Clash of Principles: Equal treatment of creditors vs. protection of trust

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How far are the transaction avoidance laws in the Member States of the EU supported by the principles of equal treatment of creditors and protection of trust? This was the research question considered by the Working Group of the Conference on European Re-structuring and Insolvency Law (CERIL)[1] – with surprising results.

When considering the harmonisation of the European insolvency law, transaction avoidance laws are often laid out as a primary consideration. However, a comprehensive analysis is often missing. The working group dealing with "transactions avoidance laws", made up of 18 researchers who represent 17 jurisdictions and led by this author, has therefore decided to use a principle-oriented analysis[2] to examine transaction avoidance laws in their jurisdictions. This method began with neither the practical problems, nor the pre-existing norms. Instead, in the first instance, the fundamental principles governing transactions avoidance laws were considered and subsequently the national insolvency laws were analysed. The results can be summarised as follows[3].

All examined jurisdictions contain both the principle of equal treatment of creditors and the principle of trust protection as core pillars of their transaction avoidance laws. However, the examination helped to form a more precise picture. First of all, the principle of equal treatment of creditors plays a meaningful role in transaction avoidance laws, but only ever in cases of preferences. The defendant, in the instance of the proceedings, has to have been an (future) insolvency creditor, so that their security or satisfaction can be seen as a breach of the principle of equal treatment of creditors. Transactions at an undervalue and transactions defrauding creditors are based on different fundamental principles with which this pilot project did not concern itself.

The principle of protection of trust is also recognised in all of the examined jurisdictions. Nonetheless, there remain clear differences in the detailed answer to the question of how the two opposing fundamental principles are to be brought into an appropriate balance, in which circumstances the trust of creditors is worthy of protection, so that they would be entitled to keep what has been granted to them.

With regards to preferences, all considered jurisdictions shared the view that, on the principle of equal treatment of creditors, they had to provide the possibility of avoidance in certain circumstances. The preferential security or satisfaction of a creditor is not acceptable when this happens in the context of an insolvency case. As it is more or less a matter of coincidence when such a case is applied for or opened, it seems unreasonable to restrict the application of the principle of equal treatment of creditors to already opened proceedings rather than to expand it to a particular period of time before the opening of the proceedings. The beginning of an insolvency proceeding can happen at an earlier, but also a later, time. It is, therefore, a matter of pure luck if the creditor satisfaction is successful and does not falter on the opening of the proceedings. This justifies moving the principle of equal treatment of creditors to an earlier point in time albeit not unrestrictedly. All the jurisdictions explored respect the proposition that the creditors' trust that they may keep what has been granted to them deserves some protection.

A first step in this direction is the requirement that the debtor, at the time of the performance, has to be substantively insolvent. The principle of equal treatment of creditors is a principle of insolvency law which cannot be applied when the debtor was not (yet) insolvent at the given time. As a result, many jurisdictions expressly require the substantive insolvency of the debtor. Two others (Malta and Poland) introduce this requirement indirectly by allowing the creditor the defence that he was not aware of the debtor's insolvency at the given time. In addition, these jurisdictions have a fixed avoidance period prior to the beginning of proceedings, which silently establishes the irrefutable presumption of substantive insolvency.

This leads to the relationship between substantive insolvency and the suspect period. In France, this period covers the entire phase in which the debtor has ceased his payments and is therefore substantively insolvent (with an upper limit of 18 months). In most other Member States, the suspect period is shorter, generally three or six months prior to the beginning of the insolvency

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proceedings. A third group, as mentioned above, does not recognise substantive insolvency as a reason for avoidance, working instead with a fixed suspect period (in which the substantive insolvency is presumed). On average, the trust in the insolvency-safety of the performance is protected when the timeframe between the legal act and the beginning of proceedings is longer than six months.

The number of avoidable actions is further reduced in all considered jurisdictions (with the exceptions of the Czech Republic and Spain) through the addition of mental elements. Most avoidance rights require the defendant to be aware of the substantive insolvency of the debtor or – which comes very close to this – the disadvantage to creditors (in particular, this is the case in the Netherlands, Portugal, Slovenia and Sweden, but also to a certain extent in France and Germany). The fact that the subjective requirements are linked to the defendant in this way demonstrates the perfect fit to the principle of protection of trust: one who knows about the financial crisis of the debtor cannot legitimately expect to be protected.

As an intermediate conclusion, one can establish that the rules around preferences almost perfectly mirror the fundamental principles. On the one hand, the national legislatures demand (directly or indirectly) the substantive insolvency of the debtor at the given time, which is both required and justified by the principle of equal treatment of creditors. On the other hand, the legitimate expectations of the creditors are (objectively) protected through suspect periods and through the requirement that the defendant was aware of the substantive insolvency of his debtor. Notwithstanding differences in the detail – the length of the suspect periods being a key example – all jurisdictions share this approach.

Two jurisdictions are exceptional. In Spain, neither the substantive insolvency of the debtor is necessary, nor are there any subjective requirements. If one takes into account the relatively long avoidance timeframe of two years, from which only the current operations of the debtor are exempted, little room remains for the principle of protection of trust. The law of England and Wales follows a completely different approach. The decisive mental element is, here, not the knowledge of the defendant but the desire of the debtor to treat the defendant preferentially. This has nothing to do with the principle of protection of trust because, in this approach, nothing rests on the trust of the creditor.

Many national jurisdictions provide additional constraints as well as extensions. For example, avoidance is facilitated – and thereby the principle of protection of trust restricted – in many jurisdictions, when the defendant concerned is a person with a close relationship to the debtor (including shareholders). In contrast, the principle of protection of trust is often indirectly strengthened by placing the burden of proof on the insolvency administrator, as well as through statutes of limitations.

In all, it has proven to be promising to assess the national insolvency regulations with a principle-oriented approach. The efforts to understand insolvency law are rewarded by considering the fundamental principles and their manifestation in national legislatures, and thereby, predominantly, by highlighting the overarching agreements rather than the differences in the details. However, to achieve this, the restricted focus of CERIL's pilot project would have to be widened considerably. In the next stage, the principle-oriented analysis should therefore be extended beyond preferences to cover the complete set of transactions avoidance rules, and subsequently over the entirety of insolvency law. The efforts to understand the fundamental dimensions of this area of law, and one day to harmonise it, will decidedly benefit from the results of the future research. ■

Footnotes:

1 CERIL is an independent and non-profit organisation made up of practitioners, researchers, and judges working in the areas of restructuring and insolvency; cf. http://www.ceril.eu/

2 In more depth, *Bork*, Principles of Cross-Border Insolvency Law, Cambridge/Antwerp/Portland 2017

3 The complete report can be accessed at http://www.ceril.eu/projects/kopie-avoidance-actions/

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