses and bankruptcy’s distributive objectives
Consistent with the previous discussion of the conception of private law as self-sustaining and internally intelligible, Weinrib describes the remedial function of damages in the following terms:

“Under corrective justice, the reason for taking damages from the defendant is the same as the reason for awarding damages to the plaintiff.”429

Damages nullify the harm suffered by the plaintiff as a result of a wrong committed by the defendant. Damages, in corrective justice terms, rectify the wrong. How then does the corrective justice objective of rectification assist in explaining the rules of bankruptcy distribution? And how should we understand the complex process of determining those claims that persist either in specie (proprietary remedies) or in some other way be elevated (a priority), as opposed to those claims which are subject to collectivism, and thus, the pari passu distributive norm? These issues can be understood with reference to the contrasting allocative objectives contained in Weinrib’s distinction between the rationale of corrective justice and that of distributive justice:

“The rationality of distributive justice is comparative (the greater share goes to the more meritorious), whereas the rationality of corrective justice is correlative.”430

A greater proportional share by way of priority or proprietary remedy is clearly corrective justice-based as it allows the idea of correlativeity to be carried over into the distributive framework of bankruptcy. From the perspective of competing creditors however, the outcome appears to be based on distributive, not corrective, justice insomuch as one party’s merit is being treated more favourably than another’s. However, merit in bankruptcy law cannot be treated in isolation from either corrective justice outcomes had insolvency not supervened, nor in terms of its impact on competing creditors whose share of the debtor’s estate or residual assets will be irrevocably diminished. In the absence of the application of statutory priorities, rights

429 Ibid at p 42.
430 Ibid at p 43.
enforcement is essentially based on corrective justice, reflected in pari passu ranking which seeks to return to creditors collectively the maximum amount available.

Furthermore, as Weinrib points out, “corrective justice can be effective only through the doctrines and institutions of private law.”431 In a bankruptcy context, of course, the institutions are judicial and administrative structures which adjudicate upon, and enforce, the pari passu rule and its exceptions.

Weinrib emphasises the common feature which binds different kinds of right with different kinds of relationship. He states:

“The task of specifying different kind of relationships is facilitated by the fact that corrective justice admits no more than two interacting parties.”432

Bankruptcy distribution as a mechanism for resolving different kinds of claims cannot be explained in terms of Weinrib’s concept of bipolarity. It deals with a number of interacting parties: each creditor with the debtor; as between each creditor of competing classes; and even, as between creditors and those to whom the debtor may have favourably or fraudulently transferred assets in order to defeat claims. This points to features of bankruptcy law which are predominantly based on distributive justice. But how the corrective justice principles of bankruptcy law combines with its distributive aspects is a complex question which my theoretical model, in Chapter 4, explains. Applying this model Weinrib’s corrective justice analysis is the starting point for explaining the ordering of claims in bankruptcy and the application of the pari passu principle. The critical question is then: how is corrective justice modified by supervening bankruptcy?

Turning specifically to Weinrib’s categories of legal relationship, the major source of division is that between relationships arising out of “independent pursuit of separate interests”433 and those created through the “common pursuit of independent interests”.434 The former gives rise to an injustice when the defendant’s independent pursuit of his or her separate interest has infringed upon another’s (the plaintiff’s) rights – this is the justification for the law of tort and unjust enrichment. The common pursuit of independent interest occurs in cases of a transfer – Weinrib insists that this must be substantially more than a mere mutual or reciprocal exchange. Rather, it signifies the exercise of a common free will through which the two transacting parties

431 Ibid.
432 Ibid at p 44.
433 Ibid at p 44.
434 Ibid at p 45.
“consensually accomplish their purposes” – hence, the categories of gift and contract. To these kinds of relationship, a third category of obligation is added, namely fiduciary relationships which places one person under an obligation to act in another’s interest in a manner which precludes the fiduciary from exploiting the relationship for gain.

This classification of relationships informs the resolution of rights and the recognition of liability in the context of bankruptcy law in three crucial ways.

The first concerns the treatment of contract claimants. What was otherwise the pursuit of a common independent interest between debtor and creditor is suspended, so that as between competing consensual creditors their claims are prima facie on an equal footing.

The second concerns the treatment of negligence claimants. To allow these non-consensual claimants to be treated pari passu with contract claimants raises issues of fairness when viewed from the perspective of being non-volunteers to a relationship and, at least in some cases, the related inability to protect one’s position in the event of debtor insolvency. Subjective ideas of fairness are of themselves insufficient to overcome the established tendency to adhere to the strict hierarchical formulation of priority ranking which gives both predictability and avoids excessive judicial involvement in the distribution process. This is not to deny that some consensual creditors will have incurred losses or changed their position on the assumption that the debtor was solvent. For contract claimants, without some other particular circumstance, no specific right has been infringed beyond achievement of that contractual goal which was to be pursued in common – so there is no special reason for departing from the pari passu principle. There may be special reasons in some cases, for example where the contract also constitutes a fiduciary relationship so that one contracting party is subject to the exercise of discretion by the other party, but in the general run of debtor/creditor cases the rationale of corrective justice justifies only proportionate recovery by the creditor. Application of corrective and distributive justice principles to a multi-party insolvency setting is considered in more detail in the following section of this chapter (3.3). A justification for altering priority treatment amongst otherwise equally ranking unsecured creditors requires a further point of reference. The model developed in this thesis considers the interaction of ‘merit of creditor claim’ with presumptions that can be drawn about ‘virtue of debtor conduct’ in the treatment of multiple claimants. The source of these
considerations is drawn from contemporary re-evaluations of natural law theory considered in the next chapter.

Third, and finally, the classification clarifies how property interests should be enforced in a bankruptcy context. Independent property interests can be enforced except to the extent that they adversely impact upon “the other’s rights to personal integrity and to property.”\(^{435}\) The consensual attributes of pursuit of interests in common infers the alienation of property. More particularly, in terms of the character of contract, the promise of one party is itself “regarded as something that belongs to the other.”\(^{436}\) One of the key points I stress throughout this thesis is that bankruptcy represents a critical transition point at which both existing rights and the expectation of acquiring rights are initially suspended. They are then resolved with reference to predetermined criteria.

It is appropriate here to introduce a related notion of property. This is relevant to understanding any specific allocation of the debtor’s identifiable assets that may occur, followed by distribution of the residual deficient estate amongst remaining claimants.

Peter Birks in his chapter in *The Classification of Obligations*, where he discusses Justinian’s analysis of the law of obligations, remarks that “[t]he law of obligations aligns with the law of property.” He notes in particular that “the former is concerned with rights *in personam*, the latter is concerned with rights *in rem*.\(^{437}\) Birks makes an observation concerning Roman Law classification in Justinian’s Institutes 2.1\(^{438}\) and 2.2\(^{439}\), which divides private law into the categories of persons, actions and things. ‘Things’ is further sub-divided into corporeal and the incorporeal rights, with the latter including the category of obligations.\(^{440}\) Expressed in terms of the character of the right that can be asserted, Birks continues:

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\(^{435}\) Ibid.

\(^{436}\) Ibid.


\(^{438}\) The Classification of Things. This threefold division is attributed to the *Institutes of Gaius*. It is stressed here that Birks’s treatment of the division is the source of controversy, and indeed, his dogmatic advocacy of associated legal taxonomy has been the subject of criticism. See Geoffrey Samuel “English Private Law: Old and New Thinking in the Taxonomy Debate” Oxford Journal of Legal Studies, Vol. 24, No. 2 (2004), pp. 335-362.

\(^{439}\) Incorporeal Things

\(^{440}\) The other categories of incorporeal things are inheritances and usufructs (a right to take and use profits of land or chattels).
“A right in rem is a right the exigibility of which is defined by the location of the thing. The exigibility of a right in personam is defined by the location of the person. Where I have a right in personam the notional chain in my hand is tied round the person’s neck. Where I have a right in rem, the notional chain is tied around a thing.”

The distinction within Justinian’s scheme between rights that are recognised in personam and those which can be enforced in rem provides the basis for the treatment of claims in bankruptcy distribution. Claims based on the tort of negligence, which I will argue on the basis of Weinrib’s categories of legal relationship might prima facie be elevated in bankruptcy distribution, can only be treated by way of priority within the ranking of unsecured creditors. This is so as there is generally no specific asset under the control of the debtor to which the violation of the creditors’ interests or rights pertain. Further, as between claimants in negligence and those capable of asserting a proprietary claim, the former can have no superior right. This is because the relationship between the law of obligations and the law of property dictates that the thing to which the ‘notional chain’ pertains has been alienated and thus can never be part of the pool of assets to be allocated among unsecured creditors.

Although not a major theme of my analysis, the above distinction can be applied to an examination of the rationale for the taking, and then the treatment in bankruptcy, of secured credit. This, it will be recalled from Chapter 1, is the context in which Baird and Jackson, and Elizabeth Warren, debate the logic and rationale of bankruptcy collectivism and pari passu ranking. The behavioural attributes of risk align with the law of property – the taking of security attracting legal consequences only in terms of property law. This central feature of debtor/creditor relationships in both the pre- and post-insolvency contexts can be understood without reference to external criteria of economic incentive.

Weinrib in the concluding parts of his Juridical Classification of Obligations, asks the question “can the different kinds of rectification be the basis of juridical


442 The contrast between consensual and non-consensual unsecured claimants is explored further in section 3.3.1, there in the contexts of merit of claims, virtue/ un-virtuous conduct on the part of debtor and the nature of consent. The theme of virtue is developed also in Chapter 4 (4.2.1.1).
classification”\textsuperscript{443}; and proceeds to answer his own question in the negative. The answer also means that categories of rectification are not the basis for classifying entitlements in bankruptcy. We must rather attend to the nature of existing rights infringed by the event of bankruptcy. In this way we are able to distinguish between those creditors whose rights are converted into claims, though elevated over or ahead of other creditors, the latter who must be satisfied from the residual pool of assets. This means also that correlativity by itself cannot determine entitlements in bankruptcy.

3.3 The character of corrective justice and correlativity
The objective here is to propose the application of an approach to obligations in private law which, when direct enforcement is prevented by debtor bankruptcy, informs the ordering of creditor entitlements in bankruptcy – this being a central component of a natural law based model for understanding the bankruptcy system.

3.3.1 Understanding the event of bankruptcy and its participants from the perspective of corrective and distributive justice
In the preceding sections I introduced the idea in private law of a minimum number of conceptual features and the bipolarity of legal relationships. This section moves beyond analogy-based analysis, applying corrective and distributive justice’s contrasting ordering to both the pooled and separate obligations affected by supervening debtor insolvency. A major theme of this section of the thesis is to consider creditor collectivism and pari passu ranking in the context of the mathematical expression of corrective and distributive justice.

The challenge here is to determine how to address corrective justice’s emphasis on bipolarity of relationship, and the remedy awarded for breach of obligation within the relationship, within a multi-party context where there is an inability on the part of the debtor to satisfy all current and expected claims. An understanding of this condition necessitates an examination of the dichotomy between corrective and distributive justice applied to a pre- and then post- insolvency context. The analysis explains the pari passu treatment of like claims - distributive justice’s series of ratios - though the content of the calculation and the rationale in the fairness of outcome is based upon norms of corrective justice. Additionally, the analysis illustrates the complexity of the

processes for ordering competing claims (corrective justice’s restoration of transactional equality). Also introduced are the related challenges of determining the state of equality between parties to which justice applies and how the notion of virtue provides only a partial explanation of the pari passu principle. The following section in the thesis shows that Weinrib’s further explanation of equality, though valid in explaining the nature of private law obligations, is insufficient to explain how in bankruptcy relationships between debtor and creditor, and as between competing creditor claims, are to be resolved. A further explanatory technique must be applied. This is derived from natural law and is discussed in Chapter 4.

Weinrib pays particular regard to Aristotle’s account of corrective justice explained in mathematical terms – which, when reduced to basic expression, amounts to equality between “two parties to a bipolar transaction”444. In simple terms the idea is that ‘my plus is your minus’. In contrast, distributive justice is signified by a proportionate share between participants based upon external criteria. My argument on this point is that the allocation of entitlements on bankruptcy should first be determined, not according to mathematical equivalence, but rather by reference to the quality of the competing claims. What is distributed is the totality of the debtor’s liquidated assets, shared by way of a ratio whose order is determined by reference to external criteria of corrective justice. The criteria, whilst corrective justice based, must then be applied within a multi-party insolvency setting. Aristotelian mathematisation of corrective and distributive justice can thus be applied to explain the coherence and logic underlying bankruptcy law’s scheme of distribution.

One of my major concerns is to identify how Weinrib proposes to overcome what he concedes as the shortcomings in Aristotle’s mathematical exposition whereby:

“Aristotle [in] present[ing] corrective justice as a transactional equality, but he does not tell us what the equality is an equality of. This omission is serious, because corrective justice remains opaque to the extent that the equality that lies at its heart is unexplained.”445

Significantly, Weinrib remarks that Aristotle in his endeavour to explain private law devised an understanding “that defied explication in terms of his own ethics”446 – thus perhaps pointing to his earlier discussion analysed above (section 3.1) as to private law as a self-understood internally intelligible phenomenon. The step taken by

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445 Ibid.
446 Ibid.
Weinrib to overcome the problem of defining equality, namely that of resort to Kantian right, is discussed below (3.3.2). First, however, we must refer to Weinrib’s discussion of Aristotelian justice and the distinction it draws between distributive and corrective justice – thus demonstrating how these notions can further inform an understanding of the purposive attributes of bankruptcy laws.

One of the features of Aristotle’s mathematisation of corrective and distributive justice highlighted by Weinrib, is the ideal that the justice component can be signified as an intermediate state or mean that lies between excess and deficiency. This is an extension of Aristotle’s more general approach to the understanding of ethics – one of a number of examples being given by Weinrib is that of wittiness signifying the balance or mean that lies between buffoonery and boorishness; thus a state of virtue.

As Weinrib points out, the problem with these notions of virtue is that they are oriented to the pursuit of excellence of internal character, whereas justice is clearly focused on one’s interaction with others. The incremental step in translating internal personal characteristics into a description of justice is the recognition that other persons are positively or negatively affected by an excess of deficiency in a particular attribute. So, this idea of “justice seem[ing] to be the good of someone else”\(^{447}\) allows justice to be conceived as “virtue practiced towards others.”\(^{448}\) This is of course by no means the complete picture. Weinrib at this point discusses Aristotle’s subtle recognition that issues of justice need not be confined to issues of vice or deficiency in character. By introducing the aspect of “other-directedness” he accommodates the further concept of justice’s recognition of controversies arising out of one’s holdings.\(^{449}\) By this means, an excess or deficiency can of itself be unjust regardless of any “vice of character”. Importantly then, in this concept of justice, a dichotomy is drawn between judgments as to excess and deficiency of character, and judgments as to excess and deficiency of holding. The latter can only be made by way of comparison and is thus interpersonal in nature. Whilst both are ‘other-directed’, justice which is coextensive\(^{450}\) with virtue and ‘justice in holdings’, are distinct. This distinction centres on equality. In virtue-based justice “equality plays no role”\(^{451}\) as the controversy need bear reference only to the conduct of the single person. In contrast, justice in holdings can only be understood or gauged with reference to

\(^{447}\) Ibid at p 59 from *Nicomachean Ethics*, 1130a2.  
\(^{448}\) Ibid at p 59.  
\(^{449}\) Ibid at p 59 the three examples which Aristotle presents are wealth, honour and security.  
\(^{450}\) That is to say; having the same time, boundaries and scope.  
\(^{451}\) Ibid at p 60.
another person or persons. In Aristotle’s account of justice, justice in holdings is pivotal. It is adaptable to an understanding of the recognition and treatment of creditor entitlements in bankruptcy. Weinrib in both *The Idea of Private Law* and other writings\(^{452}\) stresses that:

“Aristotle’s identification of justice in holdings with equality does not imply that everyone’s holdings ought to be the same in quantity or value.”\(^{453}\) and further;

“Equality is merely a way or representing the norm that injustice violates.”\(^{454}\)

Acceptance of this condition is crucial to Aristotle’s mathematisation of justice. Equality, which represents a state of balance or equilibrium, is that to which different modes or forms of justice are applied to change holdings in response to injustices which have created the unequal allocation. As Weinrib observes, “[j]ustice functions for holdings as equality functions for mathematical terms.”\(^{455}\) By treating justice equivalent to equality it is possible to reduce legal remedies to mathematical equations. The mathematical equation, to the effect that a defendant’s plus is the claimant’s minus, lies at the heart of Aristotle’s conception of corrective justice.

Can Aristotle’s account of justice, as described by Weinrib, assist our understanding of the operation of bankruptcy? I suggest it can, particularly from the perspective of the ‘other-directedness’ of virtue. A virtuous person pays their debts as and when due. Such a person, in a contractual setting, is free to pursue his or her self-interest and gain. But from the perspective of a wrongdoing\(^{456}\), being insolvent is not without more a wrong. However, to recklessly incur debts, or to dispose of one’s assets in order to defeat creditors, or to prefer a particular creditor over another in the knowledge of one’s impending insolvency, are clearly wrongs and signify the behaviour of an unvirtuous person towards others. These injustices or wrongful acts are borne equally by the general body of creditors. The fact that insolvency law has the separate, though interrelated, objectives explained in Chapter 1 of maximizing the return to creditors and bringing to book those guilty of mismanagement, has as much to do with promoting good (virtuous) conduct as it does with economic rationality.

\(^{452}\) See also fn 15 of “The Juridical Classification of Obligations”.
\(^{453}\) Ibid at p 61.
\(^{454}\) Ibid.
\(^{455}\) Ibid.
\(^{456}\) In section 1 of Chapter 4, the event of bankruptcy will be analysed in the context of a classification scheme which addresses the relationship between rights, wrongs and remedies.
Although Weinrib’s principal concern is with corrective justice as an explanation of the character of private law obligations, his shorter description of the character and objectives of distributive justice is highly insightful. It not only emphasises the distinction between distributive and corrective justice, but also assists an understanding of the current limits of bankruptcy law in addressing particular types of ill arising in the dealings between individuals. It is here that I return to the contrasting mathematical attributes of distributive and corrective justice.

It is important to reiterate the idea that justice in holdings has “different ways in ordering relations among persons”, respectively in ‘distribution’ for distributive justice and in ‘transaction’ for corrective justice. To fully grasp the distinction it is appropriate to address the corresponding mathematisation. Distributive justice entails the application of a series of ratios which align the sharing (distribution) of the benefit or burden based upon comparative merit. For the purposes of understanding pari passu ranking within the multi-party setting of bankruptcy distribution, comparative merit is suspended and replaced with non-subjective notions of collective rather than bipolar correlativity. This then forms the basis for equal sharing of the burden of the loss and the benefit of the assets available for distribution.

Corrective justice, on the other hand, entails the quantity being determined as that rightfully belonging to one party which must be shifted back to the other, the most straightforward example of which is the restoration of mistaken payments. Although the dominant view is that restitution of a mistaken payment is an application of corrective justice, that analysis has been criticised. See in particular Dennis Klimchuk “The Normative Foundations of Unjust Enrichment” in R. Chambers, C. Mitchell and J. Penner (ed.) Philosophical Foundations of the Law of Unjust Enrichment (Oxford University Press, 2009). Klimchuk’s concern is to find an explanation of liability for an unknowing receipt of a mistaken payment. This thesis, however, takes the position that any strict liability restitution of a mistaken payment corrects an inequality irrespective of the knowledge of the payee. Klimchuk provides an analysis of the respective corrective justice account espoused by Ernest Weinrib and an opposing Value Instrumentalism approach offered by Hanoch Dagan. At the heart of the corrective justice justification of liability in unjust enrichment, as it pertains to mistaken payments, is the need to engage in some artifice to step from the Aristotelian condition of correlativity where the doer and sufferer of the same wrong is clearly apparent. In addition to a payer’s legal title which causes a potentially illusory distinction between ownership of the thing of value and title to the value (pp 87-88), the nature of imputing knowledge of the mistake to the payee is seen as problematic. Klimchuck’s key concern is that “to explain the completion of the cause of action in Unknowing Receipt on the terms that Weinrib argues corrective justice requires, we must impute to the defendant not only acceptance of awareness of a benefit but awareness of being in receipt of it.” (p. 90) Whilst Klimchuk believes it possible through such constructive process to step from imputing “accept[ance] [of] a benefit as non-gratuitously given” to one of “not hav[ing] a right to retain it”
distributive justice operates by way of rearranging resources (arrangement in Weinrib’s Aristotelian-based terminology) whereas corrective justice operates as an interaction governed by a mathematical model. Focusing on the mechanics of bankruptcy, this distinction when applied to admitting claims and distributing entitlements, can be expressed in terms of determining those interactions which merit their continuity in existing form, and thus should not be subject to the arrangement which is otherwise applied as part of the distribution. Further analysis is of course necessary to deal comprehensively with both non-consensual tort claimants and with dealings between debtor and creditor which might attract the court’s discretion in recognising a proprietary entitlement.

What does this concept of mathematisation tell us about the nature of the event of bankruptcy and how might it aid our understanding of the treatment of obligations in bankruptcy? Weinrib states that “[a] violation of corrective justice involves one party’s gain at the other’s expense.” When viewed from the mathematical aspect of a mean in initial equality, “the actor now has too much and the victim too little.” Where a tort has been committed the wrong – or in corrective justice terms, the violation – has already occurred prior to insolvency and remains in need of rectification or restitution, in whichever way we may wish to express the remedial response. It can further be argued that by treating some tort claimants pari passu with consensual unsecured creditors, the latter are, in contemporary parlance, unjustly enriched at the expense of the former, at least in cases where the latter had the opportunity to avoid the loss. This arises by virtue of a transfer of a distributive based ratio with the victims of the equality based violation being treated equally within the distributive scheme. This criticism by itself does not establish a clear basis for organising a scheme of distribution which gives certainty to the contrasting

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(p. 93) it does not, in terms of the cause of action, overcome the impediment per Lord Justice Bowen’s dictum that “liabilities are not to be forced upon people behind their backs.” (citation omitted) Space precludes a detailed explanation of the opposing Value Instrumentalism rationale for restitution of unjust enrichment in relation to mistaken payments. Suffice to say though that it focuses on redress of the undermining of the payer/claimant autonomy arising through the impaired consent to the transfer. The process is ‘instrumental’ in that it reflects a set of values to which a legal system ought in a normative sense aspire. As with Klimchuk’s analysis of the corrective justice stance, the Value Instrumentalism explanation whilst having an abstract appeal, fails short once the practicalities are brought to bear. Problems of a clear duality or reciprocity would again seem a critical issues with Klimchuk concluding that Value Instrumentalism analysis does not adequately overcome the challenge that “the defendant is not in any way implicated in the compromise of the plaintiff’s autonomy.” (p 96)

460 Ibid.
461 These ideas are developed further in the next section in relation to the concepts of Kantian right and correlativity.
treatment of non-consensual and consensual claimants, the latter of whom have incurred losses of varying magnitudes, and at different points in time, in expectation of the debtor’s continued solvency. Functionalist economic analysis would suggest that many consensual creditors have some degree of capacity to anticipate and adjust for debtor insolvency, if only by way of making provision for the contingency through insurance. In contrast, the approach adopted in this thesis looks more to the nature of the obligations and the rights attached thereto. The appropriate treatment of these different types of claimant can be addressed in terms of the virtue of the debtor and the nature of consent (if any) on the part of the creditors. The concepts of equality and virtue, as they apply to the occurrence of debtor insolvency, explains the pari passu principle in corrective justice terms as well as providing a philosophical basis for departing from the principle. The interaction of virtue in the conduct of the insolvent debtor’s treatment of different classes of creditor, together with the latter’s merit, is examined in the next chapter (refer 4.2.1.3).

To further appreciate these approaches to bankruptcy’s distributive processes, it is appropriate finally in this section to give closer consideration of Weinrib’s description of Aristotle’s notion of distributive justice. The application of distributive justice involves identification of the following three essential elements:

“- - - [1] the benefit or burden being distributed, [2] the persons among whom it is distributed, and [3] the criterion according to which it is distributed.”

In bankruptcy the benefits being distributed are the debtor’s liquidated assets. Expressed conversely, the burden being allocated is the deficiency in the debtor’s estate. The persons among whom the distribution is made are those unsecured creditors who, having been compelled to surrender their individual rights, benefit by proving their claims in the collective distribution. Both the multi-party setting and the need to effect a transfer (distribution) from debtor to creditors supports an understanding of pari passu in terms of distributive justice’s processes for achieving outcomes. The objective and norms to which it conforms nevertheless are corrective justice based. The criterion of the distribution is thus a combination of the character of the individual claim that was surrendered and the equal treatment of like claims.

Both the above structure and distinctions can be observed in this definition of the Corporations Act’s rule of pari passu ranking:

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462 Ibid at p 62.
“Except as otherwise provided by this Act (ie the provisions relating to secured creditors and preferential debts) all debts and claims proved in a winding up rank equally and, if the property of the company is insufficient to meet them in full, they must be paid proportionately (pari passu).”464

This definition recognises that some debts receive preferential treatment. The preference of such claims is based on distributive merit, and this in turn depends on the bipolar relationship between creditor and debtor. Otherwise, the default treatment is proportionate. This also draws on the distributive justice process insomuch as it is a ratio-based arrangement. The objective nonetheless is understood in corrective justice terms as seeking to restore the balance between multiple creditors and the debtor as much as the practicalities of deficiency permit. Continuing this reference to the Australian statutory setting of corporate insolvency law, the granting of a priority, for example to mass-tort claimants, would likely fall somewhere in the s 556(1) rankings (a) through to (h), and given the use of the word ‘next’ would be fully met prior to the next in ranking and ahead of all other unsecured debts and claims.465

These of course are matters of public policy to the extent that the outcome is reliant on a statutory mechanism. Nonetheless the outcome is based on distributive merit, the distributive principle being in Weinrib’s terms, one of distribution as holding. Moreover, if the notion of debtor virtue towards claimants is invoked in order to justify disparities in holding upon bankruptcy distribution, the merit of a victim of a non-consensual wrong may, at least in some cases, have a stronger claim to justice than the victim of a wrongdoing incurred in the course of a consensual relationship.

None of the above supports any radically different conclusion from an economic analysis of bankruptcy. However, corrective justice theory provides deeper insight into the merits of claims considered as part of the bankruptcy process and, significantly, allows us to observe bankruptcy distribution as a coherent body of legal norms and rules that can be understood in comparatively non-instrumental terms. It provides a robust method for examining both the ranking of claims and the recognition of personal and proprietary restitutionary claims which will diminish the distributional pool. Further, corrective justice presents an alternative perspective on the recognition and setting aside of antecedent transactions. These breach the notion of correlativity, the corrective justice perspective enabling recognition of what should

463 Section 555 Debts and claims proved to rank equally except as otherwise provided
464 CCH, Company, Corporate & Securities Law, Australian Corporations Commentary [162-620].
465 The problem does not arise for restitutionary proprietary claimants because the property successfully claimed is simply excluded from the pool of divisible assets.
be traced and recovered and then applied to the distributive justice based benefit of the general body of creditors.

Chapter 4 applies natural law theory to both the justification in the ordering of creditor entitlements and the associated character of intervention required to achieve both the translation into entitlements and the corresponding distribution of the debtor’s liquidated assets.

### 3.3.2 Understanding the nature of creditor rights in terms of corrective justice and correlative

This section continues the analysis of ethical attributes appropriate to a rights-based model of bankruptcy distribution. Adopted is a perspective on the recognition of creditor entitlements drawn from notions of equality in bipolar relationships to which corrective justice applies. This process, which Weinrib terms as ‘correlativity’, provides only a partial explanation of the subject matter of this thesis as it deals exclusively with private law obligations falling outside the unique circumstances of debtor insolvency.

Weinrib emphasises that rejection of Aristotle’s corrective justice rationale:

> “- - - is to postulate that the reason for taking resources from the defendant is not the same as the reason for giving resources to the plaintiff.” 466

It is plausible to extrapolate this idea of justification to a consideration of the logic of bankruptcy distribution. The idea suggests the following:

1. The reason for taking from the insolvent debtor should be the same reason for giving to the debtor’s creditors. In this way a collectivised procedure of surrendering individual creditor rights of recovery is complemented by pari passu ranking.

2. This reasoning can be further understood in terms of the principle that the reason for ‘taking’ from one creditor and ‘giving’ to another can only be made with reference to the reasoning for taking from the debtor and giving to the preferred creditor.

The latter of these statements can be seen as presenting a normative basis for establishing criteria for bankruptcy distribution. At the same time it establishes a basis for the elevation of particular unsecured creditors within the ranking of priorities and possibly for the granting of a proprietary remedy. The emphasis on corrective

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justice enables scope to consider restoration of some degree of correlativity between
debtor and creditor, though within the context of the implications for the overall
distributive outcome. The ‘taking’ in my second statement is notional as it is not the
taking of a resource the creditor either possessed or to which he had a proprietary
claim, but rather it is that amount that the debtor is effectively deprived of through the
diminution of the residual pool available for distribution. Collectively, these two
statements look to the correlative character of entitlements in explaining the logic to
which bankruptcy distribution conforms. The logic is wholly corrective and is not
based on any distributive criteria.

One of the most significant aspects of Weinrib’s private law thesis is that it proposes
a normative basis for identifying what it is to which correlativity pertains. Weinrib
expresses the challenge in the following terms:

“There is - - - a troubling lacuna in Aristotle’s explication of corrective justice. -
- - The problem is: in what respect are the parties equal?”

Unless this further challenge is resolved, corrective justice as a basis for describing
the normative character of private law obligations remains remote from contemporary
application. It is firstly appropriate to accept that such a gap likewise applies to
corrective justice’s capacity to illuminate the identification and ordering of creditor
entitlements in bankruptcy. Secondly, Weinrib’s proffered method of covering the gap
– the idea of Kantian right – should be accepted, at least in part, as addressing the
challenge of identifying a normative explanation of bankruptcy distribution. Whilst
accepting that Kantian philosophy is appropriate to Weinrib’s particular exploration
of the character of private law, a further step is required for the development of a
coherent rights-based theory of bankruptcy distribution. The nature of this further
requirement derives from the distributive character of bankruptcy. Bankruptcy law
must deal rationally with a multiplicity of competing claims. It must further be
underpinned by an acceptable basis of intervention necessary to achieve such
outcomes efficiently. The source of this understanding is drawn from contemporary
re-revaluations of natural law, though Kantian philosophy, as will be shown, does

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467 Ibid at p 76.
468 The ethical philosophy of Immanuel Kant (1724-1804) is drawn upon to a necessarily
narrow and limited extent in this thesis. Here in this chapter in relation to the asserting of a
moral attribute of law that, as an ideal, it is hostile to consequentialism and how this might, for
the purposes of this thesis, be modified through reference to other moral philosophies (in
particular contemporary reappraisals of Thomistic-based natural law). The objective is to
enable Weinrib’s explanation of corrective justice to be adapted to the particularity of
bankruptcy law. Kantian philosophy is again drawn upon in Chapter 4 (4.3.1 and 4.3.2) to
explain in bankruptcy law the coexistence of characteristics of coercion and acquiescence.
469 Chapter 4 at 4.2.1
have direct bearing on the model I develop in explaining the application of a coercive bankruptcy law regime to private law entitlements. The following passages summarises Weinrib’s examination of equality within universal moral laws. I apply this to provide a rudimentary understanding of relationships to which bankruptcy law applies.

Dealing firstly with the notion of equality, one of the significant features of Weinrib’s Aristotelian description of corrective justice is the distinction he draws between excess/ deficiency in holdings and justice in holdings. Justice in holdings is that to which corrective justice’s remedial mechanisms are applied. This distinction was initially discussed above in 3.3.1, in terms of corrective justice’s indifference to subjective comparisons of quality and value. For the purposes of the Aristotelian concept there are two interrelated ways in which equality is expressed; one in positive terms and the other in negative terms. These are respectively the ideas that corrective justice, not being comparative, is concerned chiefly with what one party has done to the other, and that corrective justice does not concern itself with the subjective presence or absence of the worth of the parties. This latter point is expressed in the following terms:

“To factor moral or social worth into justice in holdings, one must link persons to one another not through the correlativity of doing and suffering harm but through a comparison of the degree to which they each have such worth.”

This idea can be applied to the context of bankruptcy. It establishes that worth should not function in bankruptcy distributive considerations for both positive and negative reasons. To do so would:

1. ‘Sever’ the link between the distribution and the character of the private law obligation,
2. introduce problems of indeterminacy, and
3. create the risk of the type of opportunistic behaviour identified in Chapter 1 as a major concern of the law and economics critique of bankruptcy.

For corrective justice to function as a coherent and universal explanation of the recognition and treatment of private law obligations, it must detach itself from the

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470 Ibid at p 78.
471 Ibid at p 77.
472 Elsewhere described as that which is implicit in the transaction Ibid at p 79.
473 Ibid at p 77.
particulars of the individuals concerned.\textsuperscript{474} The necessity for detachment creates a void which can only be explained in terms of the character of humans and their interactions to which an equality exists. The void is filled by the law’s recognition of correlative rights, interference with which justifies the award of a remedy. It is the character of the interaction of self-determining agents which is the necessary substitute that allows concern for individual roles and relative position to be set aside. This in turn enables recognition of the operation of the moral status of self-determining agents whose actions and omissions justify legal intervention.

The concept of detachment is significant in giving effect to Aristotle’s exposition of private law in which:

\begin{quote}
"
- - - he rightly saw that distributional considerations and dispositional virtue were irrelevant to [private law’s] distinctive equality."\textsuperscript{475}
\end{quote}

This supports the idea that bankruptcy law should not be viewed as an instrument of social ordering. The conclusion is contained within the confines of bankruptcy’s distributional character and its own distinctive interaction with private law. Nevertheless, the question remains as to whether the nature of Kantian right sufficiently explains the more applied aspects of the recognition and treatment in insolvency of creditor entitlements, over and above the general insights gained as to the nature of private law.

The scope of this thesis does not permit an exploration of the nature of Kantian philosophy. Suffice to say that the notion of moral duties which are at the core of Kantian philosophy presupposes that actions are inherently right or wrong, and can be regarded as such irrespective of other consequence. This idea recognises what is termed Categorical Imperatives, so, in law, it is hostile to consequentialism:

\begin{quote}
"I ought never to act except in such a way that I could also will that my maxim should become a universal law."\textsuperscript{476}
\end{quote}

And;

\begin{quote}
"The Idea of the will of every rational being as a will that legislates universal law."\textsuperscript{477}
\end{quote}

Universality commands self-determining agents to exercise their free-will in a particular way and not to perform some particular actions. Self-determining agents are both autonomous and rational. In terms of the justificatory force of the law, a self-

\textsuperscript{474} Ibid at p 81.
\textsuperscript{475} Ibid at p 83.
\textsuperscript{476} The Groundwork of the Metaphysics of Morals 4.402
\textsuperscript{477} Ibid 4.432
determining agent’s respect for, and duty under, the law is qualified in that no law is sustainable which contradicts or conflicts with moral rationality. Weinrib states the link between Aristotelian legal theory and Kantian philosophy in the following terms:

“Implicit in corrective justice’s relationship of doer and sufferer are the obligations incumbent in Kantian legal theory on free beings under moral laws.”478

The problem lies in the abstract nature of this awareness. As Weinrib remarks479, Kantian right is noumenal480 in character. Without wishing to seem trite, the law of bankruptcy exists in the observable or phenomenon world. This does not necessarily lead to the conclusion that the alleged “impoverished starkness”481 of a Kantian right renders it meaningless to a normative theory of bankruptcy distribution. Rather, my argument is that better focused insights are needed and that these can be deduced from some of the ethical theories482 that have been used to inform both taxonomic approaches to the law and more recent attempts to articulate contemporary natural law jurisprudence.

3.3.3 Understanding bankruptcy distribution through a corrective and distributive justice perspective

Earlier in this chapter (3.1.4) I introduced the idea of institutional and conceptual features in a non-functional theory of the law. Particularly in an applied area of the law such as bankruptcy, identification of these features points clearly to a structure that has both coherence and defined boundaries of application. Introduced in this section are ideas drawn from the contrasting of corrective and distributive justice that

479 Ibid.
480 Das ding an sich – the thing-in-itself.
482 Theories of normative ethical behaviour can be divided into the teleological and the deontological, though importantly for the purpose of this thesis the further distinction is drawn between the deontological and ontological. Derived from the Greek word telos (end) teleology is the study of the ends or purpose of things. Deontology, in contrast, derived from the Greek work deon (obligation, necessity) is the study of moral obligations pertaining to duties and rights, and is thus, means rather than ends focused. The distinction between the teleological and the deontological provides a framework for jurisprudential investigation which the thesis applies to an examination of the extent to which bankruptcy distribution should be driven by identifiable and agreed end objectives. Most often these objectives, as I have discussed above (Chapter 1 and Chapter 3.1), are expressed in economic terms. The purpose of introducing the distinction is to further analyse the question: should bankruptcy law allow admission of moral arguments into the discussion of creditor entitlements? This theme permeates both in this and the next chapter of the thesis. The distinction between the deontological and the ontological (the study of the nature of being) is critical to an understanding of natural law theory, as it might be applied to the principles determining creditor entitlements on insolvency (refer 4.2.1.2 in particular).
assist in explaining the authority necessary in order to achieve ordered and collectivised outcomes, whilst at the same time retaining a degree of flexibility to accommodate exceptions to this norm. Important also is identifying a basis for the ongoing development of bankruptcy rules to meet changing expectations. The discussion in this section emphasises the different types of complex ordering required in order to do justice to the recognition and resolution of creditor entitlements. Building on this discussion, Chapter 4 deals in more detail with the validity of bankruptcy's coercive elements (4.3) and its capacity to admit moral argument to explain both its basic tenets of collectivism and exceptions thereof (4.2).

As a normative theory, Weinrib’s expression of an Aristotelian idea of private law has a clearly defined and certain structure. This is illustrated by the following statement:

“To take a modern example, the legal regime of personal injuries may be organised correctively or distributively. Correctively - - - my payment to you of damages will restore the equality disturbed by my wrong. Distributively, a compensation scheme - - - shifts resources among a pool of contributors and recipients in accordance with a distributive criterion.”483

A bankruptcy regime does not conform to this model. There may of course be a temptation to impose a predominantly distributive basis on our understanding of bankruptcy’s component rules. The temptation would be understandable insofar as a pool of cash resources is created through the sequestration, and then realisation, of the debtor’s unencumbered assets, followed by distribution based upon the criterion of pari passu sharing. Too strong an emphasis on the distributive characteristics of bankruptcy, except as they apply to the statutory priorities, is, however, counterproductive, denying the subtle manner in which the regime as a core objective goes about admitting claims of often diverse character, and where appropriate, preserving their nature. The distribution is a stepped process which focuses foremost on the interests of creditors and their entitlements. Having done so, it then resolves them in accordance with statutory criteria.

My analysis of bankruptcy distribution is based on the idea that insolvency is a supervening event impacting on the enforcement of private law rights. Understanding the nature of the event in relation to private law obligations either in existence, or expected to come into existence at the time of debtor bankruptcy, is assisted by an understanding of alternative forms of justice. This is essential in the development of a

483 Ibid at p 70.
coherent rights-based framework of claim recognition and distribution. Weinrib remarks that:

“Aristotle’s contrast of corrective and distributive justice does not determine whether the law should treat an incident correctively or distributively. But if the law is to be coherent, any given relationship cannot rest on a combination of corrective and distributive justification.”

This strict dichotomy cannot equally be applied to the incidence of bankruptcy. For present purposes it is worth noting that Weinrib addresses the idea of ordering as follows:

“Corrective and distributive justice are modes of ordering because they represent the different ways in which external relationships can be coherent.”

Significant to the model developed in this thesis is the process of determining the manner in which different types ‘external relationships’ are impacted by the event of insolvency. The choice between corrective and distributive treatment no longer necessarily applies; rather features from both can be drawn upon to achieve both coherence and the purposive nature of outcomes. The ordering is normatively rational and deals with the transitioning of private law rights without collapsing the distinction between corrective and distributive justice.

Earlier, in considering ‘forms’ as classification, Weinrib makes the observation that one approach may be to “divide the empirical world on the basis of different causes of legally significant effects.” Alternatively, “one might base the classification on the different roles of the interacting persons.” As for the latter, Weinrib cites as examples, amongst others, corporate directors and manufacturers of products, both roles of which are pertinent to Chapter 2 of my thesis. The role of corporate directors is germane in terms of a director’s duties under the conditions of limited liability and separate corporate personality, whereas the functions of manufacturers are critical in relation to the law’s treatment of the harms that arise out of the use of their products. Moreover, an analysis of bankruptcy entitlements and distribution from the perspective of the role of the debtor’s interaction with creditors is a relationship that can accommodate Weinrib’s analysis.

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484 Ibid at p 73.
486 The Idea of Private Law (1995) (Harvard University Press, London) at p 69. In his reference to Talmudic tort law, Weinrib looks at the sources of the event, whereas in a number of the classification frameworks looked at in Chapter 4, the character of the event itself is focused upon.
487 Ibid
Applied to the nature of a bankruptcy regime which is clearly grounded in the practical world of social relationships and economic causes and effects, it is the order and structure of juridical\textsuperscript{488} relationships which is relevant to this thesis.

In Weinrib’s Aristotelian conception of justice, the interaction unique to corrective justice is that of the parties being \textit{immediate} whereas within distributive justice the interaction is \textit{mediated} through a distributive arrangement.\textsuperscript{489} The distinction between the \textit{immediate} and the \textit{mediated} provides valuable insights, enabling description of a normative rationale for the admitting and ordering of creditor entitlements in bankruptcy.

The \textit{immediate} and the \textit{mediated} correspond to two distinct forms of injustice. Under the \textit{immediate}, the relationship (bipolar)\textsuperscript{490} is one of doer and sufferer of an injustice under which the latter’s holdings is diminished. The injustice is only appropriately rectified through reversal of the specific victim’s harm. In contrast, the injustice associated with a distributive arrangement is one of an overdraw of a common resource. In bankruptcy distribution the harm is derivative and shared collectively through the diminution of the debtor’s liquid funds and available or retrievable assets, which corresponds with the injustice of an overdraw to which distributive justice is directed. The overdraw will have arisen through the debtor’s actions (or inactions) which may range from the inadvertent, to the accidental or incompetent, through to the reckless and fraudulent. Within this range, we can further relate to one of the critical tensions inherent in bankruptcy. This tension is between the individual’s incentive to seek to stand separate from the collective process and the group incentive to impose as wide a possible participation. The economic oriented analysis described in Chapter 1 focuses heavily on the need to anticipate and manage the incentives of the players as part of a desire to ensure efficiency and predictability in the bankruptcy process. The process of admitting claims and distributing the debtor’s liquidated assets is clearly \textit{mediative} in nature. The approach I adopt is, however, more directly focused on where and how the bankruptcy regime operates in relation to private law, and thus how the processes of corrective and distributive arrangement can both be adopted in order to explain both the characteristics of collectivism and its

\textsuperscript{488} Juridical classification was considered in detail in 3.2 of the thesis.
\textsuperscript{489} Ibid at p 71.
\textsuperscript{490} The idea of bipolarity in relationships within a non-functional theory of private law was introduced in section 3.1.4.
appropriate exceptions. Equally important is the exploration of the limits of bankruptcy in dealing with particular types of complexity and uncertainty.

It is obvious that Weinrib did not have in contemplation the nature of a bankruptcy regime as part of his analysis of the distinction between corrective and distributive justice. Nonetheless, both bankruptcy’s allocative character and the necessity for resolution of individual and collective legal relationships enable valid insights to be drawn from his analysis. These can be applied to bankruptcy law’s practical legal context.

Dealing firstly with bankruptcy’s allocation processes, Weinrib’s states that:

“- - - distributive justice mirrors the open-endedness of the number of parties that can participate in a distribution. Whereas the addition of parties in corrective justice is inconsistent with its structure, the addition of parties in distributive justice merely decreases the size of each person’s share in the subject matter of the distribution.”\textsuperscript{491}

In bankruptcy we can say that the cash deficiency associated with an inability to pay debts as and when due, the standard cash flow based definition of insolvency, is a form of overdrawing. Unsecured creditors whilst having no proprietary right over the debtor’s cash, working capital, or unencumbered assets, have, however, a collective claim mediated through the agency of the trustee or liquidator. The proportional amount of the claim that can be satisfied is progressively diminished with the admitting of further equal ranking claims. The ‘open-endedness’ of bankruptcy distribution is of course not boundless as it operates strictly within the rules which have evolved to admit claims. Thus the potential, and often unfortunate, actuality for unsecured creditors is to receive little, if any, recompense. The focus, however, is on the comprehensiveness with which valid claims are recognised. If it were not comprehensive, the division of resources would be arbitrary.

Corrective justice is most relevant and immediate to specific injustices committed by one party against the other. This is particularly significant where a number of wrongs remain unrectified when the wrongdoer becomes insolvent. This case presents a specific challenge to Weinrib’s statement that:

\textsuperscript{491} Ibid at pp 71-72.
“- - - since coherence consists of having a legal relationship reflect one of the forms of justice, loss-spreading as a tort doctrine is incoherent.”

The deficiency in an insolvent debtor’s available assets compels the imposing of a requirement of loss-spreading. As will be discussed, there are persuasive arguments based on the nature of the injustice which support the granting of a priority to involuntary tort claimants ahead of consensual unsecured creditors. Weinrib’s idea of coherence is based on the assumption that corrective, but not distributive, justice is a coherent rationale for legal intervention. It is this assumption that forms the model adopted in this thesis. The model assumes, however, that the bankruptcy process itself operates as a form of distributive justice.

I turn now to the manner in which bankruptcy law resolves differing types of legal relationship that are suspended at the time at which external intervention in the debtor’s affairs is formalised. As in the case of the dichotomy between corrective and distributive justice, Weinrib draws a clear distinction between the respective interactions; the former being immediate, the latter mediated. Bankruptcy is, in terms of Weinrib’s distinction, a mediated process. However, the ‘mediator’ (trustee or liquidator) is required to operate within a corrective justice framework except where bankruptcy law explicitly priorities distributive factors, for example in the corporate context in relation to employee wages. Undoubtedly, the mechanism at the heart of the bankruptcy procedure whereby creditors surrender their individual rights in exchange for the opportunity to prove their debts, points very much to an interaction by way of mediation between the debtor and creditors conducted through the office of the trustee or liquidator. However, underlying this apparent instrumental process is the capacity for resort to the assumed position had insolvency not occurred. This achieves, as practically as possible, the rectification that would apply in the bipolar interaction of immediacy. Such a rectification is distinct from the enforcement of a security which is precipitated on either the occurrence of insolvency or a breach of a covenant which does more than to give effect to rights arising outside bankruptcy. Bankruptcy distribution pertains instead specifically to both the trustee/liquidator’s recognition of a proprietary-based entitlement and the court’s granting of a remedy to enforce the proprietary entitlement.

492 Ibid at p 75.
493 As to whether bankruptcy distribution is in a strict sense loss-spreading, or capable of being otherwise characterized, is considered in the next chapter (4.3).
As Weinrib notes, both corrective justice's immediate interaction and the underlying bipolarity, are most directly manifest in the lawsuit. Significantly, he goes on to emphasise that “many of the principal doctrines of the common law - - - reflect the bipolarity of private law relationships.” Therefore, aside from the statutory mechanism for admitting claims whose amount is uncertain because of an unresolved lawsuit (refer 3.1.3 above), it is these general law doctrines that are often explored in the granting of a proprietary or other equitable remedy. The courts and the legislature are highly cautious in developing the law in this direction because of the obvious detrimental effect the creation of new interests will have on the general body of creditors.

Consistent with Elizabeth Warren’s observations about the complexity and less confined nature of bankruptcy, a wide variety of individuals and individual classes of unsecured creditor are vulnerable in the event of debtor insolvency, though predominantly treated collectively on a pari passu basis. On the face of it, redressing wrongs in individual circumstance is clearly not within the domain of bankruptcy law, but one dealt with outside bankruptcy law as a matter of social policy. The corrective justice standing of the creditors at the time of debtor insolvency informs the distributive arrangement. This said, the insolvent corporate distributive scheme contained in s 556 of the Corporations Act 2001 is one example of where the position of employees as a distinct group of unsecured creditors is clearly favoured. The priority of employee entitlements is based on notions of fairness, not economic efficiency. It is an example of non-economic distributive justice.

To conclude this analysis, the idea of coherence that is inherent in a distinction drawn between corrective and distributive forms of justice, can be adapted to an explanation of the circumstance of bankruptcy’s intervening in the interaction of the affected parties. In simple terms, my natural law framework of bankruptcy is based on these principles:

First, correlative based relationships which, either on the basis of agreement or as justice dictates, give rise to legal disputes which must be resolved in terms of corrective justice.


Secondly, failing these particular conditions, the logic of bankruptcy is one of collectivism. The logic is premised on corrective justice save to the extent that bankruptcy legislation prioritises interests on a distributive basis.\(^{496}\)

In spite of the distributive (or redistributive) character of the bankruptcy system itself these principles show that the system is internally intelligible, the intelligibility being deducible from the internal intelligibility of private law.

### 3.4 The contrasting of right and advantage in private law

The contrasting ‘right’ and ‘advantage’ approaches to private law are used here as a basis for briefly proposing how a normative theory of private law can be used to reconcile the corrective and distributive justice objectives of bankruptcy law.

Using the tort of negligence as his principal area of interest in private law, Weinrib maintains a clear distinction between the relationships of “a right or wrong, on the one hand, and an advantage or a disadvantage, on the other.”\(^{497}\) The nature of right has been considered earlier this chapter, and its relationship with wrong in the context of remedy is considered in Chapter 4. My task here is to examine whether the distinction drawn by Weinrib between advantage and disadvantage is relevant to an understanding of bankruptcy distribution.

Weinrib defines advantage as:

> "- - - something that contributes affirmatively to the contingent level of welfare that someone enjoys at a relevant time, and a disadvantage is something that diminishes that level."\(^{498}\)

Advantage and disadvantage are not, in Weinrib’s view, disconnected from the concept of right. A right is manifest in an advantage and an infringement of a right is measured in terms of the disadvantage that must be remedied. What however is significant is Weinrib’s proposition of a model of private law under which the determination of a right is primary, and stemming from this, advantage should not have an independent status. This idea is consistent with Weinrib’s other analysis concerning internal intelligibility and a non-functional approach to private law (3.1 above).

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\(^{496}\) See 3.3.1.


\(^{498}\) Ibid.
Addressing specifically the ‘right versus advantage’ distinction, my normative framework of creditor entitlement recognition and bankruptcy distribution favours advantage neutrality. On the one hand, the rule of pari passu ranking rejects the granting of advantage. On the other hand, the accommodations given by way of priority or proprietary remedy should provide a remedy that is directly informed by the character of the rights which have been adversely affected by the debtor’s behaviour prior to insolvency. ‘Behaviour’ in this latter context is widely defined to include being the subject of an unjust enrichment claim which may involve no more than the passive receipt of money.499

Further weight is added to this latter idea by consideration of Weinrib’s discussion of abstract right and its association with free will. Expressed simply, freedom of will denotes a capacity to act unqualifiedly from which a normative capacity to be held to obligations will be applied. Moreover, free will entails the capacity to make choices, and indeed, the ability to conceive the outcome between different possible choices. Weinrib expresses this in terms of a “presupposition that the chooser’s particular decision could have been otherwise.”500 In relation to this idea we can conjecture, in broad terms, particular attributes of an insolvent debtor’s behaviour. Being insolvent can be caused by a multiplicity of factors, some beyond the control of the debtor. Although in some circumstances insolvency may come about as the cumulative outcome of a series of bad choices, ‘free will’ in this context refers to the obligations undertaken by the debtor. If it is assumed that the debtor’s insolvency is not a matter of choosing, the distributional aspects should be neutral, referring primarily to the character of the private law right affected by the event. This rationale of bankruptcy distributional objectives is clearly distinguishable from the regime’s other attributes, particularly those concerning antecedent transactions and recovery of preferences, and, in the corporate context, the penalties imposed in case of allowing a company to trade whilst insolvent. Here the law will deliberately, and as comprehensively as possible, deprive the wrongdoer and his associates of the ill-gotten advantages so as to benefit the disadvantaged unsecured creditors. ‘Free will’ is not relevant to these specific concepts.501

499 Refer the above (Chapter 2 at 2.2.2.1) contrast of analysis relating to Chase Manhattan NA v Israel-British Bank (London) [1995] Ch 105.
501 Except insofar as criminal penalties are only imposed on those who have exercised free will.
My argument here should not be taken as a statement that notions of advantage have no role to play in understanding and guiding legal development. The structure of corporate law which contains attributes of both private and public law drawn from both common law and statute, provides one example of deliberate endeavours to create circumstances that will be conducive to welfare gains. If, however, it is true, as I have argued, that preservation of the coherence in bankruptcy distribution is drawn from the coherence within private law, advantage cannot be a primary goal. To elevate it to primary status would sever the link between the character of private law obligations and their resolution in the case of debtor insolvency.

The context for which I have argued in this chapter, and apply in the next, is that the event of debtor insolvency is one in which critical and applied policy choices must be made. Economic and natural law perspectives may well equally validate and explain the core principles of collectivism and pari passu ranking. It is, however, when we come to potential exceptions that caution needs to be taken in analysing judicial and statutory developments. Only clearly articulated principles of equity and fairness can explain how departures from the pari passu principle can be justified. The theme of a rights perspective is further adopted in the development of a natural law-based model which addresses both the ethical and moral dimensions involved in creditor entitlement recognition and ordering. The model is also developed from the perspective of the necessity to effect distribution in accordance with the principle of coherence discussed in this chapter. Additionally, in the next chapter particular attributes of legal classification and distinction are used to identify the nature and legal implications of debtor insolvency.
CHAPTER 4

THE ORDERING AND STRUCTURE OF BANKRUPTCY LAW
CONCEPTS OF CLASSIFICATION AND A NATURAL LAW BASED
NORMATIVE PRINCIPLE

Introduction
Two related forms of legal classification are at the outset dealt with in this chapter. First, Blackstone’s distinction between rights and wrongs, and secondly, the classification of obligations derived primarily from Roman Law. The latter was first introduced in the previous chapter (3.2) – there in terms of an aligning of the law of obligations with the law of property. In both instances, the initial analysis is based on the extensive work of the late Professor Peter Birks. The proposition advanced here is that while the analysis of the theoretical, historical and moral underpinning of legal classification might be remote from the practical day-to-day demands of the law, such an analysis provides important insights into the sources of rights and remedies, and how they interact with each other. Each of these elements is critical to an understanding of the policy and judicial influences on the ordering of entitlements where legal obligations are affected by the intervention of debtor bankruptcy. An understanding of the nature of the event of bankruptcy as a distinct legal phenomenon is developed in this chapter by reference to these classificatory frameworks.

The analysis of taxonomy is an essential preliminary to the consideration given to contemporary perspectives on natural law. The idea here is to further develop the corrective justice idea of moral principle applicable to both the treatment of creditor entitlements in bankruptcy and the dealings between the parties affected by the event of debtor insolvency. Aristotelian perspectives on the nature and characteristics of the Rule of Law are then introduced. This is used to describe the manner in which natural law principles provide the basis for establishing a normative and non-instrumental explanation of bankruptcy law.

In the previous chapter, I argued that by applying a perspective based on an understanding of the nature of corrective and distributive justice, a rigorous framework can be developed for resolving problems of entitlements within
bankruptcy. The perspective is significant in terms of the development of personal bankruptcy and corporate insolvency. It enables us to assess the boundaries of both judge-made and statute law in terms of how a body of legal rules ought to apply in bankruptcy. To these ends, I argued there that ideas of intelligibility and internal coherence derived from natural law theory are highly valuable. The development of an understanding of these ideas is addressed in this chapter through an exploration of the dichotomy between private and public law, and how the dichotomy applies to corrective justice-based entitlements within a distributive framework.

4.1 The event of bankruptcy in the context of a distinction between rights and wrongs

Of all sources of law statute is the most crucial determinant of outcomes of bankruptcy distribution. It prescribes the rules of proving debts, priority, antecedent transaction recovery and many of the detailed provisions of the bankruptcy process. Additionally, in the case of insolvency, the broad scheme of corporate law which gives rise to the creation and protection of separate corporate legal personality is a direct manifestation of the legislative power of the State. Clearly, the manner in which such legislatively imposed rules interact with private ordering created within the law of obligations has a significant impact on the broader mechanisms for adjudicating private law disputes in the context of inter-creditor competition.

This section of the thesis commences with a brief outline of the distinction between rights and wrongs contained in Blackstone’s *Commentaries on the Laws of England*. The relationship between the rights/wrongs, event/response and public/private law distinctions are used as a basis for describing the legal significance of the event of bankruptcy and to show how the law’s responses to this event can be understood and applied to guide both judicial responses and legislative policy. Blackstone’s *Commentaries* provide a useful starting point for considering rights and wrongs because his approach assumes that the subject matter of the law is rationally organised. The relevance is more than an illustration of an endeavour to reflect civilian approaches to codification in the common law. What is of greater significance to this thesis are ideas of an overarching form and purpose to the law. Hence, in terms of the type of intelligibility and coherence examined in the previous chapter (see 3.1.1), the approach, though not so much the exact outcome advocated by Blackstone, promotes a systematic analysis of legal rules, particularly in terms of the relationship of different areas of the law to each other.
At his highest level of ordering of the law, Blackstone organised his *Commentaries* in term of a dichotomy between rights and wrongs and beneath it drew a distinction between rights of persons and rights of things, and then wrongs which are private or public. The distinction between persons, things and actions, described in Justinian’s *Institutes* was introduced in chapter (3.2).

At least in terms of understanding the treatment of collective obligations affected by one party’s insolvency, a rights-based analysis provides the clearest explanation of the nature of the obligations involved. More particularly, for the purposes of identifying the normative characteristics of a bankruptcy regime and the outcomes that its rules serve, rights, and not remedies, are the corollary of wrongs. The rights/wrongs dichotomy allows a clear analysis of the event of bankruptcy and the reasons for both applying the collectivist norm, and for recognising exceptions to the norm. Furthermore, a rights/wrongs mode of analysis assists in identifying the circumstances in which a discrete body of legal rules, applied in this thesis to the context of corporate personality and limited liability, prevents the correction of a wrong.

In contrast to Blackstone’s taxonomy of private law, Birks identifies ‘event’ and ‘response’ as forming an intelligible conjunction.502 Distinctions or juxtapositions such as these are valuable to an understanding of the ideas of corrective and distributive justice and how they have been drawn upon in Chapter 3 to describe the characteristics and scheme of bankruptcy law. By adopting this approach it will be shown also that public law can only be fully understood by reference to what it is not, so that its nature can thus be fully appreciated when viewed from the perspective of its private law counterpart. Addressing the relationship between public law and private law in these terms is a valuable element in examining the coercive character of bankruptcy distribution, on the one hand, and the manner in which this authority impacts upon the resolution of otherwise private law obligations, on the other. The nature of this distinction and the interaction of the two elements are dealt with below in section 4.3.

4.1.1 Bankruptcy’s remedial responses within a classificatory framework of obligations

I consider here the nature of bankruptcy’s remedial response which is primarily characterised in collective pari passu terms. The focus is on an explanation of the response to the insolvency event, particularly within the multi-party setting of bankruptcy distribution. This requires the application of taxonomical analysis to bankruptcy entitlement recognition. Birks’s taxonomic approach to private law in which events and responses “form an intelligible opposition”\textsuperscript{503} constitutes the basis for discussion.

In Rights, Wrongs and Remedies Birks, under the heading ‘Wrongs and Not-Wrongs’, makes the following remark:

“When a cause of action is a not-wrong the court is not being asked to remedy a wrong but to realize a primary right.”\textsuperscript{504}

And further;

“According to the taxonomy of causative events ultimately descended from the advance made by Gaius in the second century - - - there are three categories of not-wrong which generate rights directly realizable in the courts.”\textsuperscript{505}

Considering these remarks in the context of debtor insolvency, the critical issue which arises is how this notion of a realizing of a primary right informs the character of the creditor’s remedy of recovery. The term ‘not-wrong’ is coined by Birks to describe those circumstances in which an aggregate of facts (amounting to a cause of action but not constituting a legal wrong) constituting a grievance sufficient to trigger a legal response. These are primary rights-based. An example, and one relevant to the context of this thesis (refer 2.2.2.1), is unjust enrichment arising out of a mistaken payment.

Amongst the five categories or meanings of ‘remedy’ described by Birks is that which pertains to a right born of an injustice or grievance. In the event of debtor insolvency the first question is whether there has been a breach of a first tier obligation. At one level this is apparent from a breach of the simple debtor/creditor obligation.

\textsuperscript{504} Ibid at p 25.
\textsuperscript{505} Ibid at p 27.
However, if we turn to the definitions of bankruptcy\textsuperscript{506} which are based on an inability to pay debts as and when they fall due, the debtor’s position is related to the interests of general creditors collectively as a body. The capacity for creditors to prove their debts which operates as the response to the event of debtor’s insolvency, is nonetheless independent and second tier in nature. The obligation arises out of the harm stemming from the debtor’s insolvency, rather than from a breach of the primary obligation. The primary right thus being realized though the insolvency procedure is, first, to have the debt accepted, and secondly, a right to be paid pari passu and not have one’s own claim further diminished by an improper preference of another creditor.

The above analysis supports the tendency within bankruptcy regimes, both personal and corporate, to treat the outcomes of financial failure, whether caused by incompetence, bad luck or cyclical economic downturn, in identical fashion when admitting claims. Subsequently, matters of fraud and dishonesty are dealt with separately by means of antecedent transaction and property disposition recovery arrangements, and in the corporate insolvency context, the imposing of directors’ personal compensation liability in circumstances of insolvent trading.\textsuperscript{507} The adverse consequences of debtor insolvency are thus shared collectively amongst creditors. More broadly, it is on this basis, aside from economic practicalities, that a rationale for the surrendering of creditors’ individual rights of recovery upon debtor insolvency can be identified.

4.1.2 Classificatory frameworks and the translation of natural law theory into applied legal rules

At this juncture it is appropriate to introduce the question of possible normative frameworks within which a robust natural law model of bankruptcy law can be developed, particular in terms of understanding the rationale and ends to which its particular rules are applied. As Lloyd Weinreb notes of both John Finnis\textsuperscript{508} and Ronald Dworkin\textsuperscript{509}, two of the principal contributors to the development of contemporary normative legal theory:

\textsuperscript{506} See for example Bankruptcy Act 1966 s 5(2) [Solvency] “A person is solvent if, and only if, the person is able to pay all the person’s debts, as and when they become due and payable.” The same wording is used in relation to corporations in s 95A of the Corporations Act 2001.
\textsuperscript{507} Corporations Act 2001 Part 5.7B Div 3.
\textsuperscript{508} Natural Law and Natural Rights (1980)
\textsuperscript{509} Law’s Empire (1986)
“Although the principles [they develop and espouse] may gain credibility from their general acceptance, their validity, it is urged, depends not on acceptance but simply on the fact that they are, demonstrably, right.”\textsuperscript{510}

Such a statement, whilst appealing, does not provide sufficient guidance for evaluating the objectives and limitations of a discrete body of legal rules. Nor does it immediately explain how principles are applied through judicial decision or by legislative instrument. Essential components of my normative model of bankruptcy distribution are the concepts of public law and natural law – the former being a part of a classification of a legal system, the latter a theoretical explanation of all law. The distinctive normative form of public law relied upon in the model is presented in section 4.3 below. Both public law and natural law are identified by Justinian’s \textit{Institutes}.\textsuperscript{511} Whilst Weinreb may state that certain principles are “demonstrably right”, he is relying on intuition drawn from natural law, not from “general acceptance” or any other theoretical basis.

Foremost in section 4.2, I argue that to advance this idea of principles which are “demonstrably right” in the area of the law dealt with in the thesis requires a deeper inquiry into natural law. Moreover, an understanding of public law (section 4.3) provides the essential ‘bridge’ from the ethical dimension of private obligations in the context of supervening debtor insolvency, to a distributive scheme which is rational and widely accepted as the norm. It is in this manner that the ideals of intelligibility and coherence in private law argued for by Ernest Weinrib can be extended to bankruptcy law. In the context of bankruptcy a specific interpretation of public law is applied. A typical understanding of public law\textsuperscript{512} highlights the body of laws dealing with the powers, rights and obligations of the government in its dealings with those who are governed. The model developed in this thesis draws on more abstract ideas of institutional operation and the nature of legally authoritative frameworks.

While the argument of the thesis thus far clearly supports the type of preservation of creditor relativity inherent to creditor collectivism as outlined in Chapter 1, it does not explain exceptions to the pari passu principle. It is on this basis that the discussion in Chapter 3 of corrective justice was premised. It will be recalled that corrective justice forms the central element in what can be considered, Weinrib’s natural law-based

\textsuperscript{511} J.Inst.1.1.4 and Title II of Book I.
\textsuperscript{512} Public law is often expressed as being composed of the categories of constitutional, administrative, international and criminal law.
treatise on the idea of private law. It will be shown in the following sections of this chapter that coercion and elementary moral principles can co-exist, and indeed, are complementary. This theme is developed by looking respectively to natural law (source of moral principles) and the rule of law (enforcement of the law’s coercive mechanisms within ideas of coherence). The analysis will draw on iterative processes of legal development, acknowledging that such an approach entails acceptance of Alan Watson’s proposition:

“Law exists on the level of ideas as well as operating in the market place. Ideas can be borrowed and given shape tolerable in, if not ideal for, the market place.”

This reference to ‘ideas’ reflects Ernest Weinrib’s argument for a non-instrumental concept of private law as developed in *The Idea of Private Law*. Inquiry begins with recognition of internal intelligibility from which normative based principles are deduced. It is these normative principles that are then applied and modified in the market place.

### 4.2 Natural law and the Rule of Law

#### 4.2.1 Natural law

Whilst a thorough exploration of natural law jurisprudence is beyond the scope of this thesis, it is necessary to set out some of its core principles and, in particular, natural law’s central understanding of the nature of the role of man. The idea of natural law has, of course, shifted substantially from that described in the *Institutes*. The objective of this account is to present a contemporary perspective of natural law doctrine and to argue its relevance as a basis for understanding the objectives and limits of bankruptcy law. The fundamental precepts of natural law also provide insight into the bankruptcy process. This can be gained by examining the relationship between natural law and the Rule of Law. It is argued that each of the aspects of legal classification, the Rule of Law and, in particular, the perspectives of corrective and distributive justice, are essential elements in the translation of ethical principles into a practical body of legal rules such as those contained in a bankruptcy regime.

The interaction of natural law and the Rule of Law is best encapsulated in John Finnis’s statement that:

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“- - - they [the principles of natural law] require - - - that authority [as exercised in the community] be exercised, in most circumstances, according to the manner conveniently labelled the Rule of Law.”

Natural law is a basis for identifying the normative principles to which a legal system might aspire, whilst the Rule of Law are those features of a functioning legal system through which the principles are manifest.

4.2.1.1 Application of traditional natural law and its antecedents to an understanding of modern bankruptcy law
Title II of Book I of the Justinian’s *Institutes* commences with an assertion that natural law is based on the particular commonality between mankind and animals. Clearly, personal observation may suppose some tenuous conclusions as to the nature of being and human relationships. The *Institutes* identify these in the realms of male and female association, procreation and so forth. In the long history of natural law theory, perhaps one of the more critical turning points in this rudimentary analysis is described by Lloyd Weinreb:

“Albert the Great, teacher of Thomas Aquinas, rejected all forms of Ulpian’s argument that natural law is common to all animals. Natural law, he insisted, belongs only to human beings, in virtue of their specific nature as rational creatures.”

Beyond this thirteenth century refinement in understanding, it is necessary to consider some of the foremost ethical theories that have been applied to the development of natural law jurisprudence. This does not prevent some reversion to its Hellenic precepts which are equally valid. Perhaps the most significant recent exposition of a theory of contemporary natural law and its normative purposes is that developed by John Finnis in which he prefaces his analysis with the statement that:

“A theory of natural law claims to be able to identify conditions and principles of practical-mindedness, of good and proper order among men and in individual conduct.”

It is noteworthy that in defining the purposes of a natural law theory, Finnis expresses the view that the object is not so much as to identify a source for establishing a “conceptual framework for describing a social science”, but rather to function as a

517 Ibid.
basis of practical reflection for those concerned with the functioning of the law. Clearly, this conception of natural law falls well short as a source of normative structure and principle sought by Robert Austin, identified in the introductory chapter of my thesis. Nonetheless, the mode of inquiry conducted from particular and well defined natural law perspectives, when applied to the legal relationships and interaction of particular bodies of law, can lead to the type of broad deductive principle sought by Austin.

At some risk of oversimplification, Finnis’s theory of natural law commences with the premise that there exist immutable or universal values\(^{518}\), and that these are underpinned by an assumption (note not a presumption) of human reasonableness through which the values are pursued and made real in human-life. Finnis’s related assertion is that it is part of an individual’s very nature (natural law) to pursue such ends. One’s innate propensity is for the discerning of practical reasonableness in the pursuit of the universal values:

“Someone who lives up to these requirements is thus Aristotle’s phronimos\(^{519}\); he has Aquinas’s prudentia\(^{520}\); they are requirements of reasonableness or practical wisdom, and to fail to live up to them is irrational.”\(^{521}\)

In these terms, the various methods of practical reasonableness applied by the naturally rational person are the means by which pre-moral principles of natural law (basic values) are refined into attributes of moral natural law, the foundation upon which elements of justice are then derived.

Finnis’s analysis of the elements of justice (Chapter VII)\(^{522}\) provides a short though highly worthwhile example of these elements applied to the modern English regulation of insolvency.\(^{523}\) It is thus appropriate to consider some of the more significant observations made by Finnis and how the model propounded in this thesis both relates and contrasts. As for the critical notion of collectivism, Finnis observes that “bankruptcy law both gives effect to the commutatively just claims of the insolvent’s creditors and at the same time subjects all those claims to a principle of

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518 A non-exhaustive list of seven is offered by Finnis in Chapter 3 (pp 86 – 89 noting that they are basic values of well-being and do not therefore necessarily directly translate to moral good); Life, Knowledge, Play, Aesthetic experience, Sociability, Practical reasonableness and Religion.
519 Virtue of practical thought, “practical wisdom”.
520 Exercise of prudence, good judgment and common sense.
521 Ibid at p 102.
522 Ibid at p 161.
523 Ibid at p 188.
distributive justice." By adopting a rights-based focus, this thesis offers an alternative approach which, while recognising the basis of the bankruptcy process itself as being based on distributive justice, identifies the claims that are subject to commutation as being based on corrective justice.

Finnis develops further this point of competition between competing forms of justice created by "the peculiar circumstances of insolvency." The thesis model extends significantly consideration of 'competition' between alternative forms of justice and proposes in bankruptcy a basis of resolving such friction through emphasising ideas of self-understanding and internal coherence. Finnis makes a number of salient observations about the accepted norm:

" - - - as between all the ordinary creditors, who are neither preferred nor deferred under the law and who have no realizable security - - - 'equality is equity'. The debts they prove are paid to them pari passu." The model proposed in this thesis both reinforces the rationale of this norm, whilst establishing a basis for recognising judicial and policy-based measured exceptions.

Without wholly rejecting Finnis’s approach, its weakness as a source for generating legal norms can be illustrated by briefly recounting the character of Aquinas's natural law. Thomistic natural law because of its theological ontology tends of its very nature towards a more self-contained logic. At the heart of Aquinas’s natural law are four distinct but interrelated types of law: eternal law, natural law, human law and divine law. The basic premise is that the natural order of all things in nature will be to tend to fulfil their essential nature. Man, therefore, being imbued with reason through the providential or universal order of God (eternal law), will thus through the freedom to reason, direct or restrain his actions within society towards the promulgation of cohesion, the avoidance of offence and the shunning of ignorance - all in a manner in harmony with the dictates of God’s eternal order. The holistic nature of Aquinas's natural law is well captured in the following remark of Lloyd Weinreb:

“He [God] is the origin of all being, as an attentive artisan who has planned and provided for His creation and directed it towards its end, every aspect of creation is related to every aspect in a purposive, coherent whole.”

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524 Ibid.
525 Ibid at p 191.
526 Ibid at p 190.
It is this type of cohesion which is absent in Finnis’s natural law and which, more generally, impedes contemporary approaches to natural law from generating legal norms, let alone providing a basis for resolving the types of controversy dealt with in this thesis.

Finnis’s theory of natural law is regarded by Weinreb as an attempt, though one which falls well short, to find a basis of correspondence and convergence between law and morals. Such a propensity for convergence may at a superficial level seem both desirable and plausible. The proponents of this type of relationship would argue for the following systematic development of the law:

“The interdependence of legal and moral obligations caused by their joint application to the same person has the effect that, over time, a community’s legal and moral norms converge. The effort to work out an effective legal order will pull the law in the direction of the community's perception of the good.”

Indeed, it may be surmised that, were the law able to develop in such an apparent orderly fashion, the types of complexity and conflict described in Chapter 2 of this thesis would be resolved in an efficient and timely manner within a broad community consensus. Ultimately however, such a bland proposition fails to address the precise thresholds and mechanisms for the reform or modification of existing legal rules. Nor, more specifically, does it address the need for the law by both judicial and statutory development to appropriately reconcile conflicting expectations and demands, such as those which come to the fore in the circumstances of debtor bankruptcy. Whilst valuable insights can be gained from a natural law perspective, their transformation into practical legal solutions requires a more sustained analysis.

In contrast to the approach proposed by Finnis is the model developed by Lloyd Weinreb which is built very much around a close reading of the historical antecedents of natural law theory. Weinreb notices that contemporary natural law theorists and positivists both deliberately eschew consideration of the moral dimension, purpose or legitimacy of the law, so that the point of differentiation between them centres on a

528 Ibid at p 105.
529 This type of expectation about common law development is captured in the celebrated remark of Lord Mansfield that the law ‘works itself pure’ (Omychund v Barker, 26 Eng. Rep. 15,24; 1A and K. 22,23 (1744)), thus the law’s fidelity to principle rather than isolated decision. This theme of progression in the law is pursued by Michael McHugh (then Justice McHugh) in 1999 in a paper “The Judicial Method” ALJ 73 at 37, notably at p 41 that; “The movement towards overarching principle has been favoured in relation to estoppel, unconscionability, and unjust enrichment.” (case citations omitted)
debate around the existence or otherwise of a necessary obligatory character to the
law. Concerning the current state of natural law analysis, Weinreb makes the
following observation:

“- - - the reduction of natural law to its present deontological form is a
consequence of flat-out rejection of the whole ontological approach.” 530

In this statement Weinreb alludes to abandonment (either intended or consequential)
by contemporary natural law theorists (from Kant through to Finnis) of a stance that
the laws of nature are normative, rather instead seeking out moral requirements
within the law. There is thus, in Weinreb’s view, little resemblance between the grand
scheme of Thomistic philosophy and more recent attempts to develop a
contemporary natural law doctrine which is rights-focused, though steeped in moral
and ethical foundations. In terms of this significant reorientation in the examination of
objectives and justification of the law that has occurred in contemporary natural law
analysis, Weinreb makes the further observation:

“The question that Thomas Aquinas and others answered was, ‘How can
human beings be part of the natural order and still be free and morally
responsible?’ The question is now simply, ‘How can we be obligated to obey
the law?’” 531

In urging a view that ontological natural law still poses questions of enduring
relevance, Weinreb concludes:

“- - - the puzzle of human freedom in a determinate, causally ordered
universe persists for ordinary persons and philosophers alike.” 532

This idea of freedom in the context of human existence within a society characterised
by complex legal ordering, is discussed below in section 3.

Returning to morality, Weinreb makes the following remark, which is relevant to
understanding bankruptcy distribution:

“The laws of a human community - - - unlike laws of nature, do implicate
moral judgements.” 533

The moral and ethical dimension of bankruptcy law is evident from a number of
perspectives. Reference to these should ideally be applied as a basis for ensuring
that judicial and legislative developments are not directed at outcomes which are

530 Ibid at p 3.
531 Ibid.
532 Ibid at p 4.
533 Ibid at p 3.
extraneous or irrelevant to the legal obligations affected by debtor insolvency.\textsuperscript{534} It therefore provides the basis of the non-instrumental model of bankruptcy law developed in this thesis.

Bankruptcy’s distributive scheme can be addressed from a number of standpoints of morality. I apply these to an understanding of the norm that pre-solvency entitlements should be recognised and enforced as far as practical under bankruptcy's collective procedures. The morality that applies to debtor collectivism differs from the morality involved in assessing claims between debtor and creditor. That there is such a distinction is supported by the foregoing discussion in section 3.3.1 concerning pari passu treatment being akin to a distributive justice process, though significantly, subject to corrective justice norms applied on a collectivised basis. In contrast, the assessment of claims between debtor and individual creditor in the context of post-insolvency entitlement by way of priority or of proprietary claim, considers foremost the bipolarity of the relationship separate from other creditor claims. The source of the morality may, and indeed should, have a common basis particularly if internal intelligibility is assumed. An examination of natural law theory, and its contemporary re-evaluation which points to a communitarian emphasis, is used in the following passages to substantiate this analysis of the morality of creditor collectivism.

Communitarian ideas and ideals are enduring themes said to have their source in the Old Testament and the works of the Ancient Greeks.\textsuperscript{535} In a contemporary context, Amitai Etzioni states the communitarian objective to be the “re-establish[ment] in communities [of] the moral voice that leads people to encourage one another to behave more virtuously than they would otherwise.”\textsuperscript{536} The theme of virtuous debtor conduct is introduced in section 3.3.1 above and is further developed in 4.3.1. In applied terms, communitarianism deals with two issues: “the balance between individual rights and social responsibilities, and the role of social institutions that foster values within communities.”\textsuperscript{537} The ideas of rights and responsibilities resonate with this thesis’s objective of explaining the transition of private law obligation to collectivised treatment upon debtor bankruptcy. This gains expression in the discussion (4.3.2) of how bankruptcy distribution gives effect to the community’s

\textsuperscript{534} Problems of extraneous outcomes and their treatment are further considered in this chapter in section 4.3 where reference is made to statutory priorities in the contrasting contexts of corrective justice based rights and the imposing of external criteria.
\textsuperscript{535} A. Etzioni, Rights and the Common Good The Communitarian Perspective (St. Martin’s Press, New York 1995)
\textsuperscript{536} Ibid at iii.
\textsuperscript{537} Ibid.
collective purposes. In turn, ‘social institutions’ are considered in the thesis model with reference to the coercion and acquiescence (4.3.1) evident in the legal processes for orderly resolution of a debtor’s affairs.

Turning to the positivist perspective, Weinreb makes the following remark:

“The legal positivist’s response to contemporary natural law is in the same vein. Positive law - - - is identifiable by criteria of legitimacy that are not themselves requirements of morality.”

This point is relevant to the analysis of bankruptcy. If the law intervenes to vary relativity between competing creditors, and thus alters our expectations of collectivism and application of pari passu principle, it must do so on a basis of legitimacy. What are the criteria of legitimacy in this context? Economic criteria provide a possible justification for collectivism and a narrow basis for departure from that principle. But moral and ethical dimensions are also required if the principles of distribution are to be regarded as coherent. The argument is developed from the perspective of moral legitimacy as favoured by natural law scholars. In doing so I am not seeking to identify legitimacy based on legislative and judicial norms as favoured by legal positivists. I do, however, in section 4.3, present an argument from the perspective of the particular distinction between private law and public law as a basis for explaining the legitimate coercion necessary to achieve bankruptcy’s distributive outcomes.

Weinreb’s criticism of Finnis centres on whether a deontological approach to natural law is preferable to an ontological approach in establishing legitimacy. Weinreb analyses Finnis as championing a rights- and duties-based deontological approach, whereas he adopts for himself an ontological inquiry into the nature of being, proposing that this has greater theoretical validity and is a more robust basis for inquiry. The objectives of this thesis preclude a need to determine which is the better formulation of a natural law jurisprudence. Weinreb’s exploration of natural law antecedents and their re-evaluation, does, however, lend itself very effectively to the development of a natural law model of bankruptcy distribution. This arises in part from the emphasis which he places on Aristotelian metaphysics, which sits comfortably with Ernest Weinrib’s explanation of the nature of corrective and distributive justice. The latter, of course, is heavily dependent on an interpretation of Aristotle’s theory of justice.

Weinreb’s argument is that adoption of an essentially deontological perspective distorts analysis and cannot give rise to what can genuinely be described as a theory of natural law. In response to this criticism, my objective, first, is to briefly introduce some of the ideas developed by the seminal contributor to natural law jurisprudence – Saint Thomas Aquinas\(^{539}\) - in order to show their relevance to the points Weinreb is making. Consistent with Weinreb’s approach, I then suggest that clarity within the scope of the research questions explored in this thesis can be gained by examining some of the inquiry into the nature of being, reason and reasoning undertaken by Aristotle and his principal teacher, Plato. Weinreb’s approach can be seen as drawing on both Thomistic and Aristotelian traditions as part of his aim of presenting an argument for the contemporary relevance of natural law theory. I draw on this methodology to present a natural law-based explanation of the ethical dimensions of bankruptcy’s distributive processes and the moral attributes at play in the interactions between the parties – debtor and creditor, and as between competing creditors.

The fundamentals of Aquinas’s doctrine of natural law, which I have identified as founded on acceptance of the universal order of God’s creation and governing power of eternal law, are set out in the Treatise on Law, a component of his Summa Theologiae (Summary of Theology). The purpose and nature of the Summa is captured in the following:

> “The Summa is Thomas’s mature theological synthesis, aimed at providing beginners in theology with a systematic, overall account of both the divine nature, as knowable by faith-enlightened reason, and the divine plan and work of creating and redeeming the cosmos and ordaining it to a final transfiguration in glory at the end of history.”\(^{540}\)

It is unequivocally a theistic work set in its own historical and linguistic contexts. It should therefore be cautiously drawn on in trying to explain modern applied law. It

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\(^{539}\) Dominican Friar (1225 – 1274). See also the significant contribution towards applying Thomistic natural law to an understanding of the wider purposes and context of bankruptcy law developed by Veryl Miles (“Assessing Modern Bankruptcy Law: An Example of Justice” (1995-1996) 36 Santa Clare Law Review 1025). Set in what can be regarded as a Catholic Social Thought perspective on communitarianism, built also on Aristotelian ideas of justice, Miles traces the development of bankruptcy law from its harsh penal-oriented origins. Symptomatic of its theological orientation the work emphasises ideas of social justice and the common good presenting a normative view of modern bankruptcy as a mode of distributive justice by way of “requir[ing] creditors to sacrifice part of their claims to the deserving debtor through the debtor’s discharge and to other creditors through a ratable distribution of assets between similar situated creditors.” (at p 1042)

nonetheless provides a robust foundation for intellectual inquiry, particularly as its coherent nature points to acceptance of the type of non-instrumental analysis of the private law championed by Ernest Weinrib.

As in the case of Aquinas’s fundamental endeavour developed in the Five Ways by which God’s existence is proven, the Treatise on Law is contained in a series of questions (numbers 90 to 108) in which he presents propositions to which theoretical argument and counter-argument (‘Objections’, ‘I answer that’ and ‘Reply to Objection’) are, in turn, presented. The sources upon which he draws are not only biblical and include reference to a wide variety of philosophical foundations, notably Nicomachean Ethics. For Thomistic Natural Law to have contemporary value, it is necessary to look beyond the rudimentary idea that natural law constitutes the basic principles of practical-rationality for human beings, and that this has universality by virtues of nature – the subject matter of Summa Question 94. The scope of this thesis does not permit a thorough analysis of the full Treatise on Law. Nonetheless, a brief examination of a small part of the following Summa Question 95 does present a source for ethical reference by way of analogy, and moreover, adds validity to the contemporary reassessment urged by Lloyd Weinreb. Question 95 dealing with Of Human Law contains four articles; ‘Its utility’, ‘Its origin’, ‘Its quality’ and ‘Its division’. I address only the first which is concerned with the sub-question ‘whether it was useful for laws to be framed by men?’. Aquinas’s countering of objections to this question is contained in this passage:

“Laws were made that in fear thereof human audacity might be held in check, that innocence might safeguard in the midst of wickedness, and that the dread of punishment might prevent the wicked of doing harm.”

In present day thinking, it is unremarkable that laws are framed by men for the purposes of men. Aquinas does, however, go on to provide insightful and relevant statements concerning human nature in both social and broad legal contexts. He states in Summa Question 95:

“I answer that - - - man has a natural aptitude for virtue; but the perfection of virtue must be acquired by man by means of some kind of training. Thus we

541 Central to the Treatise on Law is Question 94 which contains six articles; what is the natural law?, what are the precepts of the natural law?, whether all acts of virtue are prescribed by the natural law?, whether the natural law is the same in all?, whether it is changeable? And whether it can be abolished from the heart of man?

542 St. Isidore of Seville Etym. V,20.This statement can also be consider in the context of the Rule of Law (refer following section 4.2.2)
observe that man is helped by industry in his necessities, for instance, in food
and clothing.”

This, I believe, speaks to the type of communitarian approach suggested by Weinreb,
to which I make reference in the following passages. Moreover, whilst there is
presented in the *Summa* generally, and specifically in this Question 95, a unified and
holistic process of theorizing, Aquinas directly acknowledges humankind in the
setting of participants and interaction. The character of humankind is further
developed by Aquinas in his countering of the first Objection$^{543}$ to the framing of law
by men:

“Men who are well disposed are led willingly to virtue by being admonished
better than by coercion; but men who are evilly disposed are not led to virtue
unless they are compelled.”

Here we can recognise a system of laws which have a graduated approach to
regulating private dealings of men. In bankruptcy law we can understand the
rationale of different degrees of intervention and coercion based on whether or not
the debtor has deliberately avoided obligations or sought to use the bankruptcy
procedure to his advantage or that of a favoured creditor. Notwithstanding its
antiquity and specific setting, Thomistic natural law has contemporary relevance in
the bankruptcy context.

Whilst both Finnis and Weinreb acknowledge Aquinas as “unquestionably a
paradigm ‘natural law theorist’”, Weinreb’s criticism centres on what he interprets as
Finnis’s conclusion that natural law as perceived by Aquinas was separate and
distinct from an ontological foundation of moral principles. Weinreb’s assertion about
the inseparability of natural law from universal order is summarised in a lengthy
footnote to his discussion of Natural Law without Nature. His position is stated in the
following terms:

“... to extract Aquinas’ doctrine of natural law from its context and to treat it
as separable from the idea of a universal order according to the Eternal Law
of God not only radically distorts Aquinas’ philosophy as a whole but
misconceives the doctrine of natural law itself. It is because the universe is
ordered by divine Providence that there is natural law, and because we know
that it is so ordered we know that there is natural law.”$^{544}$

$^{543}$ This, the first of three Objections, concerns that man cannot be made good against his will;
admonition is therefore of no point and there is thus no need or point to framing laws.
$^{544}$ *Natural Law and Justice* (Harvard University Press, Cambridge Massachusetts, London
These words are insightful in solving a conundrum in natural law jurisprudence, namely that of the capacity for discernment and acceptance of what might be termed heuristic norms without the need for an empirical foundation. It is the framework within which natural law is applied that is essential to understanding natural law theory. Of his own approach, Weinreb states the following:

“The argument of this book restores the original understanding of natural law as a theory about the nature of being, the human condition in particular. Not that the solution to the ontological theories is correct. The questions to which they respond, however, arises in our experience of ourselves and others as self-determining individuals.”545

As I have remarked above in relation to Finnis’s conception of natural law, the ontological approach is a valid basis for examining the objectives and limitations of a body of legal rules such as a bankruptcy regime. It works, however, only at a relatively abstract level. Without something more, it is unlikely to form a basis for generating deductive norms for the development of precise legal rules, such as those applied in the contexts of creditor entitlement recognition and insolvent debtor estate distribution. In terms of the ends sought by Finnis, Weinreb concludes that:

“No inference from fact to value is required; the process of thought is not inferential at all. Rather, one proceeds by careful reflection, or meditation, directly to awareness of self-evident, incommensurable truths.”546

As we have already seen, Weinreb mounts a vigorous and sustained challenge to the validity of the deontological theory of natural law.547 So it is worth identifying and describing what are seen as some of the more enduring ontological based foundations, analysing them particularly in terms of how they might be applied to explain the key characteristics of a bankruptcy regime, and how such a body of legal rules ought interact with others. Such an undertaking is somewhat speculative given that it is unlikely that Weinreb, let alone any of the philosophers and writers to whom he refers, contemplated the comparatively mundane circumstance of a debtor’s insolvency. Nonetheless, the moral and ethical perspectives being explored are more than merely complementary to an economic appraisal of the objectives and limitations of bankruptcy law. They provide an understanding of the moral assumptions informing bankruptcy law.

545 Ibid at p 7.
547 Weinreb states in his introductory chapter at page 8 “Stated as strongly as the theory allows the arguments for a deontological natural law do not succeed.”
Weinreb’s ontological approach is deeply grounded in Greek metaphysics, and so predates the seminal influence of Thomas Aquinas which drove natural law inexorably towards Christian notions of divine purpose. In this connexion I can only briefly touch upon some of the controversies dealing with the moral purpose of the law. Relevant to the purposes of this thesis are explanations of the ends to which a society’s laws are developed. Though initially remote, these explanations provide insight into the evolved nature of bankruptcy law whose norms are widely accepted in society as logical and necessary to deal with the phenomenon of debtor bankruptcy.

Two juxtaposed quotations are relevant:

“Protagoras  argued that societies developed law as part of their progress towards civilization and that laws are necessary to communal life. If human nature thus makes laws necessary, they are not ‘by nature’ - - - they are acquired deliberately and with difficulty.”

Contrasted with:

“The most completely opposed view is represented forcefully by Callicles - - - . He argues that the laws of the community are contrived by the weak to prevent the strong from acquiring what is naturally theirs. True justice is according to nature, [that] which favours the strong.”

To these Weinreb adds the further salient remark:

“From a strictly ethical point of view, those like Protagoras who defended the law as a human achievement and those who defended it as divine or natural prescription were allies against those who rejected as unnatural any moral obligation contrary to self-interest.”

This sequence of statements is noteworthy as it can be interpreted as foreshadowing the communitarian basis upon which more contemporary natural law doctrine might be developed. It also suggests scope for a justification of the moral and ethical underpinning of obligations. A number of relevant themes can be identified in these remarks. The first is the pursuit of individual self-interest, particularly as it is played

548 ca. 490 BC – 420 BC. Pre-Socratic Greek philosopher recognised by Plato as one of the sophists (Sophos “wise”).


550 Callicles and Thrasyymachus are both identified as being contemptuous of conventional morality.

551 Ibid at p 29.
out in commerce and trade\textsuperscript{553}, which in the extreme cases is manifested in the
dominance of the powerful over the weak. Whilst it is beyond the scope of this thesis
to trace the shifting expectations as to fair dealing in contracting, and how equity may
intervene in cases where these expectations are not met, it is appropriate to reiterate
that bankruptcy law is indifferent to any differential bargaining power between debtor
and creditor. The bankruptcy rules intervene only at the point at which a debtor’s
position is either irretrievable or can only be recovered through an orderly
suspending of individual creditor claims. Secondly, once the condition of a debtor’s
insolvency becomes apparent, each creditor’s relative bargaining position is
disregarded; creditors are treated alike, except for preferred creditors and creditors
making proprietary claims. Thirdly, characteristics such as pari passu treatment,
though widely acknowledged as communally beneficial, can only be achieved by a
legitimate authority resisting the desire of some creditors to obtain benefits by
operating outside the procedure.

These characteristics of a bankruptcy regime which in Chapter 1 were introduced
from a largely economic perspective can equally be rationalised as functions of
communal life through which intervention in the dealings between individuals can
only be justified in certain and predictable circumstances, and then, only discharged
in a manner which is impartial. It is on this basis that a correspondence between
normative legal principles, based on natural law and applying the rule of law, can be
identified.

It is important to note that the ideas espoused by the Greek writers of the fourth and
fifth centuries BC to whom Weinreb refers, are best characterised as positivistic in
nature, Weinreb’s concluding remark on these positivistic antecedents to natural law
being that the relationship between order (\textit{kosmos}) and nature (\textit{physis}) “reveal[ed] no
underlying justificatory order.”\textsuperscript{554} Against this background, it is appropriate to consider
now some of the moral and ethical dimensions of human existence identified by Plato
and Aristotle which have contributed to the development of natural law reasoning. My
brief consideration of these perspectives provides insight into some of the
characteristics of ontological natural law which may, when viewed in conjunction with
an alternative deontological perspective, constitutes a rigorous non-economic basis

\textsuperscript{553} Hence the often quoted passage of Adam Smith: “It is not from the benevolence of the
butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own
\textsuperscript{554} \textit{Natural Law and Justice} (Harvard university Press, Cambridge Massachusetts, London
for considering the objectives and limitations of bankruptcy law. The contrast between Plato’s and Aristotle’s conceptions of rationality and moral ordering is succinctly encapsulated in Weinreb’s observation:

“Reduced to barest, generally agreed essentials, the philosophy of Plato affirms that there is divinely ordered reality, which is ultimately good and determinative of the good of human beings.”

Further:

“Compared with Plato’s poetically charged vision, Aristotle’s conception of law or order in nature seems, as in a sense it was, earth-bound.”

And perhaps most significantly:

“Aristotle’s ontology, like Plato’s, was teleological. Unlike Plato, his methods and his intellectual inclination were empirical.”

As a teleological or ends/ outcomes based mode of inquiry, Aristotelian ethics are strongly orientated towards the identification of virtuous conduct through critical analysis. In particular, it is through human reason, when applied to an understanding of change that takes place between current and chosen future state of being, that concrete principles and standards of behaviour can be deduced. In these terms, ethical principles are natural, and thus ontological in character, consistent with attributes of self-determining individuals. It is these characteristics of inquiry and the judgment of ordinary people, upon which Weinreb places the important qualifiers or precursors of education and training, rather than upon the more remote and metaphysical Platonic conception. These attributes, as will be discussed further, are significant in Aristotelian notions of the Rule of Law. As Ernest Weinrib notes:

“Aristotle regarded law as at least a possible sphere for the autonomous engagement of intelligence.”

Significantly Weinrib adds to this the observation:

“- - - his [Aristotle’s] most striking insights about law received their appropriate elaboration only in the writing of Kant and Hegel.”

555 Ibid at p 32.
556 Ibid.
557 Ibid.
558 Aristotelian ontology should not be characterised as theological in nature (as Thomas Aquinas’ clearly is). Weinreb remarks that “It [Aristotle’s conception] is a wholly intellectual abstraction, with no personal appeal and scarcely any emotional or moral force.” Ibid at p 33. The ontological character thus centres on the immutability of change which must be attributed to a God-like conception.
559 “The Intelligibility of the Rule of Law” in (Hutchinson and Monohan ed.1987) The Rule of Law; Ideal or Ideology p 60.
560 Ibid at p 61.
Whilst analysis of this understanding is more fully explored below (section 4.3), it is worth reiterating here Weinreb’s rejection of a primarily deontological based conception of natural law, much of which has been advanced by reference to Kantian analysis of the experience of freedom as the basis for defining morality. The model developed in this thesis is based on a preference for an ontological understanding of natural law applied to the recognition of bankruptcy entitlements. This should not preclude a stronger preference for a more deontological emphasis when addressing the coercive attributes of the distributive process. This measured blending of approaches is also essential to converting normative principle to applied outcomes which have the type of coherence urged by Ernest Weinrib in his non-instrumental description of private law.561

A significant element within Aristotelian analysis of ethical conduct is therefore the notion of the external stimulus of change and, relevantly for our purposes, the idea that empirical observation of everyday life can enhance our understanding of virtue. This empiricism may be derived from observation of economic behaviour at both a micro-transaction and macro-societal level. What might otherwise be regarded as a relatively nebulous and subjective conception of virtuous conduct can be considered as a highly practical context of human interaction. For the purposes of this thesis, the source of change is the event of debtor insolvency. Identification of this event permits a non-abstract assessment of what the law should promote by statute and judicial decision as “virtuous” behaviour contingent upon the event of bankruptcy. Earlier in Chapter 3 (3.3.1) where I discussed the contrast in ordering achieved by corrective and distributive justice, consideration was given to Aristotle’s concept of virtue as a balance between extremes of internal character. There the discussion focused on transforming, within a theory of private law, what are attributes of excellence in character to other-person directed behaviour. Here, economic behaviour can be seen to form the basis for examining other-directedness, first absent insolvency, and then in a multi-person setting within bankruptcy’s distributive scheme. As further developed in sections 4.2.2 and 4.3.1, economic behaviour determines the context of interaction. Nonetheless the theory developed in the thesis is non-economic in nature

561 There may be some tension between the use of Weinrib’s deontological moral approach to corrective justice and Weinreb’s non-deontological conception of natural law. Weinrib’s deontological moral approach needs conceptions of natural law if its claim to doing justice on the basis of correlativity is to be sustained. Expressed simply, we must find a coherent basis for explaining the shift from bilateral to multi-lateral relationships. Bilateral relationships are based on the idea of correlative rights and duties. Multi-lateral relationships, of the sort that occur in bankruptcy, raise issues of their communal purpose. The tension exists because both ideas play a part in explaining and justifying a bankruptcy regime.
in that it emphasises ideas of coherence and moral rationality inherent to the law of private obligations. The context of economic behaviour should not push the thesis model unduly towards an instrumental explanation of the purpose of bankruptcy law. Rather the economic context provides the basis for a normative consideration of what the behaviours of the players ought to be in the event of insolvency and why it is that bankruptcy law adheres to an internal coherence grounded in the rationality of private legal rights.

4.2.1.2 Modern bankruptcy law understood from a communitarian-based re-evaluation of natural law

As argued in the preceding chapter, contrasting notions of corrective and distributive justice provide worthwhile perspectives on how bankruptcy law gives moral and ethical underpinning to the resolution of dealings between insolvent debtors and creditors. This normative rationality is likewise observed in the law’s treatment of inter-creditor competition. Whilst economic behaviour in response to insolvency is based on practical considerations, the law should guard against allowing economic principles to encroach to the point of undermining rights. Furthermore, while the exercise of legal rights has economic consequences, the concept of a legal right itself is non-economic.

Two themes are paramount in Weinreb’s criticism of the notion that natural law can identify moral obligations from which legal obligations can be generated. The first is that it fails to give proper regard to the interdependence of freedom and morality; the second, that by the substitution of ‘civil society’ for the metaphysical (the deontological rather than the ontological basis) central or self-evident principles of law can be ascertained merely by abstract reasoning, as opposed to empirical observation.

Guidance from Weinreb’s critique of contemporary natural law can be found in some of his concluding remarks concerning justice and natural law. Here he introduces the communitarian perspective. Essentially, the communitarian argument described by Weinreb, centres on the notion that it is misconceived to rationalise justice as an

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563 Ibid at p 113. The proposition of a universality of self-evident moral norms without regard to an accepted external or independent point of reference, as Weinreb sees as pervading John Finnis’ methodology, is seen as the assertion of personal conviction.
independent universal ideal.\textsuperscript{564} The ‘ontology’ of justice, must be discerned from the community's way of life and the contemporary values prevailing in that community. This argument is based on Alasdair MacIntyre’s ideas of virtue as only having meaning within the context of a communal way of life. He concludes:

“Only a fully constituted person, with a character and history, attachments to others, and a sense of himself as he is and as he would like to be can make significant moral decisions.”\textsuperscript{565}

Additionally, the communitarian perspective is an adaptation of, or even departure from, the Aristotelian approach which asserts a purposive character as part of the human essence. Instead what is seen as determinative in accepted moral obligations is the integrated nature of human life which can only appropriately generate community rather than universal norms. Again, he concludes:

“- - - to speak of morality independent of the community's way of life is a mistake and leads invariably - - - to moral debates without outcome.”\textsuperscript{566}

Stepping outside these philosophical contemplations into the practical realm of the recognition and treatment of legal obligations, a debtor’s insolvency is an event clearly demanding an outcome. Whilst a ‘legal event’ often, though not always, has an economic context and outcome, developing a rational basis of resolution is based on consideration of the ‘moral event’ of private law obligation and the ‘moral consequence’ of an inability to pay debts. The resolution of disputes arising from insolvency is to be found in a natural law model, based on the communitarian perspective of the debtor.\textsuperscript{567} Obligations are subject to a transitioning from individual

\textsuperscript{564} Ibid at p 249.
\textsuperscript{566} Ibid at p 252.
\textsuperscript{567} There are of course significant examples of communitarian ideas and ideals being applied to a normative explanation of the nature of bankruptcy law. Foremost amongst these is Karen Gross \textit{Failure and Forgiveness Rebalancing the Bankruptcy System} (Yale University Press, New Haven and London 1997). Professor Gross’s approach commences with a proposition that in bankruptcy a dual perspective on debtor and creditor which further emphasises the maximisation of creditor returns is deficient, once placed in a communitarian context. She nonetheless acknowledges the challenge, particularly in terms of the “American philosophical orientation towards individualism”, of admitting into consideration those “with a substantial nexus to the debtor.” (p. 19) A significant attribute of Gross’s theorising about the role and impact of bankruptcy distribution is that it is located in a context of where burdens are borne. This concerns foremost the business failure, but also the addressing of the processes of debtor forgiveness and sharing amongst creditors. In these terms, though not in this terminology, bankruptcy is viewed from the perspective of its externalities of where consequences ultimately have impact. Gross recognises the risk of indeterminacy and the need therefore to place a limit on the admitting into consideration community interest. She proposes a ‘three pronged’ test (pp. 211-214) which commences with identifying debtor/community nexus – this is context based and may include, for example, an ecosystem or
bipolar interactions (Weinreb’s ‘attachments’) to one of multiple and conflicting
demands to which full satisfaction cannot be given. Weinreb’s ‘fully constituted
person’ opts to have his creditors treated equally, as the attachments to a multiplicity
of others makes this the self-evident correct outcome consistent with a
communitarian ideal.

This of course is not to deny the necessity for dealing with those circumstances
where the debtor perceives a benefit in preferring a particular individual or class of
creditor. The corollary of this ideal is the need to resolve the friction caused by the
individual creditor’s potential to gain through opting out of the collectivised procedure.
Again, creditors are in a post-solvency position attached to each other through their
claims on the debtor’s deficient pool of residual assets. The logic of attachment within
a communitarian setting, rather than mere benevolence, makes the collectivised pari
passu outcome self-evidently correct in both practical and moral terms. The
communitarian approach answers affirmatively the question; would a debtor, were he
a creditor, seek to be treated with equal standing alongside other creditors, were the
circumstances reversed? These are moral decisions of significance as Weinreb
would define them. They deal with both the inability to fully satisfy obligation (‘moral
events’) and the conflict between individual and collectivised outcomes (‘moral
consequences’).

The ideal which has been put forward here does not arise without more. It requires
an institutional framework which entails a degree of coercion. The nature and validity
of these positive law attributes of bankruptcy are examined in the following sections
of this chapter.

The ideas of ‘community way of life’ and ‘attachment to others’ which are central to a
communitarian position, suggest acceptance of a predominately economic focused
understanding of the objectives of a bankruptcy distributive regime. Economic
behaviour is one way in which an individual engages with and become part of a
community; other means are through family and friendships. Likewise, bankruptcy
law clearly operates within the comparatively mundane day-to-day operation of the
social welfare nexus. The critical second step is to identify a circumstance of ‘palpable injury’
that will be felt by the debtor bankruptcy. Finally, the injury must be capable of redress
through the bankruptcy proceeding and process. Without examining this in detail in this
thesis, such an approach would seem highly legitimate in understanding the circumstances of
large-scale and complex corporate failure and is insightful in explaining the dilemmas of mass
tort and corporate bankruptcy.
community and its commercial functioning, by which resources are allocated and consumed in a manner dictated by the economic mechanisms of markets and exchange. Bankruptcy, though very often set in an economic context, has consequences warranting deeper understanding, particularly when seeking rational and efficient solutions to the shared impact of a debtor’s inability to pay debts. The challenge, in the design of bankruptcy distribution rules, is to reconcile disharmony between economic and more fundamental ethically driven objectives. The basis of the reconciliation is to be found in the morality of promising, the source of which in this thesis is based on a theory of private law specifically articulated by Ernest Weinrib.

The idea of interdependence is also highly relevant to the relationship between morality and the experience of freedom – again, an idea directly attributable to Kant, summarised in the following terms by Weinreb:

“Freedom not only makes morality possible but, fully understood, determines it. We come to understand freedom and morality together because they cannot be understood apart. The actuality of one is the actuality of the other.”

Private law, and more particularly the law of obligations, involves notions of freedom in terms of both contractual dealings (freedom to enter voluntary relationships) and non-consensual interactions which arise, for example, where a wrong is committed (freedom to exercise one’s rights). In these terms, a moral assessment of the allocative aspects of bankruptcy law can be applied. This is a genuine alternative to a predominantly economic perspective. As was explained in Chapter 1, the bankruptcy regime should intervene to preserve the relative economic position as between a debtor and classes of creditor. Equally, the regime as far as practical should in its apportionment and distribution of the debtor’s assets reflect and protect the freedoms adversely impacted by the event of insolvency, or in Weinrib’s terms, the correlativity between the parties. It is in terms of freedom which makes moral choice possible that a corrective and distributive justice analysis gives greater clarity to the objectives and limitations of a bankruptcy regime. It is through bankruptcy law’s recognition of private law obligations that reflects communitarian derived morality. It is the morality of private law obligations, alongside the morality of resolving competing claims, that the distributive framework of bankruptcy is applied through both its conceptual and institutional features. Any change, for example in the treatment of tort claims or the

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enforcement of proprietary remedies, must reflect this communitarian morality. The change must apply that morality and not upset the orderly process of enforcing claims in bankruptcy.

Weinreb offers a way through the complexity which over the centuries has surrounded natural law jurisprudence. It can be summarised by the following remark:

"Instead of trying to show how legal obligation is coincident with an independently validated moral obligation, we might begin at the other end and look first to the conditions of a just social order."569 (Emphasis added)

I do not take this statement to infer a preference for a strong positivist conception of the law under.570 Rather, I believe that Weinreb’s proposition points to the type of challenge addressed by Ernest Weinrib in his analysis of legal obligations in terms of corrective and distributive justice. When discussing the type of dilemma which has inhibited natural law’s capacity to generate practical deductive legal norms, Weinrib makes the following observation:

“No doubt the very idea of understanding something in terms of itself is problematic. - - - The understanding of law in terms of itself requires that law have a nature which renders it capable of such understanding. The integration of the activity of understanding and the matter to be understood is impossible unless the matter is informed by thought, because only through the medium of thought can the relationship between understanding and what is understood be reflexive.”571 (Emphasis added)

Determination of the condition of a just social order, and the manner in which positive law gives it effect, compels the type of integrated understanding urged by Weinrib. The ‘activity of understanding’ is developed from the moral concepts which go to make a just social order and the ‘matter to be understood’ being the legal controversies dealt with by judges and legislators. Applying this integrated approach the ‘activity of understanding’ is no longer a remote and static one, as is the case with much philosophical doctrine developed by natural law. Corrective justice, dealing with the practicalities of a legal correlativity taking place between freely acting individuals, promotes the dynamic ‘community way of life’ as urged by Weinreb. Collectively, these factors provide a workable moral conception of justice applicable to bankruptcy distribution which can be contrasted to alternative economic, sociological or political theories of the law. Thus:

569 Ibid at p 126.
571 Ibid at p 69.
“Corrective justice is not itself something posited. Rather, it is a moral concept signifying the regulation of an integration by reference to the correlative of doing and suffering an injustice.”

As described in the previous chapter, corrective justice analysis provides a valuable understanding of legal obligations and entitlements, and in turn provides guidance as to the mode and objectives of legal intervention in cases of bankruptcy distribution. Within a natural law model of bankruptcy, corrective justice takes on a restricted communitarian dimension explained by the need to move beyond the correlative of bipolar interaction to one where a multiplicity of interactions are dealt with collectively. How this collective interaction is achieved is described in the following sections 4.2.2 and 4.3.

4.2.1.3 The treatment of non-consensual claimants in a natural law setting

This section of Chapter 4 concludes with a natural law argument for the proposition that non-consensual claimants deserve priority over claimants enforcing consensual obligations. The important assumption made in relation to the latter, is that they have full contractual capacity and are not victims of unconscionable or other conduct that would render the contract voidable. The particular criteria applied are coherence, moral rationality, merit of creditor claim and the assumption that the debtor has acted virtuously towards multiple claimants, set in the context of a nature law-based presumption of a just social order.

It is important to identify the respects in which a non-consensual creditor relates to the debtor. The only relationship between them relates to the remedy. Moreover, these pre-insolvency rights are not based on any assumed level of voluntary risk bearing.

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573 Earlier in the thesis (2.1.4) footnote reference (respectively 206 and 207) is given to two High Court decisions (Woolcock Street Investments Pty Ltd v CDG Pty Ltd [2004] HCA 16 and Perre v Apand Pty (1999) 198 CLR 180) recognising negligence claims for pure economic loss. See also Barclay v Penberthy [2012] HCA 40. Of particular note is the consideration given to vulnerability and capacity for self-protection. Keifel J in a separate, though broadly concurring judgment, after setting the background context of a shift in judicial attitude away from adherence a view that “Policy choices have featured strongly in the disinclination of the common law to allow recovery for pure economic loss” [165], goes on to note that vulnerability “refer[red] to the plaintiff’s inability to protect itself from the consequences of a defendant’s want of reasonable care”.[175] For a critical analysis of the application of the concept of vulnerability in this context see C. Whitting “Tort Law, Policy and the High Court of Australia” (2007) 31 Melbourne University Law Review 569.
The natural law concept of virtue allows a number of factors to be taken into account when considering the application of rights accrued within the pre-insolvency relationship to the post-solvency context. These include coherence, which requires the nature of the pre-solvency relationship to be reflected in the application of the pari passu principle post-solvency. But it also includes the criterion of the just social order which takes into account both the debtor’s conduct and the creditor’s consent to that conduct. Both are magnified by the event of insolvency since a court cannot do justice to all creditor claims in view of the insufficiency of resources. Since the concept of virtue is based on community expectations the law is justified in applying coercion to enforce those expectations. By this means, also, the community’s expectation of an efficient and predictable resolution of the bankruptcy process can be satisfied within the framework of the underlying law (refer 4.3.2 below).

The application of the concept of virtue to tort claimants will result in many, but by no means all, such claimants being entitled to a higher priority in the distribution of the debtor’s surviving resources than consensual claimants. This will be the case whether the tort is negligence, which has attracted most attention, or assault, defamation or trespass to land. Where however, virtue (in its natural law connotation) cannot be claimed by the tort victim is where the victim could have taken steps to minimise the commission or impact of the tort (such as taking simple security precautions to prevent the commission of trespass to land) or to minimise the financial consequences of the commission of tort (such as by taking out insurance which is required by legislation, such as motor vehicle insurance, or which is readily available). In those cases in which the tort victim could not have taken reasonable steps to prevent the commission of a tort, and is therefore a meritorious creditor, the claim in bankruptcy should be satisfied in full before a consensual claim is met. The claim will not, however, be entitled to priority or equivalence to claims based on statutory priority, such as employees’ wages. This is because the distributive preferences of the legislature have priority over all corrective justice-based claims, whether arising out of wrongs or from consensual transactions.

Some personal claims in unjust enrichment should enjoy the parity given to tort claims. In particular, victims of duress or undue influence cannot take steps to prevent the defendant’s enrichment. Although duress and undue influence are not torts, or even wrongs in the sense that the recipient’s receipt of the unjust enrichment arises from a breach of duty, the natural law principles applicable to such cases are identical to those applied to tort claims. The claimant creditor ought to be entitled to
priority because he could have taken no reasonable steps to prevent the loss of wealth, and the recipient debtor must exercise virtue by repaying the amount once he has realised he has received wealth non-consensually. In many such cases the deliberatively exploitative nature of the recipient’s conduct will demonstrate lack of virtue.

Personal claims to restitution of a mistaken payment present a complex picture. Outside bankruptcy, the mistaken payer is entitled to personal restitution of the payment, subject to the application of a recognised defence such as change of position. The payer’s fault, or lack of fault, does not determine the availability of the personal remedy. In bankruptcy, however, any priority accorded to a mistaken payer over, say, a contractual claimant will depend on a finding that the creditor payer was meritorious in taking such reasonable steps as he could have done to prevent the accidental diminution of his wealth.

The application of natural law reasoning does not involve the application of instrumental methods. For example, the solution does not involve the application of economic analysis. Insofar as bankruptcy law attains efficient solutions, this is because the community’s standards in promoting a just social order requires the promotion of efficiency, not because welfare will be maximised by the promotion of efficiency. Bankruptcy law promotes the internal rationality of private law; it does not promote instrumental goals that are independent of that rationality.

The law’s prioritising of proprietary remedies in bankruptcy is less certain on the basis of this analysis. The nature of the underlying debtor/creditor relationship will often be consensual in nature, as in the case of a mortgagee whose claim to the security antedates the claims made by the liquidator on behalf of the unsecured creditors. The strongest claim to recognition and enforcement of a non-consensual proprietary interest, for example an interest based on unjust enrichment, can be made, on this analysis, to a claim based on corrective justice, upon a full consideration of the behaviour of debtor and creditor. So a claim to a constructive trust based on mistake where the debtor recipient of the payment became aware of the payment before insolvency, is rightly entitled to priority according to this model, thereby validating the analysis of the *Chase Manhattan* and *Wambo v Ariff* decisions discussed earlier. The payments in these cases were involuntary, so excluding the possibility of self-protection by the payer, and the recipient’s retention of the payment after becoming aware of the mistake means that no appeal could have been made to
debtor virtue. The same analysis can be applied to claims to an award of constructive trust based on duress or undue influence.

In *Westdeutsche v Islington Borough Council* and *Goldcorp*, on the other hand, proprietary relief was rightly denied. Both cases involved cases of failure of consideration, meaning that the basis or assumption on which the payment was made had failed. In such cases the payer's consent to making the payment is not defective, and the payer has, in theory at least, an opportunity to negotiate a basis for making the payment which adequately protects his interests. Alternatively, and perhaps more commercially realistically, the payer has a choice not to make the payment. Failure to do so, having had an opportunity to assess the terms on which the investment will be made, as well as an opportunity to explore alternative investments, demonstrates absence of virtue (or comparative merit) on the part of the creditor.

It is possible, however, that the claimants in *Goldcorp* might have been entitled to priority on the basis of deceit committed by the insolvent company in representing that it had adequate supplies of bullion which it had appropriated to the purchasers' contracts. Deceit, if proved, would have nullified any assumption that the purchasers were in a position to negotiate their own bargain. The purchasers would then be the victims of an insolvent tortfeasor. Their claims would next have to be assessed against the claim of the registered charge holder over Goldcorp’s assets, who had (presumably) also been a victim of the company’s deceit. It is not clear in the case where all the relevant parties have relied upon the same deceit or fraud that there is any communitarian value in altering priorities on insolvency. In such cases, even so-called consensual claimants are in practice non-consensual by reason of the debtor’s deceit or other fraud.

The distributive hierarchy in these cases will nonetheless be less than ideal because of the very nature of the insolvency itself. The circumstance of insolvency requires answers to hard questions of priority which would not otherwise arise. A framework of analysis based on internal coherence and non-instrumental outcomes applies to bankruptcy the same kind of moral rationality that is applied to the law of private law obligations itself.
4.2.2 The Rule of Law
In this section I argue that aspects of the Rule of Law promote the practical application of the natural law model discussed in previous sections of this chapter. They contribute to an understanding of the integrity and coherence of those aspects of the law, both statutory and judicial, that determine outcomes, particularly in complex bankruptcy distributions. A consideration of the Rule of Law is necessary in part in order to take us out of the more esoteric discussion which pervades Thomistic and similar metaphysical analysis. The objective of this section is to provide a basis for identifying legal processes which must deal with the day-to-day pervasiveness of human dealings that go wrong due to one party’s inability to pay his debts.

Whilst John Finnis and Ernest Weinrib adopt different perspectives on the nature of the Rule of Law, both pay particular regard to the significance and centrality of authority. The Rule of Law should, in Weinrib’s view, be regarded as more than a mere list of characteristics or attributes of a system of legal order. It has a more enduring underlying character that gives explanatory force to the nature and objectives of a functioning legal system. This perspective is applicable to an understanding of the various rules which make up a bankruptcy regime.

The application of natural law ideas to insolvency in a legal setting gives rise to two challenges relating to the realisation of these ideas in practice.

The first requires an applied analysis of the specific character of the rights and obligations recognised by private law, the enforcement of which are affected by the bankruptcy process. The second challenge concerns the manner in which the moral and ethical content that justifies the enforcement of rights is given proper effect. It is in this context that the following discussion of the Rule of Law is presented. In addressing both these challenges, legal classification is of critical importance – a point further elaborated in the discussion below (section 4.3) of the dichotomy between public and private law.

Neil MacCormick in his discussion of Scottish and English endeavours to assemble a comprehensive and ordered documentation of national laws, remarks that Blackstone (and others) who adhered to what he termed vestigial jusnaturalism, placed special emphasis on the supremacy of the legislature:

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574 Loosely, meaning embryonic or rudimentary development of form, or residual vestige thereof. The use of the word vestigial may seem more often applied biological development,
“The principles of natural law are vague, and they leave many things indifferent: the legislature must make law clear in all cases, and must make law for the public benefit in the areas of indifferency of natural law. The legislature's is a supreme, the judges' a subordinate or derivative, power; in so far as custom and precedent function as sources of law, they do so by virtue of a tacit command of the legislature.”

It is these ideas of power, command and authority which are central to the idea of the Rule of Law.

Aristotle considers the critical question of how the state and its various instruments of power intervene in the day-to-day dealings of members of society – this from the relatively benign perspective of the character of judicial conduct and the nature of judicial reasoning. It is this perspective which is relevant to the model developed in this thesis. The judiciary is seen as ideally distinct from other sources of oppression and exploitation. Power, in particular, must through other institutional arrangements be moderated or channelled through judicial processes.

The characteristics of conduct and reasoning encapsulated in Aristotle’s account of the Rule of Law are explained by Shklar in the following terms:

“Justice is the constant disposition to act fairly and lawfully, not merely the occasional performance of such actions.”

When placed in a litigation context, this requires particular attributes of forensic analysis of fact and argument, noting that each party will urge upon the deliberations their own most favourable interpretations, hence:

“That indeed is in the nature of persuasive reasoning, but those who judge, be they few or many, must go beyond it to reason their way to a logically necessary conclusion.”

It is in these terms that it is said that the process of mediating the exercise of power by persuasive reasoning imbues the law with an ethical character and rationality. According to this account of the Rule of Law, the process of justice functions in private disputes with attributes of impersonality and a particular mode of judicial reasoning:

but here may seem a worthwhile analogy alluding to the necessity in applied legal development to move beyond the often vague, or even ambiguous, concepts of natural law.

576 Ibid at p. 3.
577 Ibid.
“It is part of such a character to reason syllogistically and to do so his passions must be silent.”

This idea of detached reasoning by which conclusions are deduced from competing arguments is conducive to the development of deductive reasoning norms urged by Austin and MacCormick and described in the introductory chapter of this thesis. The fact, however, that this deductive reasoning cannot give certainty in legal outcomes is emphasised in MacCormick’s observation that:

“Law does not, of course, have conclusive moral value, since legally established rules can sometimes, perhaps even often, fall some way short of any reasonable moral ideal, and can even stand condemned by that test sometimes.”

And further;

“This does not mean that the law is always certain while moral it is uncertain. The reverse is sometimes the case.”

One of the key benefits of Aristotle’s descriptions of the Rule of Law is its emphasis on both the political and philosophical contexts of a legal order. This type of perspective overcomes the practical difficulty of recognising and applying any presumed inner morality of the law. It provides the type of framework of understanding alluded to by Lloyd Weinreb in his discussion of natural law and the need to seek out a basis of reconciling conflicting legal and moral obligations. It also presents a basis for rejecting, the positivist assertion that law and morals “are distinct normative systems.”

The Aristotelian notion of the Rule of Law can be challenged on a number of fronts, two of which are considered here. The first concerns the manner in which elements

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578 Ibid.
579 This idea of an enduring and inner morality of the law is given its best articulation in the writings of Lon Fuller (The Morality of Law (New Haven, 1964)), one of the key characteristics from which is described by Lloyd Weinreb: “Fuller, who was concerned to explain how law has effect, thought it as the rules themselves, prescriptions that, once their meaning is settled for the time being, can be regarded independently of time and circumstances.” Natural Law and Justice (Harvard University Press, Cambridge Massachusetts, London England 1987) at pp 103-4.
581 Ibid.
582 See generally Judith Shklar, “Political Theory and The Rule of Law” in The Rule of Law Ideal or Ideology (Hutchinson & Monahan ed.) (Carswell Toronto Canada, 1987) p. 6 and the identification of the political and philosophical context as the basis for overcoming supposed weaknesses in Lon Fuller’s argument of an inner morality of the law.
of policy, or wider economic and social contexts can impinge in hard cases to operate as a source in the development of the law, separate from direct legislative reform. This issue is dealt with in the context of Weinrib’s elaboration of Aristotle’s characterisation of the Rule of Law and his rebuttal of positivist legal theory’s scepticism about the Rule of Law. The second challenge to the notion of an essential ethical function within judicial reasoning concerns the non-exclusive nature of such an attribute. As Shklar observes:

“The judiciary is not alone in claiming a rational standing, other agencies of government also have their share of ‘tribunality’, that is, principled reasoned decision making.”

It is in this context that Weinrib argues for a clear understanding of the distinction between private and public law, and how they interact with notions of corrective and distributive justice as a broad division of the law. These relationships are examined in section 4.3 below where consideration is given to the sources and character of authority that give effect to the resolution of private disputes. These ideas were initially introduced in the previous chapter’s examination of corrective justice as a source for providing the normative basis of bankruptcy law.

Aristotle’s description of the Rule of Law merits repetition:

“He who bids law to rule seems to bid God and intelligence alone to rule, but he who bids that man rules puts forward a beast as well; for that is the sort of thing desire is, and spiritedness twists rulers even when they are the best of men. Accordingly law is intelligence without appetite.”

Weinrib acknowledges that this formulation is both rudimentary and underdeveloped, and it is only because of recent elaborations, particularly those of Kant and Hegel, that more coherent propositions of legal philosophy can be made. Starting from these latter analyses, Weinrib’s construes from Aristotle’s formulation an understanding which provides a contemporary and applied perspective of legal philosophy.

Weinrib’s formulation of a contemporary understanding of the Rule of Law is developed in terms of whether the law can be understood in instrumental or non-

586 Particularly those of Immanuel Kant referred to in this thesis. Kantian ideas are touched upon in the above discussion of natural law and some of the key aspects of Kant’s philosophy are further referred to in the discussion of the distinction between public and private law.
instrumental terms. A non-instrumental approach views law as capable of rationalising itself in its own terms and containing deductive norms which subsequently enable the development of rules which are consistent and coherent. It is in Weinrib’s other extensive writings in the areas of the juridical character of the law of obligations, and in particular the corrective justice underpinnings of the law of obligations, that the idea of a normative power of the Rule of Law is fully developed. By way of contrast, an instrumental approach to the law permits the imposition of external economic and political purposes to justify the Rule of Law. According to this approach, the law is analysed as a complex and disparate collection of objectives achieved by the instrumentality of legal rules. If taken to an extreme where the ideology of the Rule of Law is rejected, law is rendered merely as an instrument to be exploited by entrenched powers and elites – Aristotle’s twisting of spirited rulers through the use of law. Such an extreme would be recognised, for example, by Marxist theory which perceives no distinction between power and legality.

This idea of a distinction between an instrumental and non-instrumental understanding of the law is relevant to what Weinrib regards as one of the pivotal characteristics of the Aristotelian Rule of Law, giving rise to its enduring nature. This is the idea that the Rule of Law amounts to more than a list of positive attributes. Weinrib is, of course, in no way dismissive of the significance of these attributes “which bear on the legitimacy of certain modes of exercising authoritative power.” Weinrib’s assertion is that acceptance of private law as being fundamentally non-instrumental leads inexorably to a view of the Rule of Law as an ideal. This is in clear opposition to the positivist view as one only of “specific existence.” These opposing views have direct bearing on an understanding of the “relationship between form and content in the law.” Weinrib continues with the argument that acceptance of the positivist stance would render the following understanding of the law:

“The only property of law recognised here is the mode of existence known as validity, and the Rule of Law can, strictly speaking, be nothing more that the pleonastic affirmation that the existent exists.”

587 In Chapter 3 extensive consideration is given to Weinrib’s broader argument of a non-instrumental understanding of private law.
588 See for example, communist theories of law.
590 Ibid at p. 67.
591 Ibid.
592 Superfluous or redundant.
593 Ibid. This assertion about the character of the law is attributed to Kelsen.
How do these polarised views assist in developing a practical understanding of the objectives and limitations of an applied body of legal rules such as those which make up a bankruptcy regime? Bankruptcy law is a specific example of a ‘mode of exercising authoritative power’. It involves the resolution of a debtor’s affairs through the recognition of entitlements and the imposition of a distribution. By focusing on the character of validity and how it bears on form and content (the intelligible ideal urged by Weinrib) it provides a satisfactory and robust framework for understanding bankruptcy law. This enables us to understand the difference between seeking just outcomes and alternative economic and political objectives within the framework of a distribution.

A non-instrumental understanding of bankruptcy law can be expressed in terms of subjecting a pre-existing relationship to a transition. It is within this transition from a pre- to a post-solvency relationship that, under the normative application of the Rule of Law, rules can be formulated and applied. These are not merely matters of ‘specific existence’, as Weinrib summarises the positivists’ view of the Rule of Law, but rather critical questions of how an insolvent debtor’s competing obligations are resolved in terms of a moral and ethical point of reference which underpins the structure of private law. Whilst a distributive regime will contain instrumental elements by virtue of the authoritative power to do such things as suspend creditor claims, take possession of the debtor’s assets, initiate procedures for recovery of dispositions and so forth, these do not take place in a void, absent cognizance of the debtor’s pre-existing obligations and of the effect of the event of insolvency upon competing claimants. The very nature of bankruptcy rules are such that, in their application, a full assessment of the debtor’s affairs in the context of his obligations will be accomplished. This is achieved with minimal regard to economic efficiency. In most instances this ideal is realised in practice. Acceptance of this ‘basic position’ is also a necessary precursor to any reordering or recognition of new proprietary entitlements. Recognition of such interests can be explained in non-instrumental natural law terms.

Perhaps one attribute remarked upon by Finnis, with which Weinrib would concur, is the idea that:
“...the Rule of Law is based on the notion that a certain quality of interaction between the ruler and the ruled, involving reciprocity and procedural fairness, [and that this] is very valuable for its own sake.”\(^{594}\)

Whilst legal formalism as a distinct attribute of Weinrib’s scholarship is not explored in any great depth in this thesis, it is nonetheless important to note that the concept is implicit in propositions as to the law’s immanent moral rationality and order.\(^{595}\) Formalist methodology addresses the “implications of law from a standpoint internal to law”\(^{596}\) containing defined conceptual practices applied to institutionally based materials. One formalist attribute which is, however, highly pertinent and a theme applied in my analysis, is Weinrib’s close alignment with non-instrumental theories. In formalist terms non-instrumentalism infers the “seek[ing] [of] the morality specifically appropriate to private law.”\(^{597}\) I have argued in section 4.2 (in connection with communitarianism in 4.2.1.2) that some controlled relaxation of this stricter doctrinal approach is appropriate within a natural law-based theory of bankruptcy distribution. A wider reference to ethical theories that might be regarded as lying at the periphery of private law is essential to a contemporary re-evaluation of natural law jurisprudence, particularly as applied to the type of model developed in this thesis. Likewise, extending private law’s ‘immanent moral rationality’ beyond its strict internal boundaries is appropriate. This in the bankruptcy context enables accommodation of both the multiplicity of parties involved and the transitional effect on obligations of the bankruptcy process itself. I argue in the following section that applying a perspective based on the distinction between private and public law assists in developing this wider perspective.

### 4.3 Legal distinction and classification as a basis for identifying and ordering creditor entitlements – the relevance of a distinction between private and public law

Distinctions between private and public law are generally rejected by legal positivists. To summarise J.A.C. Thomas:

\(^{596}\) Ibid.
\(^{597}\) Ibid at p 50.
“Hence it is that positivist jurists, like Austin and Kelsen, would deny either the existence of public law or the existence of a difference in nature between private and public law.”

This remark is made in the context of an analysis of Institutes Book 1 Title I.4 concerning the identification of public law as pertaining to the Roman state, whilst private law was concerned with the well-being of the individual. Thomas asserts, however, that it should not be inferred that in Roman Law a clear dichotomy between rules established for the community interest as a whole (public) and those created distinctly for the benefit of individual citizens (private) was drawn. Roman Law assumed that all law functioned for the benefit of the corporate state, and Thomas identifies the source of the positivist rejection of a distinction between private and public law on this basis.

Nevertheless, the event of debtor bankruptcy and the legal responses it attracts can only be fully understood from within a framework of public and private law. In particular, public law plays a significant role in resolving disputes involving the exercise of private law rights. It is only by recognising the role of public law that the ability of bankruptcy law to deal with complex inter-creditor competition can be understood. One of the essential ideals of a bankruptcy regime, that of the seeking of a just basis of sharing amongst an insolvent debtor’s creditors, was described in Chapter 1. This led in Chapter 3 to analysis of the distinction between corrective justice and distributive justice. The distinction was applied as a basis for dealing rationally with the transition from solvency to insolvency. The various rules within a bankruptcy regime which deal firstly with the recognition, and then ordering, of entitlements draws together consideration of the rectification of injustices and the imposition of a proportional share on each creditor. In these terms, bankruptcy law necessarily deals with the threshold at which claims identified under rules of corrective justice might be protected by way of either statutory priority or recognition of a proprietary claim, as opposed to the imposing of the collective pari passu norm.

This essential characteristic of intervention leads, in turn, to a consideration of the dichotomy between private law and public law. Thus, questions as to whether a proprietary remedy should be awarded in bankruptcy to enforce a new right can only take place within a public law framework as the inquiry is purely distributive in nature.

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This qualification does not apply to the enforcement in bankruptcy of pre-existing proprietary rights or interests.

In the following analysis, I draw together one of the themes explored in Chapter 3. This is the nature of Kantian right as a critical element in establishing the moral and internal intelligibility of corrective justice (3.3.2), and how it relates to my preferred perspective on the distinction between private and public law. This interaction is significant to an understanding of the transition to which private law obligations are subject in the recognition and ordering of creditor entitlements. It will be recalled that there are conflicting views about the nature and division between public and private law. Birks’s formalist taxonomic approach would see the distinction as polarised and static, whereas Critical Legal Studies scholars such as Duncan Kennedy would regard the distinction as having collapsed. Positivists such as Austin and Bentham would regard all law as public, being a manifestation of political or similar power. Finally, a more iterative and dynamic approach is advocated by Ernest Weinrib which is more suitable to the model I will be proposing. This perspective on public law is encapsulated in two interrelated concepts used by Weinrib – the first, the “Publicness of Law” and the second, the “Publicness of Private Law”. An understanding of both concepts is essential to the institutional and positive law attributes which give effect to corrective justice. This, in turn, can be extended to key elements of my natural law-derived theory of bankruptcy distribution.

I provide now an outline of ‘public law’ which is appropriate to a natural law model of bankruptcy law.

Weinrib in his explanation of Kantian legal theory emphasises Kant’s idea of ‘public law’ as being the institutional operation of corrective justice. In Kantian philosophy corrective justice is central to the translation of free purposive activity, or individual will, into a legally authoritative framework. Importantly, through the agency of the judge, the legal norms which are created arise as a matter of right, rather than being the “instrumentalist amelioration of the collective good.” It is possible to extrapolate from these ideas in order to explain the specific legal order

601 Ibid at p 100.
602 Ibid at p 218.
603 Ibid at p 84.
604 Ibid at p 85.
which applies in bankruptcy, and which achieves collective, rather than individual, outcomes in managing a debtor’s affairs.

4.3.1 Publicness of Law – from natural law normative theory to positive bankruptcy law

In tracing the translation of free will to the publicness of law, Weinrib makes extensive reference to Kantian legal theory. In this particular instance with respect to Kant’s use of the Ulpian’s threefold precept of right: *honeste vive* (live honourably), *neminem laede* (injure no one) and *suum cuique tribue* (give each his due). The merit seen by Weinrib in this reference to the three precepts of right, is that of a progression towards a legally authoritative framework. Within this framework recognition is given to a “steady increase in the number of persons involved.” From this admittedly abstract framework, the third precept concerning the ‘giving to each what is his’ is relevant to my purposes. It focuses on the necessity for an authoritative figure external to the immediate parties to be the essential facilitator to ensure that what is due to a person is secured. In the applied institutional framework of bankruptcy, the principal challenge is to establish the appropriate mechanism which enables the treatment of one party (the debtor) who is unable to give what is due to be assessed against a multiplicity of claimants (the creditors). In terms of positive law, this describes the process of collectivism whereby individual rights are suspended, and then superseded, to enable a partial proportionally based on giving what is due.

Weinrib goes on to describe three stages in the progression from free will to the publicness of law. In summary, the first pertains to the possibility of a public world in which there are interactions and the consequent duty of rightful honour. The second, or pivotal stage, concerns the encountering of persons with each other through externally recognisable acts dictated by conditions of corrective justice. To this Weinrib adds the remark that “[t]he external nature of actions implies a world

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605 Gnaeus Domitius Annius Ulpianus (c. 170 – 223) Roman jurist.  
607 Ibid at p 100.  
608 Ibid at p 102.  
609 Ibid at p 103.  
610 Ibid.  
611 Ibid at 104.  
612 Ibid.
of shared social meaning." I argue below that the interrelationship between corrective justice and 'social meaning', and the related notion of public understanding, can be applied to an appreciation of the positive law functions of bankruptcy distribution as embodied in instruments of public law. The third stage described by Weinrib shifts emphasis beyond that of the interactors, this occurring through recognition that "a third person is needed who can recognise and bring home the parties' rights and duties." This stage is what Kant considered in his legal theory to be, public law.

I focus particularly on the third stage because it is germane to identifying, within a natural law theory of bankruptcy distribution, the authoritative character of the various component statutory instruments. It also provides insight into their limitations within a wider political or public policy context. Weinrib's description of this third stage contains a further eight elements, only three of which I consider – the court, publicly authorised coercion and deterrence. It is principally these which provide insight into the highly evolved and formalised character of bankruptcy law. The chief concerns of Weinrib and Kant are with bipolar private law relationships and dispute resolution. It is worth repeating here Weinrib's footnote reference to Kant's alternative naming of this stage as 'distributive justice':

" - - - taking over [of] the Aristotelian term [distributive justice] but not its Aristotelian significance as a structure of justice which relates persons and benefits according to a proportion."

I briefly reiterate here the basis of my analysis in Chapter 3 (3.3) which, in adapting Weinrib's Aristotelian based private law normative theory to positive bankruptcy law, gave particular prominence to the mathematisation associated with distributive justice. Application of distributive justice's mathematisation is critical in explaining pari passu ranking and the allocation of a debtor's deficient estate or assets.

I deal now with each of the three highlighted elements of Kantian public law.

The function of the court in the publicness of law is essentially that of providing external authoritative interpretation of the parties' dealings. Notions of impartiality and disinterested adjudication dictate that:

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613 Ibid.
614 Ibid at p 105.
615 Ibid pp 105 – 109. The five which I do not examine are: the structure of legal reasoning, public justification, the public aspect of adjudication, public knowability and excuse.
616 Ibid at p 105 footnote 57.
“- - - the judge cannot use the opportunity presented by the lawsuit to maximize the community’s wealth or promote greatest good for the greatest number.”

This remark, which has no direct reference to the phenomenon of a debtor’s bankruptcy, falls well short of explaining the full complexity of bankruptcy’s distributive regime. Nonetheless, valid inferences can be drawn from it which provide a viewpoint from which vital aspects of coherence can be addressed. Coherence centres on the interaction of private law and public law which arises from the necessity to resolve an accumulation of private law obligations within a predominantly legislative coercive framework. This framework must also adhere to characteristics of impartiality and disinterest.

The collective character of bankruptcy distribution, dealing with a multiplicity of parties and their claims, presupposes a highly formalised public law mechanism of overriding private law rights. Importantly, however, this feature of positive bankruptcy law fits the type of publicness in law described by both Weinrib and Kant. This is accomplished by adopting a non-instrumental approach to the operation of pari passu ranking. The very nature of the obligations considered in the context of the intervening event of insolvency, viewed from this non-functionalist perspective, dictates creditor collectivism and pari passu ranking without need for reference to any instrumental criteria.

Weinrib’s notion that the judge cannot ‘promote the greatest good for the greatest number’ is necessarily modified in a model of bankruptcy distribution which seeks to give effect to the rights in existence at the time of insolvency. An outcome of the bankruptcy process is that its benefits will be conferred on fewer than Bentham’s ‘greatest number’. Against this, the processes of asset liquidation and antecedent recoveries will ‘promote the greatest good’, though applied in relation to the rights which are treated collectively. Furthermore, from the standpoint of coherence which Kant describes in the transition from free will to the publicness of law, the measured approach adopted by courts in the recognition of proprietary remedies in bankruptcy becomes explicable. Courts, in recognising such interests, acknowledge both the validity and the underlying rationale of the scheme of statutory priorities and the consequences of departure from them. This is not a concession to ‘promote the greatest good for the greatest number’, but rather to promote recognition of the need

617 Ibid.
for very compelling reasons to allow an individual creditor to stand outside of the
collective scheme. This is a natural law conception which reflects Finnis’s proposition
of “practical-mindedness, of good and proper order among men and in individual
conduct”\(^{618}\); concepts not at all remote from, or at odds with, the three Ulpian
precepts of right\(^{619}\) introduced above.

I consider now the nature of *publicly authorized coercion* within Kantian public law
and how it can be seen to function in the context of the recognition of creditor
entitlements and bankruptcy distribution. Weinrib’s observation that “the task of
coercion, like that of interpretation, cannot be placed in the hands of the interacting
parties themselves”\(^{620}\), is critical to understanding the nature of the bankruptcy
procedure. This is particularly so in terms of the function and powers of trustees and
liquidators. The necessity for the surrendering of individual rights of recovery, the
sequestration of debtor assets and the need to deal collectively in the resolution of
the debtor’s obligations, all compel the intervention of publicly authorized coercion.

Weinrib observes that “the public significance of a wrong can be signalled only by the
availability of a coercion that represents the external operation upon the parties of the
concept of right.”\(^{621}\) Beyond Weinrib’s particular area of concern, that of the law of
negligence, this statement can usefully highlight the ‘public significance’ of
bankruptcy. Just as wrongs impact upon the parties' freedom to exercise rights,
bankruptcy impacts on the expectations of the parties and inhibits the remedying of
wrongs. The signalling contained in the bankruptcy regime involves the
predetermining of how categories of right will be treated and identifying the type of
distributive obligations to which the debtor will be subject. Bankruptcy has a
secondary economic signalling effect in terms of supporting the pricing of risk.
Although these are economic benefits in establishing a coherent bankruptcy regime
based on the idea of the rule of law, it should be emphasised that the theory being
developed here is not an economic theory.

The final element within Kantian public law which I consider is that of deterrence.
Weinrib makes the following remark:

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619 *Honeste vive* (live honourably), *neminem laede* (injure no one) and *suum cuique tribue*
(give each his due) *Digest*, 1.1.10.1 (Ulpian, *Regularum* 1).
621 Ibid.
“Coercion, taken on its own is a hindrance to freedom, but its use is consistent with freedom when it is deployed to prevent a hindrance to freedom.”622

This observation about the ends to which coercion is directed, can be applied as an important element in distinguishing between those parts of the bankruptcy regime which are either corrective or distributive in nature and those others which are more punitive, such as those rules which act against the abuse of the corporate form; for example a director’s duty to prevent insolvent trading. The coercive character of the latter type of rule does not detract from the underlying objective of augmenting the pool of assets available for liquidation and distribution. The fact, however, that there is a set of general rules applicable to entitlement recognition and distribution, and more targeted deterrent rules, conforms with the discussion in 4.1.2 above concerning the event of insolvency. The presumption there was that the cause of a debtor’s insolvency is largely ignored, with errant and dishonest behaviour being addressed by rules which are largely ancillary to the entitlement recognition and distributive processes of bankruptcy. Collectively however, the rules of bankruptcy underpin the social and economic system and support, in the main, the freedom given by a liberal society to those with the necessary capacity to enter into transactions.

Criminal sanctions, on the other hand, are genuinely deterrent and their application in the corporate insolvency context, though not a theme of this thesis, needs to be briefly touched upon. In Australia, Part 5.8 of Chapter 5 (External Administration) of the Corporations Act 2001 in s 590 addresses a range of offences committed by officers and employees (past or present) in the context of a company’s liquidation and carry a maximum penalty of $200,000 or imprisonment for five years, or both (Schedule 3). A key theme of these offence provisions is to guard against fraudulent activities that undermine the conduct and outcome of the liquidation process. Significant also are provisions such as s 588P which in relation to the insolvent trading rules (Division 3 of Pt 5.7B) provides that notwithstanding application of the compensation provisions, a director will not be protected from the instituting of a proceeding in respect of a breach of a duty or any rule of law – thus leaving open the potential for criminal sanction, for example under s 184623. The presence of these criminal sanctions does not undermine what I have argued is a close aligning of the

622 Ibid at p 108, Weinrib’s reference is to Kant’s *Metaphysics of Morals*, 121 [307].
623 Good faith, use of position and use of information - criminal offences in Part 2D.1 – Duties and Powers – Chapter 2D - Officers and Employees.
bankruptcy distribution process with the nature of rights and rules of private law obligation. Indeed, their function is to reinforce the private law system.

4.3.2 Publicness of Private Law – natural law and the determining (and varying) of distributive outcomes

I turn finally in this section to consideration of the ‘publicness of private law’, that is, Weinrib’s Kantian notion of the public character of private law, and extend this concept to consideration of the criteria for an externally imposed reordering of creditor entitlements. The concept addresses the interaction between normative principle and positive law:

“- - - public law supplies the institutions that authoritatively and impartially elaborate the law and relate it to specific instances of interaction.”

In bankruptcy law there are two levels of interaction; firstly, the interactions that consists of obligations subsisting at the time of insolvency, and secondly, the interactions resulting from the event of insolvency itself. The degree of separation of these interactions is in a natural law bankruptcy model resolved by reference to the interaction between corrective and distributive justice. The model necessarily modifies Weinrib’s dichotomy between the two in a manner similar to the way in which Kantian legal philosophy recognises a transition between private and public law.

In identifying how the normative principles of corrective and distributive justice might be embodied in the institutional framework of bankruptcy law, it is necessary to introduce a further attribute of the ‘publicness of private law’ – that of separate public functions; one political the other juridical. Illustrative of Weinrib’s adherence to a strict dichotomy between corrective and distributive justice is the remark that:

“The first [political], restricted to distributive justice and therefore inappropriate to private law, is the selection of the goal to be embodied in a particular distribution and thereby to be authoritatively inscribed into the schedule of the community’s collective purposes.”

The essential function of bankruptcy law is to resolve private law obligations within a public law supported distributive framework. Given the social and economic ramifications of corporate insolvency, in particular the development and application of the bankruptcy framework may attract political considerations. Against this, the foregoing discussion (4.2.1.2) of communitarianism as a basis of contemporary re-

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624 Ibid at p 218.
625 Ibid at p 219.
evaluation of natural jurisprudence presented an apolitical basis for the ‘community’s collective purpose’ to guide understanding and change in the entitlement recognition and priority ordering processes. This, of course, does not deny the parliamentary power and political purposes applied to the privileges of incorporation and limited liability.

Weinrib further remarks that “loss-spreading - - - like all external goals, is a matter for distributive justice and cannot be coherently achieved within the relationship of doer and sufferer.”626 In this respect, a further distinction ought to be drawn in order to support the notion of a natural law-based bankruptcy model. It may seem pedantic to apply a distinction between loss-bearing and loss-spreading. Deficiency in a debtor’s residual liquidated assets or estate is necessarily allocated amongst unsecured creditors with proven claims. The process of proving reflects the underlying private law character of the claim. The corrective justice nature of the claim should inform how the deficiency or loss is borne. It is on this basis that I suggested in section 3.3.1 of Chapter 3 and in 4.2.1.3 above the merit of particular types of tort and unjust enrichment claims potentially being granted priority ahead of consent-based claimants. I characterise this as a process of loss-bearing. In contrast, loss-spreading should be seen as distinct – ‘spreading’ inferring a reallocation of what the corrective justice character of the claim would initially dictate. This latter action within an evolved bankruptcy institutional framework should be regarded as a predominantly political function applied to such considerations as the elevating in the ordering of priorities of what are considered particularly vulnerable classes of claimant. Such a rationale can be seen to be applied to the circumstances of employee entitlements and could further be applied potentially to long-tail tort claimants – though such prioritising as I have recommended in 4.2.1.3 is designed to accomplish corrective justice. It is only this rationale, I suggest, that might justify reform of the law relating to the piercing of the corporate veil. This, however, is best addressed as a political function directed, not so much at loss-spreading, but rather to widening the base of contribution to the loss. It could still be based upon application of the ‘community’s collective purpose’, recognising of course that the thesis model applies this notion only to an understanding of bankruptcy law within the confines of its conceptual and institutional features.

626 Ibid at p 221.
I turn briefly to Weinrib’s second public function – which he describes as juridical. Earlier in this thesis (3.2) Weinrib’s use of the word ‘juridical’ is defined as ‘distinctive moral rationality’. The discussion here pertains largely to the judicial function and the distribution of justice. Whilst Weinrib emphasises that the judicial function is to interpret a transaction in accordance with its immanent form of justice, and thus bring to bear no extrinsic purpose, the function is neither static nor detached from society. Weinrib’s concluding remarks concerning the publicness of private law bear repetition:

“Corrective justice is not detached from society or from public understandings. Corrective justice is immanent in transactions and not independent from them. In drawing out the significance of corrective justice for particular transactions, positive law functions juridically. Yet the court’s role is publically specifying what corrective justice means in particular cases differs categorically from the political role of selecting an exogenous end.”

These remarks address the moral attributes of a natural law model or theory of bankruptcy distribution. In section 4.2.1 above, I discussed the development and contemporary perspectives on natural law jurisprudence. The work of Lloyd Weinreb is given particular consideration in seeking to connect what is often regarded as abstract metaphysical analysis to a more applied approach to legal development and reasoning. Two quotations deserve emphasis:

“- - - to speak of morality independent of the community’s way of life is a mistake and leads invariably - - - to moral debates without outcome.”

And,

“- - - we might begin at the other end and look first to the conditions of a just social order.”

In assessing the political function associated with the structure and ends to which the public law distributive framework is applied, we can see that its capacity to accommodate policies external to the legal system are limited. The starting point should always be the private law dealings between parties. The controversies that the distributive framework seeks to resolve should pertain largely to the impact of the intervention of debtor insolvency on those private law dealings. This is predominantly

627 Ibid at p 219.
628 Ibid.
629 Ibid at pp 221-222.
631 Ibid at p 126.
a process of loss-bearing. Any overlaying of ‘exogenous purpose’ should derive from political recognition, which must take account of a consensus\textsuperscript{632} as to what constitutes ‘conditions of just social order’. These might merit either a process of loss-spreading or interaction with another body of legal rules (such as veil piercing or recognition of corporate joint tortfeasors). To draw upon an external functional purpose outside these boundaries is counterproductive and undermines the internal intelligibility of the distributive regime.

The ideas of ‘just social order’, ‘virtuous debtor’ and ‘meritorious creditor’ which have been developed across this and the foregoing chapters of the thesis may attract criticism on the grounds of their indeterminacy. It is true that the individual rules for determining entitlements in bankruptcy should, as far as the complexity of business transactions permit, be clear and predictable in their application. However, it is inevitable that an explanatory and justificatory model of bankruptcy, of the kind developed in this thesis, will invoke concepts that have a penumbra of uncertainty. Justification for a rule are, and should be, very different from the rules themselves.

\textsuperscript{632} The pursuit of a consensus within a political setting is of course problematic. Nonetheless, the comparatively confined natures of personal bankruptcy and corporate insolvency may at least tend towards bi-partisan views.
CHAPTER 5

A NATURAL LAW BASED MODEL FOR THE RECOGNITION AND TREATMENT OF CREDITOR ENTITLEMENTS IN BANKRUPTCY DISTRIBUTION

Introduction
This chapter draws together the analysis of the two previous chapters so as to present a natural law model for the recognition and treatment of creditor entitlements in bankruptcy. The model is a response to the controversies introduced in Chapter 1, and in particular, Chapter 2. The major point of controversy relates to the relative position of consensual and non-consensual claimants. The analysis in this chapter puts forward a basis for a more favourable treatment of non-consensual claims in the distributive process. It would go beyond the scope of the thesis to resolve all the controversies identified in Chapter 2. Rather the aim is to present a model which explains both the present basis for allocating claims and how controversies about allocation upon bankruptcy can be resolved.

5.1 A normative basis of bankruptcy law
The premise of this thesis is that the essential aim of bankruptcy law is the resolution of competing claims to private law entitlements within a public law framework where an insufficiency of assets prevents enforcement of all the claims. To develop a natural law model a specific and relatively narrow meaning has been given to both private law and public law (see 4.1.3 and 4.3). In turn, in order to develop an applied understanding of these concepts, the thesis adopts methods already discussed in current debates on legal taxonomy (see 4.1.1). The methodology contrasts with, say, a critical legal studies critique, which views with scepticism such a methodology and which rejects the rationality identified by natural law scholars. Taxonomic methodology is applied to a theoretical framework based on natural law in order to determine the distribution of the insufficiency in financial resources between claimants. It is this framework that provides the ethical basis of distribution on bankruptcy.

Private law entitlements, on this model, are determined by reference to corrective justice (see 3.3). Corrective justice is not detached from social or public understanding, nor is it morally static or neutral. Rather, it responds to conditions of a just social order (see 4.3.2). Ideas of ‘just social order’ in the context of bankruptcy distribution can be identified in the nature of the private law obligations being dealt
with, and the manner in which they are resolved when bankruptcy supervenes. This is predicated on acceptance of the proposition that, outside bankruptcy, the law's remedial responses can be understood in predominantly corrective justice terms. The thesis does not resolve the debate as to whether all private law is explicable in terms of corrective justice, but rather draws on the dichotomy between corrective and distributive justice to explain the transition of private dealing into the collectivised framework of distributing entitlements.

The primary concern of public law is to resolve claims which can only be settled by reference to distributive justice. For the purposes of this thesis, the relevance of public law is that it provides authoritative institutions and processes to adjudicate these claims. Public law sets goals by reference to the community’s collective purpose (see 4.3.2). The ‘community’s collective purpose’, in the narrow context of bankruptcy, can be identified as society’s agreed distributive goals which have been recognised over centuries of legal adjudication. An understanding of the goals of a system of bankruptcy distribution to which the community sees as meeting its collective purpose is supported by acceptance of an intelligibility that is internal to the law (see 3.1). The process of identifying justice and order in the distributive process is supported initially by reference to the morality of private law relationships (see 3.2 and 3.3.2). To develop a fully coherent rights-based model of bankruptcy distribution it is necessary to supplement this understanding by reference to contemporary re-evaluations of natural law theory (see 4.2.1). This necessity arises in order to accommodate the dissolution of competing claims that must be ranked and applied to the distribution of the debtor’s estate within the model. This further source of insight is needed to enable bankruptcy distribution to manage the shift from a focus on the bipolarity of private law relationships (see 3.1) to one which in a public law setting deals with a multiplicity (of type) and multitude (of number) of interactions as part of the process of orderly settlement (see 3.2). Outside bankruptcy, private law relationships are ‘bipolar’ in nature, and therefore susceptible to corrective justice analysis. Upon insolvency, corrective justice must be modified by distributive considerations. Distributive justice compels the pooling of legal relationships which brings with it a capacity for comparing the competing merits of claims.

Insolvency should be considered as an event which transforms relationships between debtor and creditor (see 4.1.2). More particularly, by assessing the character of the event in terms separate from, but still impacting on, pre-existing obligations, the orderly process of resolving claims can be clearly understood. A key outcome of
applying a natural law perspective is to manage the relationship between 'conditions of a just social order' with the 'community’s collective purpose' in bankruptcy distribution; it provides the normative framework needed for resolving an insolvent debtor’s collective obligations. The orderliness of bankruptcy’s distributive scheme demonstrates that this relationship can be understood in terms of authorised coercion which ensures that bankruptcy distribution functions within the boundaries of community expectations (see 4.3.1). It is also in these terms that a perspective on legitimized intervention drawn from the Rule of Law is applied (see 4.2.2). The Rule of Law assists in explaining the community’s broad acquiescence to bankruptcy law’s collectivised processes, which involves the surrendering of otherwise available individual remedies. It is in these terms that bankruptcy deals rationally and objectively with entitlement recognition rather than with the enforcement of remedies. The coercive character of bankruptcy’s distributive aims is therefore validated in its own terms.

In developing a framework for the recognition of creditor entitlements in bankruptcy, particular importance is placed on natural law’s reasoning processes. These emphasise intelligent reflection and inquiry based on key premises of practical-mindedness (namely the ability to judge the merit and quality of something), and good and proper conduct (see 4.2.1). Natural law reasoning is based on the supposition that the decision maker exercises moral judgment and that such judgment derives from experience within social or communal-life contexts. This assumes that individuals are self-determining agents. Natural law is both a process of reasoning and a basis for applying to the law reflections on the nature of being and the individual's relationship with others and with authority. The natural law model of bankruptcy distribution adopted in this thesis eschews any explicit basis in theology.

In recognising the relevance of moral merit and standards, a natural law model of bankruptcy distribution is predicated on the existence of a system of private law whose aim is to relieve against injustice by enforcing a system of correlative rights and duties (see 3.3.2). In these terms, the corrective justice attribute for the recognition of creditor entitlements is directly informed by natural law theory. In contrast, distributive justice, and the manner in which it informs the nature of bankruptcy distribution, relates only indirectly to natural law theory. The nature of this link is nonetheless highly significant because it establishes the institutional framework within which bankruptcy claims are decided. Whilst indirect, this link between the distributive elements of bankruptcy law and natural law theory is a vital
element in establishing the internal coherence of the law — a significant theme within natural law jurisprudence. This link also serves as an important basis for identifying and enforcing exceptions to the pari passu collectivised norm. The link between natural law, on the one hand, and corrective and distributive justice, on the other, is essential to an understanding of how bankruptcy law operates.

A natural law model of bankruptcy requires certain assumptions to be made about the nature of private law. These are, first, that the law should be regarded in non-instrumental terms and, secondly, that private law adheres to characteristics of coherence and internal intelligibility (see 3.1). It is through these perspectives that ideals of universal validity inherent to natural law theory can be applied so as to establish a secure normative basis of bankruptcy law. The critical areas of concern are creditor entitlement recognition and ordering the distribution of the debtor’s surviving assets. These particular concerns are now addressed.

A non-instrumental analysis of private law holds that the function of private law is private law itself — it exists for its own ends without need for external reference to set objectives and limitations. According to a natural law perspective, bankruptcy distribution reflects this fundamental attribute of private law, though under conditions where obligations are suspended and modified by the event of debtor insolvency. The process of admitting, ordering and resolving creditor claims lies at the cusp of corrective and distributive justice.

A non-instrumental perspective emphasises the insight that debtor and creditor in a pre-insolvency context are connected in a particular manner described in terms of corrective justice correlativity (see 3.3.2). It is this multiplicity of ‘connections’ that are assembled, assessed and then resolved, thereby constituting the subject matter of bankruptcy law. Applying this perspective to bankruptcy distribution is a key element in identifying the limits of bankruptcy law. Its ends are those which are informed by private law when overlaid by debtor insolvency.

The outcomes-directed nature of bankruptcy distribution is necessarily reflected in legislation creating the ordering of priorities amongst competing classes of creditor. To the degree that the legislation preserves relative pre-insolvency entitlements, the pari passu distribution can be analysed as non-instrumental. Within this framework attention should be paid to the extent to which victims of imposed obligations ought to be granted priority over claimants enforcing consensual obligations.
Weinrib’s distinction between immediate and mediated interactions is relevant to explaining particular instances where, upon bankruptcy, proprietary interests are recognised (see 3.3.3). His mediation mechanism in these circumstances might seem to be instrumental but is in fact not detached from pre-insolvency corrective justice considerations as it is dealing with rights, though it is contingent upon the tension created through debtor insolvency. This tension is clearly a source of contention as the claimant who is seeking enforcement of a consensual obligation is resorting to a mediated rectification which results in the claimant standing outside of the collectivised process. In contrast, an essentially non-instrumental perspective can be applied so as to understand why the law compels an insolvent debtor to give up transfers arising out of a mistaken payment or duress. This is because the law of unjust enrichment is based on corrective justice. The courts’ consistent reluctance to allow the creation of proprietary interests ahead of what would otherwise be dictated by pari passu treatment can be understood in these terms.

A purely instrumental objective in bankruptcy would prevail in circumstances where political or economic considerations are overlaid so that a particular category of creditor, or creditors under particular types of debtor relationship, for example within an industry which is deemed particularly vulnerable, are treated more favourably than an analysis of underlying private law rights would dictate.

Closely allied to a non-instrumental perspective on private law is acceptance of the proposition that private law is internally intelligible — its meaning, purposes, rationale and boundaries are deducible by internal reference alone. Coherence in private law implies that it contains necessary minimum features that can be divided between the institutional and conceptual (see 3.1.4). This relatively abstract idea is useful in considering the outcomes-oriented character of bankruptcy law. Amongst the institutional features of bankruptcy are the moratorium against individual creditor actions, the sequestration followed by liquidation of assets, and finally the process of distribution. The relevant conceptual principles are: collectivism, pari passu ranking and the setting aside of antecedent transactions and fraudulent dispositions.

Natural law theory provides the moral principle informing bankruptcy law’s conceptual features (see 4.2.1). These conceptual features are only intelligible when enforced in an institutional structure based upon the notion of internal coherence. In turn, the essential attributes of internal coherence are ones of rationality, predictability and
rational intervention of authority into the private dealings of individuals. Coherence is achieved by applying the institutional framework of bankruptcy administration to the basis of bankruptcy in natural law theory. This is in turn supported by the principle of the Rule of Law which favours the attributes of good conduct and reasoning (see 4.2.2). This perspective emphasises the comparatively benign character of authoritative intervention in an insolvent debtor’s affairs which, over time, has come to favour corrective and distributive goals over the punishment of debtors.

Consistent with notions of non-instrumentalism and coherence, a natural law theory of private law implies an internal moral rationality. A focus on the bipolarity of private law relationships avoids any need for externally imposed concepts to be applied in order to achieve justice. Bankruptcy law, though clearly distributive, does not distribute on the basis of extraneous need or virtue. Rather, it derives its criteria from the character of corrective justice claims, albeit addressed through the condition of the debtor’s inability to provide both specific remedies and to meet the cumulative claims of creditors. This rationale can be seen as both an explanation of the pari passu norm and a constraint on the exceptions to this norm created through the establishment of statutory priorities (see discussion below in 5.3 concerning the “creditors’ bargain” and state-created priorities).

5.2 Mathematical expression of the treatment of bankruptcy entitlements within a natural law based normative model
Corrective justice, along with distributive justice, can be expressed in mathematical terms (see 3.3.1). Corrective justice can be expressed mathematically as an equality between two parties within a bipolar transaction. It serves to restore the normative correlativity between the transacting parties. In contrast, the rationality of distributive justice takes the form of compelling a proportional sharing amongst participants based upon some articulated distributive principle. These fundamental relationships can be applied to the circumstance of insolvency which itself can in mathematical terms be expressed as a critical point where the debtor’s available assets are less than the quantity of creditor claims.

Bankruptcy rules seek to apply a process of loss sharing based on the criteria of justice, equity, predictability and efficiency; though these, as indicated, are determined from a non-instrumental perspective. In bankruptcy the benefits being distributed are the debtor’s liquidated assets. Expressed conversely, the burden
being allocated is the deficiency in the debtor’s estate – applied by way of a pari
passu ratio set in terms of a proportional share of the available residual fund. The
quantum of the fund can be positively added to by antecedent transaction and asset
recovery mechanisms. The quantum of the fund and the measure of the proportional
share can, in turn, be negatively impacted though a deliberate reordering of the
hierarchy of priorities. Additionally, the granting of proprietary remedies subtracts
from the residual pool of liquidated assets in the amount based on the value of the
transaction required to restore correlativity as dictated by corrective justice (see
3.3.3).

The operation of bankruptcy distribution, expressed in mathematical corrective and
distributive justice terms, can be further elaborated as follows.

Under circumstances of insolvency, debtor (A)’s assets (X) are less than the
cumulative claims (Y) of the debtor’s creditors (B1,B2,B3 . . . Bn). X is allocated
amongst B1,B2,B3 . . . Bn in a ratio based upon the proportion (P) to which each of
B1,B2,B3 . . . Bn bears in relation to the total Y. B1,B2,B3 . . . Bn can be added to in
number and value with the effect of reducing P. On the other side of the equation, X
can be added to, through for example, the recovery of antecedent transactions. X
can in turn be reduced to the extent of each identified creditor claim that is allowed
either by agreement, or through intervention of external authority, to be treated as the
property of another. Assuming that such claims, which for present purposes will be
denoted as S, would otherwise be treated collectively as part of the general body of
unsecured claims, their value is therefore deducted from both sides of this notional
equation; X-S and Y-S. Neither personal bankruptcy nor corporate liquidation
interfere with the rights of secured creditors. Nonetheless, where the sale proceeds
of secured asset falls short of fully satisfying the secured claim, such an amount will
form a claim ranking equally with unsecured creditors. In simplistic mathematical
terms, this treatment can be expressed as follows. Cumulative claims (Y) will
increase = to the amount by which secured asset (Xs) is < secured debt (Ys).

Continuing this idea of a mathematical expression of corrective and distributive
justice, the extent to which B1,B2,B3 . . . Bn can be considered homogenous, and
thus subject to strict pari passu collectivised treatment, can be considered from a
number of perspectives. The natural law perspective examined in this thesis
suggests that as an ideal, it should be addressed from the character of correlativity
underlying the corrective justice based entitlement. This involves consideration of the
interaction of two distinct elements. The first is the remedy implied by the correlative character of debtor A’s obligations with each of creditor B1 through to Bn at a time notionally immediately prior to insolvency. The second is the effect of the event of insolvency as a legal phenomenon interfering with debtor A’s capacity to meet the private law expectations of different types of creditor. It is from this perspective that the model provides a clearer context for examining the contrast between consensual claimants and various types of involuntary creditors. It is only by creating exceptions that bankruptcy distribution allows enforcement of a corrective justice based right \((X - $ value = to Bx’s full correlative based remedy)\) instead of applying \(P\). These forms of mathematisation can only take us so far in dealing with conflict between consensual and non-consensual claimants. They do, however, provide a sound platform for understanding the basis on which other considerations will be added. These further considerations relate to the ethical dimensions of obligations whose performance has been suspended, along with the ethical implications of the event which may justify modifying the application of corrective justice where community expectations dictate modification.

It is appropriate to reflect upon pari passu mathematisation and how far it succeeds in resolving particular types of disputes arising between insolvent debtors and creditors. As a mathematical expression of proportionality, pari passu in resolving the debtor’s shortfall in funds, acts differently in assessing the creditors’ side of the equation (the suspending of bipolar correlativity in favour of collectivised equal treatment) from that of the debtor’s side of the equation (largely predetermined allocations to priority claimants followed by proportionate based allocation to remaining participants). The principle is applied to the orderly liquidation of assets. Bankruptcy distribution in these terms, demonstrates Weinrib’s ideals of private law coherence and capacity for self-understanding (refer 3.1.4 above). Whilst the model developed in this thesis goes some way to supporting priority treatment of at least some claims in the tort of negligence (see 2.1.1 and 4.2.1.3), the distortions caused by the principle of limited liability falls outside of what can reasonably be expected of bankruptcy law itself (see 2.1.3), given bankruptcy law’s well defined and internally coherent conceptual and institutional features. The analysis points to the solutions, if needed, being found within corporate law and not insolvency law. Any reform relates to the law of corporate personality and its limits. As foreshadowed in Chapter 2, this response is not explored in depth in this thesis other than to conclude that the norms of bankruptcy distribution, whilst rational and coherent, can be distorted by the misapplication of the doctrine of corporate personality.
The following section looks at the manner in which a model of the type developed in this thesis might be applied to inform the law’s treatment of non-consensual claimants and the limits to which bankruptcy’s distributive processes should be applied for this purpose.

5.3 Resolving issues of priority and understanding the limits of a distributive framework

Chapter 2 identifies a number of problems which arise in the multi-party setting of bankruptcy distribution. The purpose of the following analysis is to apply the thesis’s normative model to some of these problems. The discussion tests the robustness of the model in handling the dilemma of reconciling the interests of non-consensual claimants with the general body of voluntary creditors.

The contrast between corrective and distributive justice provides insight into the handling of different classes of claim. In consensual claims what was otherwise the common pursuit of independent interests between debtor and creditor are suspended (see 3.3.1 and again, 3.3.3). As between competing creditors their claims are assessed on an equal footing. In the case of non-consensual tort claimants, to allow them to be treated pari passu with contract claimants in some instances may negate the proper discharge of a correlative duty. The pre-existence of liability based upon a wrongful infringement of the involuntary claimant’s rights, warrants consideration for a more complete satisfaction of a claim within bankruptcy. The negligence claimant has not in any way pursued an independent interest subject to reciprocal action by the debtor. Rather, a wrong has been committed by the debtor, with the inability of the creditor to achieve redress arising directly out of the debtor’s insolvency. In natural law terms, this category of creditor potentially has a stronger moral claim than one who has taken an agreed risk. A moral claim of itself does not necessarily compel a reordering of current pari passu treatment across consensual and non-consensual claimants. It is for this reason that the thesis introduced the idea of the interaction between consent-based creditor merit and notional examination of virtuous conduct on the part of the debtor within a multi-party claimant setting (see 4.2.1.3). These concepts provide a rational and rigorous basis for prioritising the variety of claims that arise on bankruptcy. Whilst the suggested preference for some tort and unjust enrichment claimants may not resolve all disputes about priority, since priority on this model depends on the factually difficult question as to whether the creditor could take reasonable steps to protect his own position, the proposed
structure of analysis at least provides a theoretical basis for handling stresses in the
distributive framework which is internally intelligible and which constitutes a sound
alternative to instrumental considerations of incentive and deterrence. Solutions to
the problems of ‘long tail’ liability in tort, or of the strategic application of corporate
personality doctrine, cannot, however, be solved by application of this model. If a
solution is to be found to these current controversies, it will rest on an explicitly
(re)distributive basis.

Consideration of the relative standing between non-consensual and consensual
creditors is not relevant outside of bankruptcy. This is not to say that societal
(communitarian) perspectives on the standing of particular claimants are static and
not subject to change over time. The ideal of coherence and internal intelligibility
provides the mechanism to address these changes in an orderly and incremental
manner. Any elevation of non-consensual ahead of consensual claimants must be
made with reference foremost to developments in private law. This does not lead to a
conclusion that bankruptcy law is neutral in moral terms, as demonstrated by the
explanation of the pari passu principle in corrective justice terms (see 3.1.4, 3.2.2
and, in particular, 3.3.1). What the event of bankruptcy does do is to compel close
scrutiny to be given to the comparative remedial merit of different types of private law
obligation. These considerations would not arise, but for the interventions of
insolvency and the compulsion to settle the debtor’s affairs. Holistically, the law is
seeking out a just and rational basis for allocating the burden of debtor insolvency
amongst claimants.

Bankruptcy law gives effect to creditors’ entitlements – be they tortious, contractual
or based on unjust enrichment. A distributive process that favours, say, particular
classes of tort claimant over unsecured contractual claimants, would not be based
simply on the proposition that tort victims are more deserving than victims of a
breach of contract. Whilst critical and essential in determining the character of the
right, a further necessary step compelled by the debtor’s inability to pay all debts as
and when due, is needed; the weighing-up of relative merit of competing claims
initially treated on an equal footing. Economic analysis would potentially treat this
tension in the distributive process in terms of differences between different classes of
creditor in terms of risk allocation. If instead we look at the dilemma not so much from
the perspective of pre-insolvency rights, but rather as a right enlivened by the
supervening of debtor insolvency, there is room for treating some claimants more
favourably than others. The natural law perspective allows us to look through the pre-
bankruptcy classification of claims and examine some issues of justice, according to the principles of natural law. In these terms bankruptcy law can better respond to the presence or absence of consent to a relationship which is one of the key distinctions between tort and contractual claimants in the insolvency setting. Questions of risk are not wholly absent, but they are resolved by applying notions of creditor and debtor merit, each party treating the other as he would want to be treated himself. Conceptually, the comparisons involved are not, as in the law, obligation against obligation, but rather entitlement versus entitlement assessed in a natural law context of adducing societal (communitarian) expectations of merit of claim and where, from the debtor side of the distributive equation, it is virtuous to satisfy some unsecured creditors ahead of others.

A significant attribute of the model of bankruptcy distribution I have presented is the notion of a common understanding of how people should behave in order that society may function – this in terms of an interaction of ‘attachments to others’ (see 4.2.1.2) and the progression of free will within an authoritative legal framework (see 4.3.1). Such natural law ideas are reflected in the broad acquiescence to a system which seeks the maximum gain shared fairly amongst creditors. The model allows us to conjecture that society would prefer to see pari passu treatment of claims because it assists the functioning of society in handling the adverse consequences of debtor insolvency. Reference to corrective and distributive justice allows consideration to be given to the orderly treatment of collectivised obligations in the transition from debtor solvency to insolvency – this, being an attribute of economic behaviour within a well-functioning society (see 3.3.1). Additionally, the communitarian idea developed in 4.2.1.2 as to how the hypothetical debtor would seek to be treated were the positions reversed and he were a creditor, supports norms of behaviour which are self-evidently correct in both practical and moral terms. The fact that both collectivism and the instances of errant behaviour necessitate processes of coercion (see 4.3.1) does not undermine the normative validity of the bankruptcy system.

From an acceptance of the above norms it is a small, though significant, step to recognise priority for many negligence victims, an idea introduced in 2.1.1 and discussed at 4.2.1.3. Unable to protect their interests in a pre-insolvency context, except where the risk that materialised could have been insured against or

633 Thomistic natural law would explain this propensity of behaviour along lines that “Not to act reasonably, not to act with logos, is contrary to the nature of God” (Manuel II Byzantine Emperor) whereas the communitarian reevaluation would suggest that reciprocity is what reason dictates within a community of rational persons’ aspirations for a well ordered society.
reasonable precautions taken, these claimants' vulnerability is further compounded by the threat of tortfeasor insolvency. The victims of negligence are unable to assert any influence over the recovery and liquidation process. They are thus fully dependent on the process, though unable to influence its outcome through mechanisms of interest protection that may be available to most voluntary creditors. A similar case can be made for victims of other torts, such as trespass or defamation, and for some categories of unjust enrichment claimant. The related concepts of merit (as it applies to creditor claims) and virtue (as it applies to debtors) provides a rational natural law basis for prioritising claims in bankruptcy. Both concepts take into account the ability of debtors to protect themselves from the impact of insolvency. The virtuous man or woman, in the capacity of debtor, pays his or her debts as they fall due. So also the virtuous man or woman in the capacity of creditor, takes all reasonable steps to protect him or herself from the potential indebtedness of a counterparty with whom he or she is dealing. It is precisely when these steps cannot be taken that a moral claim for priority can be asserted. It allows us, and policy makers, to conjecture as to what society might presume to be the more virtuous in the debtor treating some claimants ahead of others based on comparative merit of the claim. Both merit and virtue must be considered in tandem. Public sentiment, which at least according to Lord Atkin\textsuperscript{634} underlies and explains the tort of negligence, would see as more dire negligence’s consequences in most cases and thus demand redress in the insolvency context as distinct from the claims of both creditors who voluntarily entered into transactions with the debtor.

As Professor Goode has observed, it is only upon insolvency that the law must deal with inter-creditor competition and the possible granting of priority (see (1.1.4.1). Returning to the idea that we are comparing entitlements necessitated by debtor failure, it is possible to speculate as to changes in the ‘community’s way of life’ that would demand tort priority as a ‘condition of a just social order’. These two phases are introduced and analysed in 4.2.1 and 4.3.2 as part of the process of applying to bankruptcy distribution Lloyd Weinreb’s ideas of a contemporary re-evaluation of natural law jurisprudence.

The nature of mass tort liability means that the impact of losses is widespread and shared amongst a broad spectrum of the community. Thus if the community, and their political representatives, determine the harm to be such as to deserve more

\textsuperscript{634} Donoghue (or McAlister) v Stevenson [1932] All ER Rep 1; [1932] AC 562 at 580.
favourable treatment, then a basis can be identified for granting priority ahead of consensual and other tort claimants. This may have the kind of deterrent impact contemplated by some American academics (see 2.1.1), but this is accidental and is not part of the scheme this thesis proposes since it involves consideration of those distributive considerations that legislatures, and not courts, are institutionally required to make. It has placed to the fore virtue and merit attributes of private law obligations. While negligence claims by themselves justify priority, in terms of the scheme set out in this thesis, the long-tail nature of many negligence claims provides no additional justification for priority. Logically if regrettably, 'long-tailed' tort claims raise questions of policy which cannot be resolved purely by natural law analysis.635

The above ideas of virtue, merit and self-protection can provide a rational basis for the treatment of restitutionary proprietary interests in bankruptcy including constructive trusts over, for example, mistaken payments. Restitutionary constructive trusts aim to achieve corrective justice, precisely as they restore property to a claimant who previously held title to that property. The courts have identified specific reasons such as mistake or failure of consideration, why restitution should be ordered. In this context, also, considerations of debtor and creditor virtue are relevant. Payment of money under duress or undue influence involves no element of bargaining or opportunity for self-protection. The award of proprietary remedies in such cases can easily be justified. The circumstances in which money is paid by mistake, on the other hand, is fact specific: it cannot be said a priori whether the payer could have prevented the occurrence of the mistake, for example by establishing effective payment systems which eliminate most errors. But a recipient who attempts to keep the payment once he knows that a mistake has been made cannot claim to be a virtuous debtor. The imposition of a constructive trust over the payment or its traceable proceeds is in such a case justifiable.

In addition, the thesis model assists in the identification of the boundary between those endeavours which seek to give some effect to corrective justice rights, in contrast to elevated distributive entitlements. The criteria for the latter are external to

635 Tort priority does not necessarily overcome the problems of quantification and making allowances for claims that are yet to materialise. Resolution of these circumstances lies beyond the confines of bankruptcy law. Without necessarily evaluating their merits, the circumstances point to the need for more assertive instruments of public policy such as levies on corporate registration or state-funded insurance which may be necessary to enable the compensation burden occasioned by actual or impending corporate collapse to be more widely shared.
the legal system rather than based on internal ideas of coherence. Consideration of this contrast allows a refocusing on aspects of the “creditors’ bargain” discussed in Chapter 1 (1.1.3 and 1.1.4). It worth repeating here Baird and Jackson’s observation that:

“- - - social reform should be brought about through broad changes to the substantive law rather than through ad hoc modification of rights in bankruptcy.”

Elsewhere in Jackson’s writings the idea is presented that “[t]he difficulty with state-created priorities - - - is that they suffer from [a] ‘bankruptcy incentive’ problem” whereby “[a] creditor enjoying - - - such a priority might push for initiation of the bankruptcy process when it is not in the aggregate interests of the creditors to do so.” The most common example of a statutory advantage concerns the treatment of employee entitlements. The introduction of external criteria into distributive considerations points also to potential actions by government to protect participants in particular sections of the economy from bankruptcy’s normal dissolution processes on the basis of perceived economic, social or political significance. The thesis model clarifies the distinction between developments attributable to social reform and developments explicable solely in terms of internal coherence. Imposition of a ‘social reform’ agenda involves notions of public law much wider than is necessary to establish a natural law model of bankruptcy. Recognition of exceptions to the approach I have favoured, would suggest bankruptcy law’s application in more instrumental terms. Bankruptcy law functions nonetheless within a ‘social context’ as illustrated in the foregoing discussion of a communitarian re-evaluation of natural law (4.2.1.2). Awareness of the threshold between corrective justice rights and external criteria provides a convincing focus on the extent to which bankruptcy legislation fulfils distributive aims by the creation of statutory priorities.

Tension within bankruptcy’s distributive outcomes is inevitable, and to repeat Elizabeth Warren’s observations, bankruptcy is a “more complex” and “less confined process.” Corrective and distributive justice analysis provides a focus on both elements of coherence and where, and how exceptions, such as state-created priority, ought be allowed to undermine this coherence in a measured manner.

Moreover, this proffered perspective on bankruptcy distribution, I suggest, adds some clarity in dealing with contentious issues that are wider than Baird and Jackson’s general concern around bankruptcy and state-created priority. Acceptance of the type of private law internal intelligibility that I have urged as appropriate to bankruptcy law, may at least point to the need to pursue avenues of reform outside of bankruptcy law itself that would not undermine bankruptcy’s own valuable characteristic of coherence.

5.4 Balancing coercion and deterrence within a bankruptcy distributive framework

Corrective justice derives its distinctive moral rationality from discrete bipolar relationships. This renders deterrence as a consequential distributive outcome. Bankruptcy law when considered in terms of its institutional attributes clearly demonstrates features of deterrence (see 4.3.1). Both personal and corporate bankruptcy regimes contain rules which penalise abuse of moratorium and similar safe-harbour protection, and particularly in the corporate context, there is a strong theme of penalising reckless and dishonest conduct which purports to be protected by limited liability. Nonetheless, these mechanisms should be seen within an overarching objective of ensuring the augmentation of available assets for the meeting of collective creditor claims. In other words, what initially looks like deterrence may in fact be the promotion of corrective justice. Thus, the institutional features enforce and enliven bankruptcy’s conceptual features. The operation of antecedent transaction clawback provisions briefly introduced in section 3.1.4 as a conceptual feature of bankruptcy law can be understood in these terms. Examining deterrence in this context of bankruptcy enables similar consideration of an enduring theme in natural law theory – that of virtue.

Bankruptcy’s institutional features of asset sequestration and liquidation are applied initially in neutral and impartial terms without direct examination of the conduct of the debtor. It is expected that a virtuous person pays his debts when due and payable. The condition of insolvency is itself not symptomatic of an absence of virtue – however clearly unfortunate (see 3.3.1 and 4.3.1). To recklessly incur debts, to dispose of one’s assets to defeat creditors, to prefer a particular creditor over others under circumstances of impending insolvency; these are unvirtuous conducts towards others which attract the application of both corrective and distributive (deterrent) justice. Corrective justice is fulfilled to the extent that the wrongful
transaction is unwound and property vested in the trustee or liquidator. Distributive justice will be accomplished by the imposition of additional sanctions, both criminal and non-criminal, aimed at deterring the defendant and others.
CHAPTER 6
CONCLUSION

The model presented in this thesis emphasises that bankruptcy law ideally develops in harmony with the law of private obligations. If it were otherwise, its internal coherence would be lost and it would become prone to imposition of instrumental purposes. Instrumental considerations in this context are undesirable because they reflect no more than the subjective views of those who favour their application to solve legal problems. To that extent they undermine the Rule of Law, as analysed in this thesis. The model therefore allows us to see these relationships and to predict how bankruptcy law gives effect to developments in the law of private obligations, but overlaid with the critical condition of debtor insolvency. Such matters of relative merit of competing claims would not be considered but for supervening debtor insolvency which compels such assessments to be made as part of the resolution of the debtor’s affairs. That there is no perfect solution arises from the mere fact of deficiency in an insolvent debtor’s estate which must somehow be dealt with in rational and predictable terms. Nonetheless, the point made by this thesis is that the starting point must be the character of the claims themselves. This may seem unremarkable, but it needs to be emphasised that the law of private obligations is constantly evolving. It is thus appropriate to suggest a framework within which the bankruptcy process can be harmonised with the law of obligations. Although bankruptcy is a process of allocation of definable deficiency amongst an identifiable number and type of claimants, a too steadfast adherence to the assumption that pre-bankruptcy entitlements will occasionally undermine just outcomes. A model such as that developed in this thesis cannot purport to give solutions to all the imperfect circumstances of debtor insolvency. What it does do however, is to provide a clearer focus on the transition process that occurs on bankruptcy.

The thesis commences by explaining the objectives of both personal bankruptcy and corporate insolvency law. The key aim of this first chapter has been to introduce the widely held assumption that in bankruptcy law the pre-bankruptcy entitlements of creditors should be recognised and enforced as far as practicable. Various explanations of the collectivism and pari passu norms are critiqued in order to show that when viewed from the perspective of underlying rights affected by supervening debtor insolvency, the bankruptcy process is complex and prone to uncertainty. The
theme of complexity and uncertainty in bankruptcy are further developed with reference to the entitlement recognition and distribution treatment applied in the often contentious circumstances of mass tort liability and recognition of new proprietary interests. The complexities that arise in these cases are introduced to emphasise the variety of private law obligations that must be resolved in the bankruptcy setting. Following from this private law obligations and rights footing, Chapter 3 draws upon theoretical analysis which emphasises acceptance of the law’s own structure and ends, and which explains the law normatively in non-instrumental terms. The analysis shows bankruptcy, in its key features of collectivism and pari passu ranking, to be internally coherent. The conclusion drawn is that the aims of bankruptcy are to be found in its rules and principles; they are not found externally, for example in economic explanations. In recognising that bankruptcy law is not abstract and of its very nature is highly applied, Chapter 4 addresses the type of morality that can explain the multi-party setting of bankruptcy and the frictions that arise between debtor and creditor, and between competing creditors. The source of this moral inquiry is non-theological natural law-based and the attributes of collectivism and pari passu ranking are explained in terms of the contrasts, and interactions between, corrective justice and distributive justice. Continuing the objective of bridging the divide between theoretical explanation and the applied nature of bankruptcy premised on attributes of predictability and efficiency, the thesis also in Chapter 4 proposes a basis for understanding how the coincidence of coercion and acquiescence are necessary to a well functioning bankruptcy system.

A natural law based perspective on creditor entitlements and bankruptcy distribution provides highly valuable insights. The model presented in the thesis accepts a moral dimension to the legal obligations arising out of the private dealings between individuals. It is this dimension which explains the purposes to which bankruptcy law’s distributive mechanisms should be applied. The model does not in any substantial way support radically different treatments from those currently applied. Similar conclusions about the robustness of the frameworks of personal and corporate insolvency might well be arrived at from the application of a predominantly economic perspective. But since private law entitlements cannot wholly be explained in economic terms, it is logical to put forward a model adjudicating those entitlements in non-economic terms.

Analysis undertaken in the thesis proves bankruptcy to be a discrete body of rules having internally defined functions and limits. This clarity is an important attribute
warranting careful consideration in future developments of the law so as to meet the
dynamics of the social and economic contexts within which bankruptcy law operates.
Significantly, this clarity is derived from bankruptcy’s own internal character, rather
than deduced from external reference. The model presented in the thesis allows us
to see with greater clarity what bankruptcy distribution can and cannot achieve, and
how it evolves over time to meet changing expectations. Such expectations are
derived from the changing nature of private law obligations.

The central theoretical chapters of the thesis were introduced with words to the effect
that the law of bankruptcy entitlement recognition and distribution can be understood
through its own internal intelligibility or with reference to external criteria of values
and policies. The model developed in the thesis favours the former, but importantly
acknowledges the threshold at which external criteria might be allowed to impinge.
This perspective, when considered in conjunction with bankruptcy’s interaction with
private law, facilitates identification of three discrete ways in which rules of
entitlement recognition can be developed. The first type focuses on development in
private law and corrective justice’s doctrine of bipolarity of relationship. This type of
bankruptcy entitlement recognition acknowledges change in private law remedial
responses which ought, in some way, to survive into the post-solvency distribution
setting. The second type focuses on coherence within the distributional ordering itself
and it is that which is most directly informed by natural law perspectives of reason
and interaction of virtue of conduct and merit of claim. It is within this second type of
development that the justification for priority of some tort and unjust enrichment
claims can be understood. Moreover, addressing the first and second types of
development can assist in handling the friction that arises between bankruptcy’s
distributional treatment of consensual and non-consensual claimants. What the first
and second types cannot do is to justify reform which is based not on non-
instrumental purpose or coherence, but rather on distributive justice considerations
and intent. This is the domain of the third type of development of bankruptcy
distributional principles and rules. It is through this third type of development that
bankruptcy distribution accommodates social reform agenda within which state-
created priority, such as that afforded to employees, can be rationalised.

Reiterating here the thesis’s critical ideas of bankruptcy law’s harmony with the law of
private obligations, coherence and guarding against instrumental purposes, the
penultimate chapter presents a natural law-based model for the recognition and
treatment of creditor entitlements in bankruptcy. The Preface to the thesis is followed
by a diagrammatic representation of the model. The diagram, though of course not an exhaustive description of the model’s entirety, does illustrate the distinction between bankruptcy law’s institutional and conceptual features and their respective orientations in distributive justice and corrective justice. The corrective justice line of development in the thesis explains the critical ideas of just social order and comparative merit of creditor claim – the latter informed by natural law theorising. The distributive justice line of development emphasises ideas of community collective purpose and attributes in bankruptcy law of coercion and acquiescence – these being informed by reference to aspects of public law and the rule of law, though again drawing on natural law foundations.

To summarise then, bankruptcy law whilst ideally seen in this model as discrete and coherent in its non-instrumental elements is thus not detached from private law, to which it can be seen as a necessary adjunct for dealing with the legal phenomenon of debtor failure. Moreover, the model provides a framework which facilitates foremost the addressing of the legal consequences of insolvency for the affected parties, whilst also enabling distribution and the resolution of the affairs of debtors to be considered in wider social and economic contexts. The combination of a focus on corrective and distributive justice’s respective rationale and application assists in tracing the process of translating obligations into distributive entitlements - this in terms of both the pari passu norm and its limited exceptions. Moreover, the coherence of this approach allows recognition of the fact that ultimately there are conditions or circumstances in which society’s private law-based legal mechanisms are ineffective.
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Purcell, John Anthony

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