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Faillissementspauliana, insolvenzanfechtung & transaction avoidance in insolencies : naar een geobjectiveerde regeling van schuldeisersbenadeling

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8 | Summary

8.1 Three categories of acts prejudicing creditors

Developed legal systems provide for certain legal acts performed prior to an insolvency declaration to be reversed on the grounds that they were prejudicial to the interests of creditors. There are countless ways in which a debtor can prejudice its creditors. Legal systems group the various detrimental acts into categories, but differ considerably in what the categories are, thereby complicating comparative law research in this area. In this comparison of German, English and Dutch law, the detrimental legal acts are divided into the following three categories.

1) **Legal acts compromising the integrity of the estate of the debtor**

Legal acts (whether alone or in combination with other acts) detrimental to the debtor itself and therefore detrimental to its creditors in subsequent insolvency proceedings. The main characteristic of a transaction in this category is that the counterparty was not a creditor prior to the transaction. There are two sub-categories:

- a. transactions not against value received or at an undervalue; and
- b. transactions not at an undervalue but intermediately prejudicial to creditors.¹

2) **Preferences**

The debtor does something, or allows something to be done, that has the effect of putting a person into a position that will, if the company goes into insolvent liquidation, be better than the position that person would have been in if that thing had not been done. These cases can be further subdivided into two sub-categories:²

1 An example of the latter is the sale of assets at an arm's length price in order to enable the debtor to throw a final pre-insolvency party or pay dividends to its shareholder. Although the sale is not detrimental to the creditors in itself, it is when combined with subsequent acts.

2 This further distinction is not made in English law, but is made in both German law and Dutch law. American law also makes a similar distinction within the rules on preferences and the exception for payment of debts within the ordinary course of business.

- a. payment of an undue debt, or payment in kind instead of the agreed payment in money; and
- b. payment of a debt due at the time and in the way agreed beforehand.

3) Shareholder loans and shareholder guarantees

Shareholders can prejudice creditors by not providing capital to the company, but by choosing an alternative way of financing instead.³ There are two sub-categories. Instead of providing capital, the shareholder provides:

- a. a loan, possibly even a secured loan; and
- b. a guarantee to a specific creditor of the company.

These distinctions are all found to a greater or lesser extent in the different legal systems. No legal system has, however, fully, formally and expressly introduced these distinctions. It has been demonstrated that the result of the failure to maintain clear demarcations between these different categories has been legal uncertainty. These distinctions are therefore useful not just for comparing the various legal systems, but as a potential framework for organising the law itself.

8.2 The possibility and desirability of an objective rule?

Prejudice to creditors does not, on its own and in itself, provide sufficient justification for the reversal of legal acts. Interests other than those of the creditors are worthy of protection as well. These conflicting interests are foremost as follows: (i) respect for the debtor's legal acts (especially if the debtor is a natural person) (ii) contractual finality (iii) a counterparty's interest in not being put in a worse situation and (iv) the capacity of debtors in distress to reorganise their business.

3 Why is this third category considered to be an aspect of transaction avoidance in insolvencies? In English law, the payment of a company's creditor by the company for which the shareholder acted as a guarantor (category 3(b)), constitutes a preference in the relationship between the company and the shareholder. The mere inclusion of these cases in the framework of transaction avoidance therefore needs no further explanation at this point; what does need further explanation is the treatment of these cases as being in a different category than preferences. The basic underlying idea is that the shareholder is an equity participant in the company, whereas a normal creditor is not. One should therefore not view the limitation of the shareholder's exposure under a guarantee as the payment of a creditor, but as a divestment by the shareholder. The dynamic in payments made to creditors for which the shareholder acted as a guarantor is rather similar to that in dividend payments. With regard to the issue of shareholder loans (category 3(b)), the repayment of a shareholder should not be viewed as the repayment of a creditor, but as a divestment by a shareholder. The rules about whether and to what extent a shareholder is free to also act as an ordinary arm's length creditor could also be dealt with by company law, instead of as a situation of transaction avoidance under insolvency law. In German law, as part of the recent modernisation of company law, the rules dealing with shareholder loans were removed from the German Company Act and integrated into the Insolvency Act, mostly within provisions on transaction avoidance. Since the ranking of different claims becomes only really relevant in a situation where not all creditors can be paid in full, the subject fits better into insolvency law than company law.

A balance must be struck between the interests of prejudiced creditors on one hand and these conflicting interests on the other. Legislators are required to formulate further criteria for determining which legal acts are subject to reversal and which are to be upheld. These criteria can be either subjective or objective. Subjective criteria are concerned with the state of mind of the parties involved. Examples include intent, desire to prefer, good faith and bad faith. Objective criteria are those that do not deal with the state of mind of the parties. The clearest examples of these are the periods of time involved, e.g. three months before the onset of insolvency. Also, whether the debtor was solvent or insolvent at the time of transaction is considered an objective criterion, since it does not depend on the state of mind of the debtor. The same goes for the capacity of the persons involved, such as the fact that a counterparty is, for example, a controlling shareholder of the debtor.⁴

Both objective and subjective criteria have their specific merits and drawbacks. The most notable drawbacks of subjective criteria are the following: (i) The evaluation by courts of whether subjective criteria have been fulfilled is a time-consuming and expensive exercise. (ii) The outcome of proceedings revolving around subjective criteria is often uncertain. (iii) Whether or not the parties acted with a certain state of mind does not alter the prejudice itself, and is therefore irrelevant from the viewpoint of the creditors.⁵ (iv) Subjective criteria carry with them a moral reproach, thereby causing new conflicts about the moral integrity of the counterparty.⁶ Objective criteria have their own specific drawbacks: (i) Objective

4 The distinction made here between objective and subjective criteria is different from that made in the Uncitral Legislative Guide. There the question whether the debtor was insolvent is characterised as a subjective test. Uncitral Legislative Guide, p. 137: *'In terms of the specific criteria, they can be grouped broadly as objective and subjective criteria. (a) Objective criteria. One approach emphasizes the reliance on generalized, objective criteria for determining whether transactions are avoidable. The question would be, for example, whether the transaction took place within the suspect period or whether the transaction evidenced any of a number of general characteristics set forth in the law (e.g. whether appropriate value was given for the assets transferred or the obligation incurred, whether the debt was mature or the obligation due or whether there was a special relationship between the parties to the transaction). While such generalized criteria may be easier to apply than criteria that rely upon proof, for example, of intent, they can also have arbitrary results if relied upon exclusively. So, for example, legitimate and useful transactions that fall within the specified suspect period might be avoided, while fraudulent or preferential transactions that fall outside the period are protected. (b) Subjective criteria. Another approach emphasizes case-specific, subjective criteria such as whether there is evidence of intention to hide assets from creditors, whether the debtor was insolvent when the transaction took place or became insolvent as a result of the transaction, whether the transaction was unfair in relation to certain creditors and whether the counterparty knew that the debtor was insolvent at the time the transaction took place or would become insolvent as a result of the transaction. This individualized approach may require detailed consideration of the intent of the parties to the transaction and of other factors such as the debtor's financial circumstances at the time the transaction occurred, the financial effect of the transaction on the debtor's assets and what might constitute the normal course of business between the debtor and particular creditors.'*

5 M. Bridge, 'Collectivity, Management of Estates and the Pari Passu Rule in Winding-up', in: J. Armour en H. Bennet (red.), *Vulnerable Transactions in Corporate Insolvency*, Oregon: Hart Publishing 2003, p. 18. *'The pain of the subordinated creditor, adversely affected by the preference, is no less intense because the debtor did not mean to hurt him.'*

6 If the question depends on whether the counterparty acted with a certain state of mind, the act is not reversible because of the effects, but because of this state of mind. Illustrative of the conflicts arising out of such an approach is the view held by the Cork Commission on the labelling of the provisions (Cork Report, p. 283). In our view the word 'fraudulent' in this context is inaccurate and misleading, and we are satisfied that its use has unfortunate consequences. We believe that many creditors who have been unfairly preferred, and who would otherwise readily agree to repay moneys paid to them shortly before the bankruptcy, may be reluctant to do →

criteria are inflexible and unable to take into account the specific circumstances of the case at hand. (ii) Objective criteria are more likely to infringe on the principle of finality of contracts. (iii) The reliance on solely objective criteria creates the risk that the prejudice caused to the creditors is shifted to the counterparty, without the counterparty being at fault.

The research question is whether, and to what extent, it is *possible* and *desirable* to identify transaction avoidance rules solely on the basis of objective criteria. To establish whether such an objective rule is possible, an analysis will be made to what extent German law, English law and Dutch law rely on objective and subjective criteria. If an objective rule is actually in force in one of these legal systems, it remains to be seen whether such an objective rule realizes the underlying policy of the rule, without making unjustified infringements on the conflicting interests. If such an objective rule successfully overcomes the drawbacks relating to subjective criteria, without creating new problems, this objective rule can also be regarded as desirable.

8.3 Only a uniform approach in Dutch law

Within a legal system, one would expect a uniform approach to be taken in relying mainly on either objective or subjective criteria. Such a uniform approach is taken in Dutch law. Under Dutch law, transaction avoidance always requires the fulfilment of subjective criteria. Even legal acts for which the debtor receives no consideration (e.g. gifts) can only be avoided if the debtor knew that the act would prejudice creditors. Although Dutch law has adopted this uniform approach, the *actio pauliana* in Dutch law is notoriously difficult to grasp. What the fundamental differences are between obligatory (*verplichte*) and voluntary (*onverplichte*) legal acts; the issue of which subjective elements are decisive in which case; and how these subjective criteria should be interpreted and applied in specific cases – all of these cause the *actio pauliana* in Dutch law to be highly enigmatic. The chapter on Dutch law provides thirteen recommendations for improvement.

German law and English law have not adopted uniform approaches. Under English law, the avoidability of preferences (s. 239, IA) depends entirely on the state of mind of the debtor. A preference can only be avoided if the debtor was influenced by a desire to prefer. Section 238 of the IA, which safeguards the integrity of the estate (avoidability of transactions at an undervalue⁷), does not impose a subjective requirement on the side of debtor, and the state of mind of the counter-

so when they mistakenly suppose to be a charge of fraud against them is involved. We recommend that in future the word 'fraudulent' should no longer be used in this context and that it should be replaced by the word 'voidable'.

7 The following transactions qualify as transactions at an undervalue: gifts, transaction that provide for the company to receive no consideration or for a consideration the value of which, in money or money's worth, is significantly less than the value, in money or money's worth, of the consideration provided by the company.

party is also irrelevant. The avoidance of legal acts upsetting the principle of equal sharing between creditors of the same rank (the *paritas creditorum* or *pari passu* distribution) thereby relies on subjective criteria, whereas the avoidance of legal acts compromising the integrity of the estate relies primarily on objective criteria.

Surprisingly, under German law the approach is completely the opposite of English law. Avoidance of legal acts compromising the integrity of the estate is almost completely dependent on subjective criteria. Intent (*Vorsatz*) to prejudice its creditors is required on the part of the debtor, along with the counterparty's knowledge of this intent (section 133 InsO). Protection of the *paritas creditorum* (*pari passu* distribution) on the other hand, does not attach any importance to the state of mind of the debtor, as far as the provisions dealing specifically with preferences are concerned (section 130 InsO (congruent performances) and 131 InsO (incongruent performances)). If the incongruent performance took place in the month prior to the request to open the insolvency proceedings, the state of mind of the creditor is irrelevant as well. The same applies to incongruent performances in the three months prior to the request if the debtor was already insolvent. The avoidance of legal acts upsetting the principle of equal sharing between creditors of the same rank (the *paritas creditorum* or *pari passu* distribution) therefore relies mainly on objective criteria, whereas the avoidance of legal acts compromising the integrity of the estate relies primarily on subjective criteria.

As to the third category, the outcome of a comparison of German law, English law and Dutch law is even more surprising. Within the framework of transaction avoidance in insolvency, German law has elaborate rules in place dealing with both shareholder loans and shareholder guarantees. These rules are entirely objective and provide first of all for the subordination of shareholder loans⁸ in insolvency and the unenforceability of security interests securing these loans. Furthermore, payments made on these loans in the year prior to the request can also be avoided. To the extent that payments are made on third party loans for which the shareholder acted as a guarantor, the rule is also entirely objective. Payments made on third party loans guaranteed by the shareholder result in a claim by the estate on the shareholder for the amount guaranteed.

In Dutch law there are no rules regarding these issues, including for shareholder loans or for shareholder guarantees. The argument has been made that Dutch law is flawed in this respect and that (i) shareholder loans should be subordinated in insolvency, (ii) that there should be a separate regime for payments made on these loans prior to insolvency and (iii) that shareholders cannot invoke security rights against the company's creditors. As to guarantees provided by shareholders to specific creditors of the company, a proposal has been made to introduce a rule similar to the German rule.

⁸ It is required that the shareholder owns 10% or more of the outstanding shares or that the shareholder is involved in the management of the company.

Finally, with regard to English law, although the Cork committee held the opinion that English law is flawed because it does not have a rule on the subordination of shareholder loans,⁹ English law has remained immune to critique and still provides no rules on subordination of shareholder loans. English law does, however, have a rule dealing with the specific dynamics of guarantees provided by a shareholder to a creditor. Unlike the German objective rule, the English rule only provides the trustee with a direct claim on the shareholder if the company was influenced by a desire to prefer its shareholder by making the payment to the creditor.

8.4 Conclusion

If the law makes a clear distinction between different categories of legal acts prejudicing creditors, it is both possible and desirable to come to a partly objective rule for each of the different types of legal acts prejudicing creditors. Subjective criteria cannot, however, be dispensed with entirely.

English law demonstrates that a largely objective rule is possible for legal acts compromising the integrity of the estate. This in clear contrast to German law and Dutch law. A crucial step in identifying such an objective rule is the limitation of the sanction to the return to the estate of any benefit obtained by the counterparty out of the transaction. It was shown in the dissertation that such an objective rule is desirable. However, to be able to also avoid transactions effected long before the onset of insolvency, as well as legal acts where the prejudice caused to the creditors outweighs the benefit received by the counterparty, reliance on subjective criteria is indispensable.

In clear contrast to English law and Dutch law, German law demonstrates that the protection of the principle of equal sharing between creditors of the same rank (the *paritas creditorum* or *pari passu* distribution) can be protected by a largely objective rule. Such an objective rule would target, above all else, the so-called transfers in lieu of payment¹⁰ and the voluntary creation of security interests for exis-

9 Cork Report, p. 435, 436: *'The strength of the case of those who seek a change in the law – and a radical at that – can be seen if a simple and perhaps extreme example is taken. A wholly-owned subsidiary company is under-capitalised. It relies virtually wholly on moneys lent by the parent. Its affairs are conducted by and in the interest of the parent and they are mismanaged. There is a history of transactions between subsidiary and parent which, although not individually or collectively susceptible to attack at law, have, cumulatively, advantaged the parent and disadvantaged the subsidiary. All profits earned by the subsidiary have been paid up to the parent by way of dividend and the moneys needed by the subsidiary to conduct its business lent back by the parent. The subsidiary, at the instance of the parent, has obtained substantial credit by relying on its membership of the group of companies headed by the parent. The subsidiary indicates its membership on all documents and billings by showing a device or logo distinctive of the group. The subsidiary becomes insolvent and goes into liquidation. The parent company declines all liability for its subsidiary's debt to external creditors, and competes with them by submitting a proof in respect of its loan. The result is that, out of the total funds realised by the liquidator for distribution among the creditors, a substantial proportion goes to the parent company. We recognise that a law which permits such an outcome is undoubtedly a defective law.'*

10 In payment of a debt, the giving by the debtor and receipt by the creditor of something other than money.

ting debts. I have submitted that such an objective rule is also desirable. However, for the trustee to be able also to avoid preferences created in a period long before the onset of insolvency, reliance on subjective criteria is indispensable here as well. The same goes for the avoidance of due payments.

German law also demonstrates that, again in clear contrast to English law and Dutch law, prejudice caused to creditors by shareholder loans and shareholder guarantees can be curbed by an objective rule. The basic premise of this objective rule is, like the German rules, that if a shareholder provides a loan or a guarantee instead of providing additional capital, the risk associated with the loan or guarantee is, in economic terms, to a large extent equivalent to the risk associated with capital. This objective rule provides for the following, irrespective of the mental state of parties involved: (i) the subordination of shareholder loans, (ii) the unenforceability of security rights securing these loans, (iii) a separate regime applicable to payments made under these loans and (iv) a direct claim of the estate on the shareholder that acted as guarantor to one of the company's creditors when this creditor received payment in the period leading up to the declaration of insolvency. It was shown in the dissertation that this objective rule is also desirable. To uphold the principle of contractual finality, this objective rule will necessarily be limited in time. Repayments of shareholder loans, as well as payments of third party loans guaranteed by the shareholder further back in time, can only be made susceptible to transaction avoidance in insolvencies if certain subjective criteria are met.

To further illustrate the possibility of introducing a highly objective set of rules on transaction avoidance in insolvencies, model provisions have been drafted (see Appendix).