

UNCITRAL-World Bank Group Judicial Capacity-Building Initiative on International Best Practices in Insolvency Law

Avoidance of Transactions

Why we must think about the subject

- The central problem in insolvency
- Two principles for addressing the problem
 - Making the cake as large as possible; recovering assets
 - Sharing the cake fairly: equal or “pari passu” treatment
- Summaries of best practice relating to those principles
 - UNCITRAL Legislative Guide on Insolvency Proceedings
 - World Bank Principles for Effective Insolvency Regimes
- How they affect us as **judges** and why we should look at them
- We look at **principles not rules**

Avoidance of Transactions

Maximising the estate and sharing it fairly (UN 87)

- Three techniques
 - Preventing erosion of the insolvency estate
 - Recovering losses from transactions
 - Recovering losses from trading

- Our focus

**Recovering losses from transactions
(restoring loss of value or restoring equality)**

Avoidance of transactions

- **Are we talking about fraud or the *actio Pauliana*?**
- **What are “avoidance” claims in insolvency?**
 - Preferring a creditor (WB C.11.2/UN 87(c))
 - Transactions at undervalue (WB C11.1/ UN 87(b))
- **What are the differences between fraud claims and “avoidance” in insolvency?**

Paulian action in Romanian civil law

- Individual action
- The condition of proving a violation of a legitimate right or personal interest
- The condition of proving a prejudice
- Effects:
the unenforceability of the legal act to the creditor of the action, and, possibly, to the creditors intervening in the respective litigation

Action for “*cancellation of fraudulent acts*” in Romanian insolvency law

- Collective action
- The purpose of restoring assets for the insolvency estate, to cover the liabilities for the benefit of all creditors
- No proof of prejudice required - the damage suffered by creditors is established in the final table of claims against the debtor's property.
- Effects:
the nullity of the contested act with *erga omnes* effects

Preferring a creditor

- **Why does “preferring” (or favouring) a creditor matter?**
- **By what principle do you identify “preference”?**
- **What sort of transactions might demonstrate a “preference”?**

Types of transactions subject to avoidance

- Preferential transactions

1. Transfer of ownership to a creditor

to satisfy a previous debt, if the amount which the creditor might obtain in the event of the debtor's bankruptcy is less than the amount obtained under the transfer deed

2. Preferential right

for a claim that was unsecured

3. Advance payments

on account of debts

Observations:

- ❖ The law does not distinguish between different types of creditors
- ❖ The avoidance of preferential transactions results from the breach of the rights of the creditors who are not beneficiaries of these operations.

Transactions at undervalue

- **Why do transactions at undervalue matter?**
- **By what principle do you identify a transaction at an undervalue?**
- **What sort of transactions might be transactions at an undervalue?**

Types of transactions subject to avoidance - Transactions at an undervalue

1. The transfers
free of charge

sponsoring for humanitarian
purposes are exempt

2. Operations in which the
debtor's obligations manifestly

exceed the obligations received

Observations:

- ❖ Objective criteria - no condition of the bad faith of the acquiring third party
- ❖ The disparity between values must be obvious
- ❖ The syndic judge has discretion to establish the obvious character, but no legal criteria or any percentage threshold for resolving this issue.
- ❖ In addition to the percentage criterion, the concrete value of the disproportion must be considered in relation to the liabilities that should be covered
- ❖ The appropriate expert evidence is mandatory to determine the value by reference to standards such as reasonable or market value prevailing at the time of the transaction

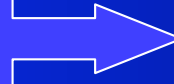
Types of transactions subject to avoidance - Transactions to defraud creditors

1. Acts with all parties' intention



to conceal assets from pursuit by the creditors or to otherwise prejudice their rights

2. Deeds of transfer or undertaking with the intention



to conceal/delay the insolvency or to defraud a creditor

Observations:

- ❖ These are the most common cases of avoidance actions encountered in practice
- ❖ The case involves proving the debtor's fraudulent intent and the complicity in the fraud of the co-contractor, third party or creditor, by other admissible means of proof than the legal presumption

Examples:

- ❖ Selling the goods at the remaining price in the accounting, after deducting depreciation, without bringing a profit to the company
- ❖ The transfer of the main movable assets from the debtor's patrimony that contribute to the achievement of the main object of activity
- ❖ The sale of the goodwill of the debtor who had, at that time, significant debts to creditors

A mental element?

- **Is an intention to prefer required? If so, must that be dominant or only substantial?**
- **Good faith in transactions?**
- **What evidence do you need?**

Solvency

- **Must the company be insolvent at the time of the preference or the transaction?**

Defences

(UN 92 and 97)

- **Can the transaction (treatment of creditor or disposal of asset) be justified?**
 - Good faith?
 - Business purpose?
 - Reasonable belief that transaction beneficial?
- **What might be typical reasons?**

Defense - Justified transactions

Ordinary course of the business

No cancelation may be requested in respect of an act awarding or transferring assets, made by the debtor in the ordinary course of its business

New financing in the context of preventive restructuring proceedings and out-of-court agreements

Conditions:

- **Concluded in good faith**
- **Such arrangements were likely to reasonably result in the financial recovery of the debtor**

Suspect period

(WB C11.3/UN89)

- **Is there a limit on how long a payment or disposition is vulnerable to challenge?**
- **What is the principle behind any limit?**
- **How is the period calculated?**

The “look-back”/ suspect period

- The last two (2) years before the opening of the proceeding for the transfers free of charge, transactions to defraud creditors, transactions with related persons
- Six months before the opening of the proceeding for transactions at an undervalue and preferential transactions

Observations:

- It is a substantive condition, not a term of procedural law, susceptible to interruption or suspension.
- The suspect period ends at the time of opening the insolvency proceeding
- It may invoke not only the presumption of fraud but also the justification of attacking a legal act concluded outside the suspicious period, proving that the debtor has delayed the opening of insolvency proceedings to expire the terms of 2 years / 6 months, through abuse of procedural rights.

Related persons

(WB C11.3/UN 90-91)

- **What do we mean by “related” or “connected” persons? Examples?**
- **Why are they treated differently?**
- **What is the difference in treatment?**
- **Presumptions: how they work**

Connected persons and the role of presumptions

Operations with persons having legal relationships with the debtor:

- ❖ A general partner / shareholder or an associate holding at least 20% of the share capital/ shares
- ❖ A member or director when the debtor is an economic interest group
- ❖ A director, a manager, or a member of the debtor's supervisory bodies
- ❖ Any other individual or legal entity with control over the debtor or its activity
- ❖ A co-owner or joint owner of a common asset
- ❖ The spouse, in-laws, or kindred back to the 4th degree

Avoidance proceedings

(UN 93)

- **Who can bring proceedings?**
- **Against whom can proceedings be brought?**
- **What is the effect of avoidance proceedings?**

Effects of avoidance transactions

Counterparty rights:

Good faith:

- Claim equal to the price paid plus the value added of that asset, at the very most, generated by investments
- Participation in distributions of amounts **before ordinary unsecured creditors**

Bad faith:

- Claim equal to the price paid
- Participation in distributions of amounts as a **subordinated creditor**

The subsequent acquirer has the same obligations and rights as the third-party acquirer acting with bad faith.

An approach

- What is the transaction (payment)?
- Who is the counterparty?
- What does that tell you about the suspect period?
- What does that tell you about the burden of proof?
- What was the solvency of the company at the time of the transaction (payment)?
- Was the difference in value “significant”?
- Was the effect of the payment a “preference”?
- Is any mental element satisfied?
- Was the transaction (payment) justified?
- What can be done to restore value to the estate or to ensure creditors are treated equally?