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Re: REPORT ON TRANSACTIONS AVOIDANCE LAWS (CERIL REPORT 2017/1)
By: Working party on Transactions Avoidance Laws

Reporter: Professor Reinhard Bork [1]

# *Clash of Principles: Equal Treatment of Creditors vs. Protection of Trust in European Transactions Avoidance Laws*

The following text explains the concept and results of a research project executed by a working group of the Conference on European Restructuring and Insolvency Law (CERIL). The study sought to collect detailed information on national transactions avoidance laws and to identify correlations using a principle-based analysis, making enquiries into the relevance of the principle of equal treatment of creditors and the principle of protection of trust.

## 1 INTRODUCTION

1. The present research project has been undertaken by a working group of CERIL (the Conference on European Restructuring and Insolvency Law). It sought to collect information on transactions avoidance rules in insolvency laws[2] from various jurisdictions (preferably, but not exclusively, the jurisdictions represented by the members of the group) and to examine them in light of their underlying policies and principles.

[1] The Working Party discussing and contributing to this Report consisted of, in addition to reporter and chair Reinhard Bork (Germany): Miodrag Dordevic (Slovenia), Artur Galea Salomone (Malta), Annina H. Persson and Göran Millqvist (Sweden), Tomás Richter (Czech Republic), Ignacio Sancho (Spain), Catarina Serra (Portugal, co-chair), Jean Luc Vallens (France) and Rolef de Weijs (the Netherlands, assisted by Meren Baltjes); further conferees involved were Reinhard Dammann (France), Jasnica Garašić (Croatia), Ivan Ikrényi (Slovakia), Renato Mangano (Italy), Grégory Minne (Luxembourg), Anders Ørgaard (Denmark), Melissa Vanmeenen (Belgium), Oleg Zaitsev (Russia) and Kristin van Zwieten (United Kingdom).

[2] Regarding terminology, this study adopts the English distinction between corporate insolvency and personal bankruptcy. In other countries, the word "bankruptcy" refers to corporate as well as personal financial difficulties. These differences in approach can be left to one side for the purposes of this research.

2. National insolvency laws typically contain rules on avoidance actions. Some of them are designed to provide sanctions against fraudulent behaviour or transactions at an undervalue, whereas others aim to enforce the principle of equal treatment of creditors (*par condicio creditorum*) by enabling the insolvency practitioner to challenge the preferential treatment of a creditor (hereafter also referred to as "the defendant") within a given "suspect period" prior to the application for, or opening of, insolvency proceedings. Although the principle of equality among creditors (the *pari passu* rule) finds application mainly in insolvency proceedings which have already been opened, it may seem appropriate under specific circumstances to extend the application of the principle to include the time period prior to the commencement of insolvency proceedings, particularly if transactions were performed when the debtor was already insolvent (i.e. unable to pay their debts).

3. Permitting transactions avoidance in most cases means disappointing the expectations of the defendants that they may keep what they have received, and these expectations may be held even where the debtor turns out to be insolvent. Hence, the principle of protection of trust comes into play. Various methods of protecting legitimate expectations are incorporated into transactions avoidance laws. Some rules contain time limits or subjective requirements (e.g. knowledge of the creditor that the debtor was insolvent when their claim was satisfied). Other rules are rather narrow in that they restrict their scope to performances of the debtor, protecting creditors who have taken performance rather than received it – for example, satisfaction of a claim in individual enforcement proceedings is challengeable under some national laws but not others. On the other hand, transactions at an undervalue are challengeable in many jurisdictions without any protection of trust being offered (based on the conviction that he who has received a performance without consideration is not worthy of protection).

4. Hence, the group sought to collect information on national transaction avoidance laws (as they apply to formal liquidation proceedings), enquiring into their connection to the principle of equal treatment of creditors and looking for various methods to protect the legitimate expectations of creditors during the implementation of transactions avoidance laws. The goal of this undertaking was to test the principle-based approach in insolvency law and to collect insights in the tenets of national transactions avoidance laws.

## 2 METHODOLOGICAL OUTLINE

5. The group decided to collect the necessary information using a questionnaire which was based on several premises. It is useful to outline the basic cornerstones of this research project.

### (1) Insolvency proceedings

6. The questionnaire restricted itself to insolvency law. As a result, general creditor protection by other rules, particularly by company law (e.g. in rules on directors' liability), was not included. Furthermore, the study concentrated

on the understanding of insolvency proceedings as classical liquidation proceedings, thus leaving similar provisions for enforcement actions, restructuring proceedings or debt adjustment outside of the scope of the questionnaire. However, this does not mean that reference to restructuring efforts, for example, was completely excluded; one question dealt with the protection of new finance provided in pre-insolvency restructuring proceedings against avoidance in subsequent insolvency proceedings (after these restructuring efforts have failed). However, concentration on classical liquidation proceedings seemed advisable, since the focus was on the underlying principles and not on a comprehensive portrayal of all avoidance law phenomena.

(2) Transactions avoidance law

7. From the outset, the group members agreed that a principle-oriented approach should be pursued but it should not be applied immediately to the entire scope of insolvency law. It seemed advisable to confine the study to one section of insolvency law, and transactions avoidance law seemed to be a suitable subject. The term "transactions avoidance law" has not been defined in the questionnaire; any definition, never mind one that is too narrow, may prompt national conferees to involuntarily exclude certain instruments provided by their national laws from the scope of the project. However, it was evident from the answers given that there is a common understanding of the legal instruments which should be discussed in the present context: transactions avoidance law comprises all norms which invalidate hitherto valid legal acts on the opening formal insolvency proceedings, whether by force of law (*ipso iure*), through impugnment by the insolvency practitioner or by a court decision.

8. However, some limitations must be mentioned, which are due to this being a pilot research project and its deliberate limitations in scope. First, neither the legal consequences (e.g. voidness by force of law, by declaration of the insolvency practitioner or – as in most countries – by mandatory/discretionary court decision, resulting in the obligation to return that which was received or to pay compensation, an obligation to pay interest, and/or effects on third parties) nor the procedural details (e.g. the standing to bring avoidance actions, the competence of the insolvency court/general division court, cost issues) belonged within the scope of this study; instead, the focus was on the substantive prerequisites for and boundaries of transactions avoidance. Applying a principle-based approach to the complete field of transactions avoidance law must be left to future research and discussion.

9. Second, the project did not seek to collect comprehensive information on each and every detail of national transaction avoidance laws, instead covering the essential decisions of national legislators in this field. This may lead to neglecting differences between jurisdictions regarding some very special

constellations[3] but will hopefully ensure that results allow for easy comparison of different countries and their laws.

10. Third, this study does not aim to present a proposal for a harmonised transaction avoidance law.[4] In testing the principle-based approach, it is an introductory methodological piece which prompts refinement through further academic work in the future, rather than a comprehensive and exhaustive analysis of the subject.

(3) Principles

11. The choice of principles to be scrutinised in this study requires further explanation. The project concentrates on two of the main principles of insolvency law, with principles being understood as fundamental, basic standards and as building blocks underpinning the rules of insolvency law, systemising the law as well as legitimising the legal consequences of these rules.[5] The project was restricted to two of the most important principles, these being the principle of equal treatment of creditors and the principle of protection of trust.[6] It is assumed that the latter is relevant to nearly all transactions avoidance cases (since transactions avoidance by its very nature means disappointing the expectations of the defendants that they may keep what they have received) whereas the former probably can support some but not all avoidance actions, particularly if the defendant is not a creditor (but rather a donee, for example). If the defendants are not creditors, then they cannot be treated the same as other unsecured creditors, i.e. they cannot be put in the same position by challenging the performances they have received, thus transforming their status from satisfied/secured creditors to unsatisfied and unsecured creditors. Hence, other principles, such as the principle of predictability (legal certainty) or the principle of optimal realisation of the debtor's assets, must be implemented to explain these avoidance norms. However, these can be left to future research and discussion. The present study does not pursue the idea that all transactions avoidance rules can be justified by the principle of equal treatment of creditors. On the contrary, it aims to carve out not only the scope but also the limits of this principle, simultaneously looking to identify where there is a need to enforce other principles. Hence, it was agreed that the aforementioned two main principles, which can be observed separately as well as joined together, should be the focus of this initial project and that their relevance to national transactions avoidance laws should be explored.

[3] For example, the voidness of allocation of assets by an individual businessman with limited liability (*entrepreneur individuel à responsabilité limitée*) under French law refers to a very peculiar constellation which has very few counterparts in other jurisdictions.

[4] Interesting thoughts concerning the harmonisation of avoidance laws can be found in *Andrew Keay*, The Harmonization of the Avoidance Rules in European Union Insolvencies, International & Comparative Law Quarterly 66 (2017), 79, 92 et seq.

[5] Cf. *Reinhard Bork*, Principles of Cross-Border Insolvency Law, Intersentia, Cambridge/Antwerp/Portland, 2017, para. 1.21.

[6] A similar approach was taken by *Rebecca Parry* in Rebecca Parry/James Ayliffe/Sharif Shivji (eds.), Transaction Avoidance in Insolvencies, Oxford University Press, 2nd edn., Oxford 2011, para. 2.20.

(4) National laws

12. Finally, the specific national insolvency laws included in this project should be listed. As mentioned above, the questionnaire has been completed with respect to Czech, Dutch, French, German, Maltese, Portuguese, Slovenian, Spanish and Swedish law.[7] Some conferees added remarks on the legal situation in England and Wales under the Insolvency Act 1986. Additional information could be obtained from two recent publications, one covering in detail the transactions avoidance laws of Austria, England and Wales, France, Germany, Hungary, Italy, Lithuania, Poland and Spain[8] and the other dealing in providing an overview of the laws of all Member States of the European Union, plus those of Norway and of the United States of America.[9] Overall, it can be said that a representative and balanced sample of national insolvency laws has been evaluated.

## 3 DEFINING THE PRINCIPLES

13. The first step in collecting views from different jurisdictions was defining the two main principles: the principle of equal treatment of creditors and the principle of protection of trust.

(1) Equal treatment of creditors

14. Regarding the principle of equal treatment of creditors, it was suggested[10] that the principle of equal treatment of (unsecured) creditors belonging within the same class, also known as the *pari passu* rule (*par condicio creditorum*), is a centrepiece of insolvency laws. If a debtor were unable to pay their debts in full, independent and individual enforcement proceedings by each creditor would lead to unfair results, since this would enable the quickest and most assertive creditors to obtain full satisfaction of their claims, while others would most likely receive no dividend whatsoever. Since this result is deemed inappropriate, individual enforcement proceedings must be banned and replaced with collective enforcement proceedings in the form of insolvency proceedings. These collective enforcement proceedings are conducted in the best interests of the general body of creditors, amongst whom "the pain is to be shared", and culminate in a distribution of the proceeds in which all creditors are to be treated equally through a strict application of the *pari passu* rule, which is included in many national insolvency statutes.[11] Transactions avoidance law also partly seeks to enforce the principle of equal treatment of creditors by enabling the insolvency

[7] See fn. **Fout! Bladwijzer niet gedefinieerd.**.

[8] *Gerard McCormack/Reinhard Bork* (eds.), Security Rights and the Insolvency Regulation, Intersentia, Cambridge/Antwerp/Portland, 2017.

[9] *Gerard McCormack/Andrew Keay/Sarah Brown*, European Insolvency Law – Reform and Harmonization, Edward Elgar Publishing, Cheltenham (UK)/Northampton (MA, USA), 2017, p. 130 et seq.; see also *Keay*, ICLQ 66 (2017), 79-105.

[10] Based on *Bork* (fn. 5), para. 4.6 et seq.

[11] Examples are s. 107 Insolvency Act 1986 (England and Wales); Art. L643-8 Code de Commerce (France); Art. 287 Companies Act (Malta); Art. 34, 46, 128a Financial Operations, Insolvency Proceedings and Compulsory Dissolution Act (Slovenia); s. 18 Priority Rights Act (Sweden).

practitioner to challenge preferential treatment given to a creditor in a specific period prior to the application for, or opening of, insolvency proceedings. Hence, the scope of the principle of equality is extended to include a period prior to the opening of insolvency proceedings.

(2) Protection of trust

15. Regarding the principle of protection of trust, the following description was proposed.[12] Reasonable contractual partners usually assess the risks of the counterparty becoming insolvent prior to conclusion of the relevant contract. However, creditors' expectations may not be met where the debtor's insolvency leads to actual insolvency proceedings, which may modify or even ruin the creditor's legal position. In such circumstances, the question arises as to whether the law does anything to protect the creditor's expectations. Protection of trust is an important pillar in every legal order and a basic tenet to be enforced under the rule of law, as people must be sure about their legal rights and positions. Once they have acquired these rights, they trust in their stability and continuity, and expect (with good reason) to be protected against unjustified changes or deprivation. This is also true of the influence of insolvency proceedings on creditors' rights. Creditors expect their legal positions to be safe and thus seek protection of these expectations, particularly against transactions avoidance. However, it is obvious from the outset that a fully comprehensive protection of trust is not always compatible with the central features of insolvency, in particular with regard to transactions avoidance law. First, the principle of protection of trust only covers legitimate expectations. For example, if a creditor cooperates with the debtor to their own benefit, but to the disadvantage of the general body of creditors, expectations of keeping what has been received are not legitimate and therefore must not be protected. Second, justice may require that transactions avoidance be permitted, especially where other principles, such as the principle of equal treatment of creditors, come into play. In these cases, the conflicting principles must be weighed against each other and balanced whenever insolvency laws are adopted or amended. The outcome may very well be that the creditor's interests must take a back seat and that protection of trust cannot be granted.

## 4 NATIONAL VIEWS

16. Not surprisingly, the first results from evaluating the answers to the questionnaire are that all jurisdictions involved in the study have special rules on transactions avoidance. As a general rule, they are included in the respective insolvency law, regardless of whether this takes the form of a separate insolvency statute or is part of the national company/trade law.[13] All

[12] Based on *Bork* (fn. 5), para. 4.55 et seq.; see also *Reinhard Bork*, Vertrauensschutz im Europäischen Insolvenzrecht, in: Festschrift für Nikolaos K. Klamaris, Sakkoulas Publications, Athens/Thessaloniki 2016, 77 et seq.

[13] Cf. ss. 235-243 Insolvency Act 182/2006 (Czech Republic); ss. 238-246, 423-425 IA 1986 (England and Wales); Arts. L632-1 - 632-4 Code de Commerce (France); §§ 129-147 Insolvenzordnung (Germany); Art. 303 Companies Act (Malta); Arts. 42-51 Faillissementswet (Netherlands); Arts. 127-137 Bankruptcy Act (Poland); Arts. 120-127 Insolvency Act (Portugal); Arts. 269-278 Financial Operations, Insolvency Proceedings and Compulsory Dissolution Act (Slovenia); Arts. 71-73 Insolvency Act (Spain); Chapter 4, ss. 1-21 Bankruptcy Act (Sweden).

national laws require that the transaction was detrimental to the general body of creditors and all know of the general distinction between preferences[14], transactions at an undervalue[15] and intentionally fraudulent transactions (the *actio Pauliana*)[16], the latter being occasionally treated separately from the residual avoidance rules.[17] However, upon looking closer, many differences between the analysed laws become evident.

(1) Scope of the principle of equal treatment of creditors

17. The first point to be addressed is the scope of the principle of equal treatment of creditors.[18] Almost all conferees reported that the principle of equality serves as a cornerstone for the justification of avoiding of preferences[19] but is inept at justifying the avoidance of transactions at an undervalue and of intentionally fraudulent acts. [20] It is only in Sweden that all rules seem to be justified by the principle of equality. To some extent, Dutch law is also an exception, since in 1896, the Dutch legislator found the primary basis for rooting transactions avoidance principally in the state of mind of the debtor. However, many Dutch scholars favour the approach of this research project and agree that it is the principle of equal treatment of creditors which justifies the annulment of preferences.

(2) The role of the principle of protection of trust

[14] Regarding preferences, it should be noted, however, that many laws distinguish between "congruent coverage" (the debtor pays debts which are due and pays the debts in the way in which the creditor could make a claim for) and "incongruent coverage" (the creditor receives performance which he was not entitled to, whether this lack of entitlement is due to the time of performance or due to the concrete transaction demand). Incongruent coverage is often easier to challenge, since the legal requirements for such a challenge are less strict. This distinction will be neglected in this study since it is of no special relevance to the principle-based approach; for an overview of the national laws on preferences, see *McCormack/Keay/Brown* (fn. 9), pp. 138-151.

[15] Cf. *McCormack/Keay/Brown* (fn. 9), pp. 152-157.

[16] See also *McCormack/Keay/Brown* (fn. 9), pp. 159-161.

[17] Examples are Art. L 1341-2 Code Civil (France); ss. 423-425 IA 1986 (England and Wales); Art. 1144 Civil Code (Malta); Arts. 527-534 Civil Code (Poland). The opinion of AG *Ruiz-Jarabo Colomer* in *Christopher Seagon als Insolvenzverwalter über das Vermögen der Frick Teppichboden Supermärkte GmbH v Deko Marty Belgium NV*, ECLI:EU:C:2008:575, para. 23 et seq. is enlightening with regard to the relationship between avoidance under civil law and avoidance under insolvency law. For the avoidance of other transactions, see *McCormack/Keay/Brown* (fn. 9), p. 135.

[18] In some countries, special treatment is provided for shareholder loans (e.g. Germany and Portugal; for details, see below at para. 23). Under these rules, transaction avoidance is facilitated above normal avoidance of preferences. This means, on the one hand, that the scope of the principle of equal treatment of creditors is extended to this special group; shareholders must return what they have received and are treated the same as other unsecured creditors when it comes to the distribution of the proceeds unless national insolvency law subordinates their claims. On the other hand, shareholders are treated different to other creditors. This seems to be an infringement of the principle of equal treatment of creditors regarding the prerequisites for transactions avoidance, yet it can be justified by reduced worthiness of protection due to the fact that shareholders, who are free to finance their company with either capital or loans, must accept that their loans are to be treated as capital rather than as a normal obligation.

[19] However, for England and Wales, see below at para. 22. For the U.S., see *Lawrence Ponoroff*, Bankruptcy Preferences: Recalcitrant Passengers Aboard the Flight From Creditor Equality, 90 (2016) American Bankruptcy Law Journal, 329-398, 337.

[20] Cf. below at para. 33.

18. Against this background, the question of how the legitimate expectations of creditors are to be protected takes centre stage.

*(a) Types of challengeable actions*

19. In this context, the first question to be answered concerns the type of transactions which are challengeable: are all transactions within the scope of avoidance law or only those of the debtor, which would exclude performance by third parties and satisfaction via individual enforcement or set-off? In many countries, all legal acts are subject to avoidance rules, regardless of whether they were performed by the debtor, the defendant or a third party, provided that they are detrimental to the general body of creditors. Examples of this are France, Germany, Poland, Portugal and Sweden. However, in other countries, transaction avoidance is restricted to transactions of the debtor that have disadvantaged the general body of creditors. This is true for the Czech Republic, England and Wales, Malta, the Netherlands, Slovenia and Spain. This excludes satisfaction by individual enforcement prior to the application for insolvency proceedings (which can be justified not only by the principle of protection of trust but also by the principle of legal certainty), whereas set-off is often not allowed if the creditors acquired their claims or ended up in the set-off situation through an avoidable transaction or under comparably suspicious circumstances.

*(b) Substantive insolvency*

20. The next question concerns the substantive insolvency of the debtor: does the law require the debtor to be insolvent at the time at which the transaction to be challenged was carried out? National laws have divergent answers and altogether it paints quite a colourful picture. Only a few states require substantive insolvency (inability to pay debts when they fall due/overindebtedness) at the relevant time for all avoidance actions; this is true, for example, in France and Slovenia.[21] In many countries, substantive insolvency at the time of the transaction is a prerequisite for the avoidance of preferences (Czech Republic, England and Wales, Germany and Sweden).[22] Some also require substantive insolvency for the avoidance of transactions at an undervalue (the Czech Republic, England and Wales), whereas most laws do not possess this requirement for the avoidance of intentional fraudulent transactions. In contrast, under the laws of Malta, Poland and Spain, substantive insolvency of the debtor is irrelevant; instead, a fixed suspect period prior to the dissolution of the company or the commencement of insolvency proceedings is implemented,[23] which may serve as an implicit irrebuttable presumption of the debtor's insolvency. Similarly, Dutch law contains no express reference to the insolvency of the debtor; however,

[21] In Slovenia, the legal term "insolvency" covers mainly the inability to pay debts within a longer period of time, and in case of overindebtedness the debtor is considered to be insolvent unless it is proven otherwise.
[22] In some countries (the Czech Republic, England and Wales) it suffices that the substantive insolvency was caused by the transaction.
[23] Cf. below at para. 21.

according to the Supreme Court of the Netherlands, the mental elements (i.e. knowledge/collusion) require that the opening of insolvency proceedings and a lack of assets for use in such proceedings were reasonably foreseeable at the time of performance,[24] which indirectly makes the insolvency of the debtor an important factor. The same is true for Portugal, where the mental element of "bad faith" is defined as awareness of the debtor's existing or imminent insolvency.

*(c) Suspect period*

21. Almost all countries involved in the study (except the Netherlands[25]) have established a suspect period in their insolvency laws.[26] Creditors' trust can be protected by restricting avoidance of transactions to legal acts which have been performed within a certain time period prior to the application for, or opening of, insolvency proceedings, meaning that defendants who have received their money or goods earlier than the beginning of such a suspect "twilight" or "claw back" period remain unaffected. However, the finer details here are also hugely varied. First, the laws choose different starting points for the calculation of the relevant time period, which always runs backwards: in Malta, this is the opening of insolvency proceedings;[27] in other countries, this is the application for such proceedings (the Czech Republic, England and Wales, Germany, Poland, Portugal, Slovenia, Spain and Sweden).[28] Second, in all countries except Malta (here, the suspect period has a uniform length of six months) and Spain (which has one or two years) the length of the suspect period depends on the avoidance grounds.[29] For preferences, the length varies from three months (Germany and Sweden) to six months (England and Wales, Poland and Portugal[30]) and even to one year (the Czech Republic and Slovenia). Transactions at an undervalue are treated identically to preferences in some states (the Czech Republic) and differently in others; for example, the suspect period is six months to three years in Sweden, one year in Poland and Portugal, three years in Slovenia and four years in Germany; in England/Wales, it is two years for companies and five years for individuals. For intentionally fraudulent transactions, all countries except Portugal (which has

[24] Hoge Raad, 22.12.2009 – 08/02255, ECLI:NL:HR:2009:BI8493 (*ABN AMRO BANK N.V. v. van Dooren q. q. III*), para. 3.7.

[25] Time periods are only relevant here to the burden of proof.

[26] General remarks on relevant time periods can be found in *McCormack/Keay/Brown* (fn. 9), p. 135 et seq., p. 141 et seq.

[27] The law of Malta refers to the "dissolution of the company", which is a result of the court decision to open insolvency proceedings.

[28] Equivalents can be found in other methods of commencing insolvency proceedings, for example the out-of-court appointment of an administrator in England and Wales. The difficulty here is that some rules which mention the "opening" of proceedings are referring to the application for or the commencement of the proceedings rather than the opening decision of the court; cf. also *McCormack/Keay/Brown* (fn. 9), p. 161 et seq.

[29] In some countries, suspect periods are longer for closely related parties; cf. below at para. 24.

[30] In Portugal, there are two avoidance regimes. Under the so-called unconditional avoidance rule, the only prerequisite for challenging specific transactions, including preferences and transactions at an undervalue, is a certain suspect period. However, there is also a general avoidance clause with a general suspect period of two years, which requires detriment to the creditors and bad faith of the defendant. This means that in Portugal there is a uniform suspect period (two years) coexisting with specific suspect periods which depend on the type of transactions at stake and on the avoidance grounds.

no specific rules on intentionally fraudulent transactions but provides a general suspect period of two years[31]) implement a significantly longer suspect period (four to ten years in Germany, and five years in the Czech Republic, Poland and Sweden) or have no time limit at all (England and Wales, Malta). Some laws use a longer time period if the defendant is a shareholder[32] or a closely related party (insider).[33] A special case is France, where the suspect period depends on the cessation of payments and is determined by the court accordingly but is no longer than eighteen months prior to the opening decision; in addition, the court may overturn gratuitous acts within the six months prior to the date of cessation of payments.

*(d) Mental elements*

22. Another way to protect the legitimate expectations of the defendants is to attach mental elements to avoidance actions, i.e. to require intent, knowledge of certain circumstances or – as a defence – good faith, be it on the part of the debtor or the defendant.[34] Again, national laws proceed quite differently. Regarding the avoidance of preferences and transactions at an undervalue, some countries (e.g. the Czech Republic, Portugal[35], Spain) refrain from using subjective requirements entirely. Others take a different approach: for preferences, they frequently demand knowledge of the defendant of the debtor's (imminent) inability to pay debts (partly in France, Germany and Portugal[36], and completely in Slovenia and Sweden) or of an application for insolvency proceedings (Germany and the Netherlands), sometimes framed as a "good faith" defence (Malta and Poland).[37] In contrast, "good faith" of the defendant is irrelevant in England and Wales[38] and instead the debtor's desire to put the other party in a better position is necessary, which proves that (a) the rule in question is directed against the debtor company and its management, and not against the creditor[39], and (b) that the purpose of the norm is less to enforce the principle of equal treatment of creditors and more to punish misbehaviour.[40] Regarding transactions at an undervalue, some countries also accept the "good faith" defence regarding the counterparty's knowledge (Malta and Poland) or the debtor's intent (England and Wales). Others require the knowledge of the counterparty (Portugal[41]) and of the

[31] See above at fn. 30.
[32] Cf. below at para. 23.
[33] Cf. below at para. 24.
[34] General observations by *McCormack/Keay/Brown* (fn. 9), p. 163 et seq.
[35] See above at fn. 30.
[36] See above at fn. 30.
[37] For the burden of proof, see below at para. 28.
[38] *Rebecca Parry* and *Sharif Shivji* in Rebecca Parry/James Ayliffe/Sharif Shivji (eds.), Transaction Avoidance in Insolvencies, Oxford University Press, 2nd edn., Oxford 2011, para. 5.116.
[39] It should be stressed that this is not compatible with the system being proposed. We owe *Thomas H. Jackson* greatly for pointing out that preference laws sort out rights among creditors *inter se*, while other avoidance laws adjust the rights of creditors vis-à-vis the debtor: cf. *Thomas H. Jackson*, The Logic and Limits of Bankruptcy Law, Beard, 2001, p. 146 and 36 (1984) Stanford Law Review 725, 726. Criticism is also provided by *McCormack/Keay/Brown* (fn. 9), p. 140; *de Weijs* (fn. 57), p. 5.
[40] See *Green (liquidator of Stealth Construction Ltd) v Ireland* [2011] EWHC 1305 (Ch). Criticism by *Parry* (fn. 6), para. 2.39 et seq., para. 2.44.
[41] Albeit under the general avoidance rule only; see above at fn. 30.

debtor that the legal act would prejudice the creditors (the Netherlands), while others have no subjective requirements (Germany, Slovenia and Sweden). In contrast, intentional fraudulent transactions can only be challenged if the parties colluded with one another (Malta and the Netherlands) or if the debtor at least wilfully acted against the interests of the general body of creditors (the Czech Republic, England and Wales, Germany) and the defendant knew of this intent (the Czech Republic and Germany).

*(e) Special creditor groups*

23. Reduced protection is granted on several levels for special creditor groups. For example, some – but not all – countries have special rules for shareholders. In Germany, payments of the debtor company made with regard to shareholder loans can be challenged without further requirements if (1) the debtor is a company which does not have a natural person as a general partner, nor a general partner which is a company that has a natural person as its own general partner, and (2) performance was rendered no more than a year (ten years for the granting of collateral) prior to the insolvency application; the latter holds true for Portugal. Other laws (those of the Czech Republic, England and Wales, France, Netherlands, Poland, Spain and Sweden) don't address shareholders in a special way but courts tend to include them in rules for closely related parties, as described in the following paragraph. Only a handful of laws contain no special rules at all (i.e. the insolvency laws of Malta and Slovenia).

24. Regarding closely related parties, many European laws (with the exception of Malta) provide reduced protection for such insiders.[42] In some countries, the suspect period is longer for closely related parties[43] than for normal unsecured creditors (the Czech Republic, England and Wales, Sweden and Slovenia, though in the latter this concerns personal bankruptcies only). In others, there is a rebuttable presumption that the requirements of detriment to the general body of creditors (Poland and Spain), of substantive insolvency (the Czech Republic, Sweden) or of mental elements (England and Wales, France, Germany, the Netherlands, Portugal, Slovenia – with the aforementioned caveat – and Sweden) have been fulfilled.[44]

25. Other groups are rarely addressed. An exception can be found in Polish law, where charges obtained within the 12 months prior to the insolvency application can be declared ineffective if the debtor is not the personal debtor of the creditor (i.e. the charge secures a third person's debt) and has not obtained any (or only insufficient) performance. Under the insolvency law of England and Wales, avoidance is also possible for floating charges under certain conditions.

[42] Cf. *McCormack/Keay/Brown* (fn. 9), p. 137 et seq., p. 139.
[43] In many cases, this comprises members of the same group of companies.
[44] General remarks on the relevance of such presumptions in *McCormack/Keay/Brown* (fn. 9), p. 135.

*(f) New financing*

26. In the debate on pre-insolvency restructuring, a "safe harbour" for new financing is frequently postulated.[45] Currently, some countries do not provide such special protection for credit given to support restructuring efforts in insolvency proceedings which are opened after these efforts have failed (the Czech Republic and Malta).[46] However, most laws include explicit exceptions (France, Poland, Portugal, Slovenia, Spain and Sweden; the Netherlands *de lege ferenda*) or provide for a broader "restructuring privilege" developed in case law (Germany). However, many of these privileges are dependent on certain conditions, such as a serious restructuring concept or a restructuring agreement which has been approved by a court.

*(g) Inability to return*

27. One might think that laws protect defendants by restricting the effects of transactions avoidance to the enrichment still available to the defendant, which means that creditors must not return what they have received if that which they obtained was sold, spent or consumed while trusting in the validity of the transaction. However, in the national laws covered by this study, this special protection is either not available at all (the Czech Republic, France, Malta, Poland, Slovenia, Spain and Sweden) or it is restricted to gifts and other gratuitous acts provided the defendant acted in good faith (Germany, Portugal, the Netherlands).

*(h) Burden of proof*

28. It goes without saying that defendants are better protected if the burden of proof for the prerequisites of transactions avoidance lies with the insolvency practitioner. Indeed, this is the case in almost all countries, albeit where there are rebuttable presumptions for certain prerequisites,[47] particularly those concerning shareholders[48] and other closely related parties.[49]

*(i) Limitation period*

29. The final instrument for protecting those who have received something in a challengeable way is the limitation period. This should not be confused with the suspect period mentioned earlier:[50] the latter concerns the time period during which the challengeable act is required to be performed, while the

[45] Cf. Chapter 4 (Arts. 16 and 17) of the proposed EU Directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures (COM (2016) 723 final of 22 November 2016) and the explanations on pp. 3, 6, 22 and Recital 31.
[46] See also the overview in *McCormack/Keay/Brown* (fn. 9), p. 168 et seq.
[47] Used extensively in Slovenian law, and to a lesser extent in the Netherlands and Spain.
[48] Above at para. 23.
[49] See above at para. 24.
[50] Cf. above at para. 21.

former deals with the question of how much time the insolvency practitioner has to bring a lawsuit against the defendant. Almost all laws provide such limitation periods but differ on the details: six months (Slovenia), one year (the Czech Republic and Sweden in some circumstances) or two years after the insolvency order (Malta, Poland and Portugal[51]); six months (Sweden) or three years (the Netherlands and Germany) from the moment (the Netherlands and Sweden) at which or the end of the year (Germany) in which the insolvency practitioner gained knowledge of the voidable transaction; the complete duration of the insolvency proceedings (France and Spain).

*(j) Additional remedies*

30. Some countries have additional remedies for use regarding transaction avoidance, such as shielding certain transactions from the application of generally worded rules. A concrete example of this is the protection of conventional gifts against avoidance as transactions at an undervalue (in the Czech Republic and Germany). However, these exceptions and special requirements do not affect the principle-based analysis and can thus be omitted from consideration here.

## 5 EVALUATION

31. Analysis of the answers to the questionnaire leads to interesting insights into the structure of transactions avoidance laws. The shape of the principles involved in the study can be inferred, and commonalities as well as differences between the national approaches to solving a shared problem can be identified.

### (1) Principles

32. Not surprisingly, all national transactions avoidance laws are based upon the principle of equal treatment of creditors and on the principle of protection of trust to some extent. However, the answers to the questionnaire contributed very helpfully to formulating a more precise perspective.

*(a) Equal treatment of creditors*

33. One – not unexpected[52] – result of the study is that the principle of equal treatment of creditors can be enforced where the defendant was an existing creditor at the point of time at which he received the performance, whereas other principles must be enforced where the defendant was not a creditor prior to the transaction. It has been skilfully pointed out by various group members that in cases in which the defendant is not a creditor (e.g. he is a donee), the principle of equal treatment of creditors is ill-equipped to support the avoidance action. Instead, the analysis of Thomas Jackson[53] that rules on

[51] To be more precise: six months from the year the insolvency practitioner gained knowledge of the voidable transaction and in any case no more than two years after the insolvency order.
[52] See above, para. 2.
[53] *Jackson* (fn. 39), p. 122 et seq.; similarly in 36 (1984) Stanford Law Review 725, 756 et seq.

avoidance of antecedent transactions seek above all to alleviate the "common pool" problem faced by the creditors of a distressed debtor can be of assistance in finding the adequate justification. According to this thesis, avoidance norms strive to prevent individual creditors from opting out of collective proceedings once this event becomes likely, as well as to maximise the value of the debtor's estate as a whole.[54] The opt-out argument, however, is congruent with the equality argument, since preventing creditors from opting out of collective proceedings means ensuring equal treatment within these proceedings. Jackson himself accepts this correlation.[55] Regarding the second argument, further discussion is required as to (a) whether "preserving the value of the debtor's estate" is a principle in the sense defined above, with legitimising force for transaction avoidance rules or an objective, or is instead a mere description of a desirable effect from a creditor's point of view, and (b) what the differences are between "preserving the value of the debtor's estate" and the principle of optimal realisation of the debtor's assets.[56] This is a challenging subject to be further pursued by future research projects. As a result, evaluation of the present study will confine itself from now on to the impugnment of preferences.

34. Further general scepticism towards the relevance of the principle of equal treatment of creditors has been expressed by several authors.[57] They point out that the proceeds from the debtor's assets are not equally distributed among the unsecured creditors, since most insolvency laws acknowledge a long list of preferred creditors. It is they who benefit from the avoidance law, not the ordinary unsecured creditors (to whom the *pari passu* rule applies). However, this is a reproach against privileges and the legislators who grant them, rather than an objection to the relevance of the principle of equal treatment of creditors. First, there are many countries that have no priority rules whatsoever[58], though it cannot be denied that national insolvency laws frequently provide for the ranking of unsecured claims, for example by giving certain claims of employees, dependants or public bodies (such as tax and social security authorities) priority over the general body of unsecured

[54] The background to this is, on the one hand, giving restructuring efforts a fighting chance by keeping the assets of the business together as a going concern, and, on the other hand, the decree "be just before you are generous", i.e. "pay your creditors from the assets with which you are liable for your debts before you make gifts"; cf. for the latter *Robert Charles Clark*, The duties of the corporate debtor to its creditors, Harvard Law Review 90 (1976/1977), 505, 510.

[55] *Jackson* (fn. 39), p. 123 with fn. 2 and p. 130.

[56] Cf. *Bork* (fn. 5), para. 4.27 et seq., 4.37. See also *Parry* (fn. 6), para. 2.28, 2.30 et seq.: "maximization of the pool of assets".

[57] Extensively *Rizwaan Jameel Mokal*, Corporate Insolvency Law – Theory and Application, Oxford University Press, Oxford, 2005, p. 326 et seq.; see also *Adrian Walters* in John Armour/Howard Bennett (eds.), Vulnerable Transactions in Corporate Insolvency, Hart Publishing, Oxford/Portland 2003, para. 4.17; *Rolef de Weijs*, Towards an Objective European Rule on Transaction Avoidance in Insolvencies, Amsterdam Law School Legal Studies Research Paper No. 2011-03, p. 17, also available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1817663 (last visited 27 April 2017). Defending, however, *Keay*, ICLQ 66 (2017), 79, 83 et seq.; cf. also *Jackson* (fn. 39), including further references.

[58] Examples are Austria, Croatia, the Czech Republic, Denmark, Estonia, Finland, Germany, Slovakia and Sweden; see *McCormack/Keay/Brown* (fn. 9), p. 102 et seq. and Table 3.1. (p. 116 et seq.).

creditors.[59] Second, these priorities are clear exceptions to the principle of equal treatment of creditors, and it must be assessed whether such privileges are justifiable. However, this is not a task for the present project; it suffices to suggest that the principle of social protection can serve as a basic justificatory standard for prioritising certain claims of employees, while it is more difficult to vindicate privileges for public bodies such as tax or social security authorities.[60] Third, the *pari passu* principle also applies within groups of preferred creditors (e.g. all employees who enjoy preferential distribution of the proceeds under national insolvency law must be treated equally within their privileged rank). Regardless, the existence of priorities (which constitute dubious exceptions and thus require special justification) does not challenge the principle of equal treatment of creditors as such and, within its own boundaries, does not weaken the relevance of this principle to transaction avoidance law.

35. However, one aspect should be given special attention. It has been pointed out that proper avoidance rules have *ex ante* effects in the sense of supporting out-of-court negotiations, since they create "a disincentive for a single creditor to take legal action to obtain an advantage, thereby facilitating collective creditor action".[61] Further discussion is required as to whether transactions avoidance laws have a deterrent effect at all.[62] It seems more likely that only parties equipped with thorough legal advice take future transactions avoidance into consideration when dealing with a debtor in financial distress, but this may be different when faced with the special situation of an aggressive creditor who asks for preferences in exchange for supporting the restructuring process. Regardless, it seems dubious whether supporting pre-insolvency restructuring efforts is an aim – let alone a principle – of transactions avoidance laws. Admittedly, one of the basic standards of insolvency law is the optimal realisation of the debtor's assets, and restructuring – instead of liquidating – the enterprise is frequently the preferable solution. Hence, rules which support restructuring efforts conceivably enforce the principle of optimal realisation of the debtor's assets.[63] However, norms which support pre-insolvency restructuring only through their deterrent effects cannot be justified by this result, which under these circumstances is a side-effect rather than a policy or a principle. To avoid misinterpretation, it is worth reiterating that transactions avoidance law can – subject to further exploration – be justified partly by the principle of optimal realisation of the debtor's assets but not in terms of supporting pre-

[59] For extensive reports on priorities and preferential claims in various countries, see *Dennis Fabers/Niels Vermunt/Jason Kilborn /Tomás Richter/Martí Tidaro* (eds.), Ranking and Priority of Creditors, Oxford University Press, Oxford 2016.

[60] For details, see *Bork* (fn. 5), para. 4.16 et seq., 4.69 et seq., 6.100 et seq.

[61] *International Monetary Fund*, Orderly and Effective Insolvency Procedures, Washington DC, 1999, p. 25, also available at http://www.imf.org/external/pubs/ft/orderly/#content (last visited 27 April 2017). See also *United Nations Commission on International Trade Law*, Legislative Guide on Insolvency Law, Parts 1 and 2, United Nations Publications, New York, 2005, p. 136, also available at http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf (last visited 27 April 2017); furthermore *de Weijs* (fn. 577), p. 14.

[62] *Keay*, ICLQ 66 (2017), 79, 85; *Walters* (fn. 57), para. 4.21 et seq.

[63] More at *Bork* (fn. 5), para. 4.40 et seq.

insolvency restructuring; instead, this is only in terms of protecting the integrity of the estate.

*(b) Protection of trust*

36. The description of the principle of protection of trust provided above[64] very much maintains its focus on the individual defendant. It was helpfully suggested by national conferees that this should be complemented with a broader view, taking into account the effects of transactions avoidance laws on the market in general. It is indeed useful to point out the *ex ante* effects of avoidance rules[65] and the social costs of implementing overly broad avoidance rules. All market participants have the potential to become insolvent and thus their transactions may be subject to scrutiny with regard to the application of avoidance rules. If avoidance rules are framed so broadly or so loosely that they present a risk even to relatively innocent, arms-length transactions, avoidance law would pose a serious threat to the general stability of trade. The social costs arising from foregone transactions and from elaborate screening, planning and monitoring may outweigh any benefits which the rules could potentially bring when applied *ex post*. However, in the present study the focus is on striking a balance between principles which justify avoidance and others which oppose it. Where this balancing gives rise to unavoidability (because protection of the defendant's trust is required), additional restrictions for the benefit of trade in general are neither necessary nor possible. General policy and deliberations of social cost may come to the forefront only where protection of (individual) trust is not due.

37. Furthermore, the extent to which the expectations of the defendant deserve protection – in other words, the question as to which expectations are legitimate and outweigh the interests of the general body of creditors in enriching the estate and supporting restructuring efforts – must be carefully discussed. For example, the expectation of a donee to keep a gift is probably not worthy of protection. However, as has been emphasised by the Dutch member of the group, Rolef de Weijs, the expectation of the defendants not to be put in a worse position than they would be in without the vulnerable transaction is legitimate and deserves protection, e.g. by limiting the avoidance of gifts to the amount by which the defendant is still enriched.[66]

(2) <u>Balancing interests under a principled approach to preferences</u>

38. Regarding preferences, all national transactions avoidance laws considered in this study aim to balance the interests of the general body of creditors in equal treatment against the interests of the defendants in the protection of legitimate expectations. However, they do so in very different ways.

[64] At para. 15.
[65] However, also see above at para. 35.
[66] Details above at para. 27.

*(a) Core features*

39. Concerning preferences, all jurisdictions share the opinion that the principle of equal treatment of creditors requires them to be challengeable under certain conditions. It is generally agreed that preferential treatment of single creditors – particularly by granting performance or security – is not acceptable if it occurs in the run-up to formal insolvency proceedings. Since the exact commencement of such proceedings is more or less coincidental, it seems inappropriate to restrict the scope of the *pari passu* rule to opened proceedings instead of extending it to a certain period prior to their commencement. This commencement is not temporally fixed but depends mostly on the debtor's or creditor's decision on when to initiate formal proceedings, which can be made earlier or later. Hence, it can be said to be sheer luck of the draw that the decision to open proceedings has not been made yet (which would have a seizure effect on the debtor's assets) when the creditor receives the performance or security which he would not have received if the decision to commence insolvency proceedings had been made earlier. This justifies extending the scope of the principle of equal treatment of creditors to a period in which such proceedings are looming. However, none of the laws included in this study take the stance that preferences should be challengeable without any limitations; they all respect the idea that the expectation of creditors to keep what they have received must be protected, provided that this expectation is legitimate.

40. Against this background, a first prerequisite for extending the principle of equal treatment of creditors should be the substantive insolvency of the debtor at the time when the transaction to be challenged was carried out. At its core, the principle of equal treatment of creditors is a principle of insolvency law and therefore cannot be applied to situations in which the debtor was not insolvent at the relevant time. This also means that creditors may – as far as preferences are concerned – trust in the stability of transactions if the debtor had no financial problems. In other words, preferences are not preferences at all if the debtor was not insolvent when the transaction was performed. Most jurisdictions accept this idea by binding the avoidability of preferences expressly to the substantive insolvency of the debtor.[67] Only a few countries have no such direct prerequisite in their laws. Instead, they introduce this requirement indirectly by granting a good faith defence, permitting the defendants to prove that they had no knowledge of the debtor's substantive insolvency at the time of performance of the transaction (Malta and Poland).[68] It is only Spain where the law neither requires insolvency nor permits the good faith defence. Given that these three jurisdictions provide fixed suspect periods[69], they seem to operate with an unexpressed irrebuttable presumption of the debtor's insolvency within a certain time period prior to the commencement of formal insolvency proceedings.

[67] Cf. above at para. 20.
[68] Cf. below at para. 42.
[69] See below at para. 41.

41. This leads to an additional observation regarding the relationship between substantive insolvency and suspect periods.[70] In France, for example, the suspect period covers the entire period during which the debtor has ceased payments, i.e. is substantively insolvent, albeit with a cap of eighteen months. In other countries, this twilight zone is shorter – often three (Germany and Sweden) or six months (England and Wales, Portugal[71]) prior to the commencement of insolvency proceedings, which contributes to the protection of trust more than the French solution. A third group does not require substantive insolvency but has a fixed suspect period as the decisive prerequisite, which spans from six months (Malta and Poland) to two years (Spain) and may serve as an unexpressed irrebuttable presumption of the debtor's substantive insolvency. On average, trust in the stability of the transaction is protected if the period between the transaction and the commencement of insolvency proceedings is longer than six months.

42. In addition, the number of transactions challengeable as preferences is reduced by subjective prerequisites in many countries (in all except the Czech Republic and Spain).[72] Most national transaction avoidance laws require the defendant's knowledge of the debtor's substantive insolvency or of the detriment to the general body of creditors (the Netherlands, Portugal, Slovenia, Sweden and, with some exceptions, France and Germany) or grant a good faith defence (Malta and Poland). Taking mental elements into account on the creditor's side fits perfectly with the principle of protection of trust, since he who is informed of the debtor's financial crisis cannot legitimately expect to be protected against the pre-emptive application of the principle of equal treatment of creditors and to keep what they have received once the imminent insolvency proceedings have been opened.

43. Considering the interim results, the law of preferences mirrors the underlying principles in most countries. On the one hand, national transactions avoidance laws require (directly or indirectly) the debtor's substantive insolvency at the time of the transaction being carried out, which is required as well as justified by the principle of equal treatment of creditors. On the other hand, legitimate expectations are protected by fixed suspect periods and especially by the requirement that the defendant knew of the debtor's financial crisis, which is supported by the principle of protection of trust. Aside from differences in details (e.g. the length of the relevant suspect period), the avoidance laws involved in this study share this general approach and can be justified by the principles mentioned.

44. Exceptions are Spain and England and Wales. In Spain, neither substantive insolvency of the debtor nor any mental elements are required. Combined with a very long suspect period of two years, it is difficult to justify the result that all transactions performed within the last two years prior to the commencement of insolvency proceedings – except for ordinary acts of the professional or business activity of the debtor performed under normal conditions – can be challenged. This approach leaves little room for the

[70] For suspect periods, see above at para. 21.
[71] See above at fn. 30.
[72] See above at para. 22.

protection of trust. In England and Wales, the approach taken is completely different, since the decisive element for protecting the defendant against the early application of the principle of equal treatment of creditors is not the creditor's good faith but the debtor's bad faith, i.e. the desire to put the defendant in a better position. This approach has nothing to do with the principle of protection of trust, since the creditor's trust is irrelevant. Hence, other principles must be enforced.[73]

*(b) Additional aspects*

45. Many national laws provide additional constraints as well as extensions. Avoidance is frequently facilitated and protection of trust is thus restricted for closely related parties.[74] This is especially true for shareholders[75], who in many cases are treated as subordinate rather than ordinary unsecured creditors. As opposed to this, the defendant's expectations to keep what they have received are granted additional protection by restricting transactions avoidance to acts of the debtor[76], by allocating the burden of proof to the insolvency practitioner[77] and by the use of limitation periods.[78] A special case here is the restructuring privilege for new financing.[79] This can hardly be justified by the principle of protection of trust, since a person who grants credit for the financing of restructuring efforts must take the shipwreck of such efforts into account and cannot legitimately trust in special treatment compared to other unsecured creditors. Privileging new finance is not justified by the principle of protection of trust. It is instead a political decision to provide an economic incentive to supporting restructuring efforts, hoping that such efforts do not fail and are for the greater good of all involved parties.

## 6 CONCLUSION

46. All in all, it seems promising to apply a principle-based approach to national insolvency laws. Carving out the fundamental commonalities instead of stressing the differences in details by focussing on the underlying principles and their reflection in national insolvency rules supports all efforts to understand and – eventually – harmonise insolvency laws. However, the approach of this pilot research project must be expanded. The next step should be to apply the principle-based approach to the entirety of transactions avoidance law and gradually to other fields of insolvency laws. The results of these future research projects may help to incrementally harmonise this field of law.[80]

[73] Details above at para. 22.
[74] Cf. above at para. 24.
[75] More above at para. 23.
[76] Details above at para. 19.
[77] See above at para. 28.
[78] Cf. above at para. 29.
[79] Explained above at para. 26.
[80] Cf. above at para. 36.