

# The Harmonisation of Transaction Avoidance: A Compromise Solution

## 1. Introduction

The European Insolvency Regulation Recast – hereinafter EIR(R) - displays uncertainties relating to jurisdiction but more particularly to the applicable law.<sup>1</sup> The current legal uncertainty surrounding the disputes on the topic undermines the rationale of private international law which is to increase the foreseeability of the outcome of the legal dispute.<sup>2</sup>

At the same time, legal uncertainty undermines the efficiency of the internal market. From an economic point of view, the objective legal uncertainty increases litigation and the cost of the legal disputes.<sup>3</sup> In general, legal uncertainty constitutes a deterrent for cross-border transactions, and therefore it has a negative impact on the level of integration of the internal market.<sup>4</sup>

The need for legal certainty is even stronger concerning insolvency law as it constitutes a system that deals with the life and death of the companies that participate in the internal market. Indeed, the Recast states that ‘the proper functioning of the internal market requires that cross-border insolvency proceedings should operate efficiently and effectively’.<sup>5</sup> Moreover, the ‘Five Presidents’ Report: Completing Europe’s Economic and Monetary Union’ identifies insolvency law as one of ‘the most

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<sup>1</sup> Oriana Casasola, ‘The Transaction Avoidance Regime in the Recast European Insolvency Regulation: Limits and Prospects’ (2019) 2 IIR 163.

<sup>2</sup> Xandra Kramer, ‘European Private International Law: The Way Forward’ (September 8, 2014). In-depth analysis European Parliament (JURI Committee), in: Workshop on Upcoming Issues of EU Law. Compilation of In-Depth Analyses, European Parliament Brussels 2014, p. 77-105 < <https://ssrn.com/abstract=2502232> > accessed 27.10.2020.

<sup>3</sup> Helmut Wagner, ‘Economic Analysis of Cross-Border Legal Uncertainty: The Example of the European Union’ in Jan Smits (ed) *The need for a European Contract Law. Empirical and Legal Perspective* (Europa Law Publishing 2005).

<sup>4</sup> *ibid.*

<sup>5</sup> Regulation (EU) 2015/848 of The European Parliament and of the Council of 20 May 2015 on Insolvency Proceedings (Recast) [2015] OJ L141/19, Recital 3.

important bottlenecks preventing the integration of capital markets'.<sup>6</sup>

The present contribution seeks to assess the possible solutions to the unsatisfactory results of the current EU regulation with the knowledge acquired from a comparative study concerning transaction avoidance in U.K., Germany and Italy. In particular, the paper aims to address the harmonisation of transaction avoidance at the EU level. Moreover, it suggests the possibility to harmonise the regime applicable to transaction avoidance actions available both in insolvency law and in private law.

The paper is organised into five sections. The first section (Section 2) critically assesses the proposals of harmonisation suggested in the academic literature and by international organisations such as INSOL Europe.<sup>7</sup> In particular, the section seeks to highlight how the findings of the comparative research of the study may call into question the feasibility of a full harmonisation. Additionally, it explores and evaluates alternative ways to tackle the issues emerging in the EIR(R) with a private international law (PIL) approach.

The second section (Section 3) explores the possibility of an alternative form of harmonisation. It proposes a partial harmonisation of the transaction avoidance rules that fits within the current EU PIL framework. The section suggests a new system of PIL rules to determine when to apply the proposed harmonised rules. Instead, the third section (Section 4) focuses on how to implement the proposal at the EU level. The fourth section (Section 5) attempts to provide more detailed guidance on the content of the proposed harmonised substantive rules in insolvency. Finally, the fifth section (Section 6) focuses on transaction detrimental to the creditors under the general law (i.e. *action pauliana*).

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<sup>6</sup> Five Presidents' Report: Completing Europe's Economic and Monetary Union on 22 June 2015 <[https://ec.europa.eu/priorities/publications/five-presidents-report-completing-europeseconomic-and-monetary-union\\_en](https://ec.europa.eu/priorities/publications/five-presidents-report-completing-europeseconomic-and-monetary-union_en) > accessed 27.10.2020.

<sup>7</sup> i.e. International Association of Restructuring, Insolvency & Bankruptcy Professionals.

## 2. The State-of-the-Art Academic Literature and Its Critical Analysis

In the last decades, few studies have focused on the EU harmonisation of transaction avoidance.<sup>8</sup> These studies generally address the issue considering the option of a full harmonisation, meaning the creation of uniform rules applicable across the EU in substitution to the present national rules.<sup>9</sup> This section seeks to provide a critical overview of the studies conducted on the topic and provide an alternative approach to the topic of harmonisation.

First, in 2010, an EU funded study conducted by INSOL Europe dealt with the harmonisation of insolvency law at the EU level.<sup>10</sup> First, the study assesses the necessity and feasibility of harmonising insolvency law in general terms.<sup>11</sup> Second, it includes transaction avoidance actions among the matters of insolvency law where harmonisation is deemed worthwhile, necessary, and attainable.<sup>12</sup> It must be noted, however, that the INSOL study fails to explain how the worthiness, necessity and attainability of the harmonisation of transaction avoidance have been assessed.

On the one hand, the necessity of the harmonisation of these rules can be determined by looking at the legal issues emerged in the Court of Justice of the European Union (CJEU) case law and other potential issues. Consequently, one should assess whether a harmonised system of rules can solve these issues. Finally, whether the proposal of harmonisation is a proportionate answer to the issues should be evaluated.

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<sup>8</sup> Andrew Keay, 'The Harmonization of the Avoidance Rules in European Union Insolvencies' (2017) 66 ICLQ 79 (Keay I); Andrew Keay, 'Harmonisation of Avoidance Rules in European Union Insolvencies: the Critical Elements in Formulating a Scheme' (2018) NILQ 85 (Keay II); Gerard McCormack, Andrew Keay, Sarah Brown, *European Insolvency Law: Reform and Harmonisation* (Edward Elgar 2017) 130; Roel J. de Weijs, 'Towards an objective European rule on transaction avoidance in insolvencies' (2011) IIR 20(3) 219; INSOL Europe, 'Harmonization of Insolvency Law at EU Level' PE 419.633, April 2010 <[https://www.eesc.europa.eu/sites/default/files/resources/docs/jpoljuri\\_nt2010419633\\_en.pdf](https://www.eesc.europa.eu/sites/default/files/resources/docs/jpoljuri_nt2010419633_en.pdf)> accessed 27.10.2020; Reinhard Bork, Report on Transactions Avoidance Laws (CERIL Report 2017/1) < <http://www.ceril.eu/uploads/files/20170926-ceril-report-2017-1-final.pdf>> accessed 27.10.2020; Federico Mucciarelli, 'Not Just Efficiency: Insolvency Law in the EU and Its Political Dimension' (2013) 14(2) EBOR 175.

<sup>9</sup> Eva J. Lohse, 'The Meaning of Harmonisation in the Context of European Union Law - A Process in Need of Definition' in Mads Andenas and Camilla Baasch Andersen (eds) *Theory and Practice of Harmonisation* (Edward Elgar 2011) 282.

<sup>10</sup> INSOL Europe, 'Harmonization of Insolvency Law at EU Level' (n 8).

<sup>11</sup> *ibid*, 26.

<sup>12</sup> *ibid*, 18-20.

Although the INSOL study reflects upon some case law examples, it does not provide a thorough analysis that shows the necessity of harmonisation. However, the current system of private international law rules on transaction avoidance lacks clarity, certainty and predictability of the legal outcomes.<sup>13</sup>

Whether some of these issues could be addressed by harmonising the avoidance rules at the EU level has been discussed by Professor Andrew Keay, whose work will be later analysed in detail.<sup>14</sup> Instead, there is a clear gap in the scholarship on the question of proportionality. So far, there is no academic commentary on whether there are less invasive and more proportionate measures in relation to the issues.

Moreover, although the INSOL study affirms the worthiness and attainability of the harmonisation of transaction avoidance rules, it does not provide the basis of such affirmation. Both assertions could be argued on economic and legal bases. The present research does not focus on the worthiness of the harmonisation proposal. This evaluation would require an economic analysis that weighs whether the benefits introduced by harmonised rules would balance or overcome the costs of the process.<sup>15</sup> In contrast, the present research seeks to contribute to assessing the attainability of harmonisation. This requires a legal analysis of the present framework of rules combined with a forecast on the impact of harmonised rules on the insolvency frameworks of the EU member states.

Although the INSOL study focused on several insolvency law issues, some suggestions were given concerning possible reforms of the EIR rules on transaction

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<sup>13</sup> Jurai Alexander, 'Avoid the Choice or Choose to Avoid? The European Framework for Choice of Avoidance Law and the Quest to Make it Sensible' March 2009 < [https://papers.ssrn.com/sol3/papers2.cfm?abstract\\_id=1410157](https://papers.ssrn.com/sol3/papers2.cfm?abstract_id=1410157)> accessed 27.10.2020; Zoltan Fabók, 'Grounds for Refusal of Recognition of (Quasi-)Annex Judgements in the Recast European Insolvency Regulation' (2017) 26 IIR 295; (Fabók I) Zoltan Fabók, 'The jurisdictional Paradox in the Insolvency Regulation' (2016) 4 NIBLeJ 3 (Fabók II); Federico Mucciarelli, 'Private International Law Rules in the Insolvency Regulation Recast: A Reform or a Restatement of the Status Quo?' (August 25, 2015) < [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2650414](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2650414)> accessed 27.10.2020.

<sup>14</sup> Keay I (n 8).

<sup>15</sup> Oren Sussman, 'The Economics of the EU's Corporate-Insolvency Law and the Quest for Harmonisation by Market Forces' (2005) OFRC Working Papers Series 16.02.2005 Oxford Financial Research Centre; Louis Visscher, 'A Law and Economics View on Harmonization of Procedural Law' (2010) 9 RILE Working Paper Series < <https://core.ac.uk/download/pdf/18510011.pdf>> accessed 27.10.2020.

avoidance.<sup>16</sup> Such suggestions have been later commented in another EU study commissioned with a specific focus on avoidance actions and rules on contract.<sup>17</sup>

First, the INSOL study suggests abolishing any reference to the law governing the transaction in Article 13 EIR - now 16 EIR(R).<sup>18</sup> Second, it requires a distinction involving connected parties. Third, it recommends providing at the EU level a unified suspect period, differentiated between connected and non-connected parties. Fourth, it proposes bad faith as subjective criteria for either the debtor or the beneficiary of the transaction. It also suggests regulating the burden of proof concerning the subjective criteria, without, however, providing any guidance on the topic.

Fifth, it suggests that only insolvency practitioner should be entitled to bring avoidance action to court on behalf of the insolvency estate. Sixth, the study advises that the reform of the topic should cover a minimum list of actions. This should encompass: (i) all legal acts undertaken at an undervalue; (ii) preferences; (iii) all legal acts with connected parties and; (iv) any transfer of funds in breach of final judicial decisions.<sup>19</sup>

Following these assessments, some attempted to develop the idea of harmonising transaction avoidance at the EU level.<sup>20</sup> First, in 2011 Professor Roel J. de Weijts has addressed the topic of harmonisation of transaction avoidance in a comparative study between the English, German and Dutch regimes.<sup>21</sup> The study attempts to elaborate rules on transaction avoidance predominantly based on objective criteria.<sup>22</sup> The objective approach is suggested to reduce the time for judicial examination of avoidance claims, increase the certainty of the outcomes of the proceedings and avoid moral reproaches of the parties.<sup>23</sup> This study, however, is limited to the formulation of a blueprint for harmonised rules at the EU level, while it does not assess the feasibility of such a harmonisation in practice.

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<sup>16</sup> INSOL Europe, 'Harmonization of Insolvency Law at EU Level' (n 8) 20.

<sup>17</sup> Harmonization of Insolvency Law at EU Level: Avoidance Actions and Rules on Contracts, Briefing Note, 2011 <<https://www.europarl.europa.eu/document/activities/cont/201106/20110622ATT22311/20110622ATT22311EN.pdf>> accessed 27.10.2020.

<sup>18</sup> *ibid* 15.

<sup>19</sup> *ibid*.

<sup>20</sup> de Weijts (n 8); Keay I (n 8); Keay II (n 8) McCormack, Keay, and Brown (n 8).

<sup>21</sup> de Weijts (n 8).

<sup>22</sup> *ibid* 223.

<sup>23</sup> *ibid* 222.

In contrast, Professor Andrew Keay addresses the option of harmonisation and its feasibility in more concrete terms.<sup>24</sup> In his paper, Keay weighs the advantages and drawbacks of harmonisation. On the one hand, he considers six points in favour of harmonisation. First, Keay suggests that harmonisation “would reduce conflicts and diverges.”<sup>25</sup> He highlights that harmonisation would bring uniformity and consistency, which in turn would enhance the development of the internal market.

Second, a common framework might facilitate credit because it increases the predictability of the outcomes of legal disputes.<sup>26</sup> Third, harmonised rules will foster equality among creditors as the same rules would apply to all insolvency proceedings opened within the EU territory.<sup>27</sup> Fourth, harmonised rules may overcome peculiarities of individual national systems that allow avoidance claims in limited circumstances.<sup>28</sup>

Fifth, harmonised rules could increase procedural efficiency both in terms of time and costs. Indeed, the insolvency practitioner would need to know only one set of rules to challenge any transaction regardless of the law applicable to the transaction.<sup>29</sup> Lastly, harmonised rules might prevent forum shopping. If the reasons for moving the centre of main interest of a company is to take advantage of more favourable avoidance rules, the harmonisation of those rules will provide a level playing field across the EU that may reduce forum shopping.<sup>30</sup>

On the other hand, Keay also discussed possible drawbacks of a harmonised system.<sup>31</sup> First, his article questions whether the harmonisation would have a positive impact on the cost of credit.<sup>32</sup> This is presumed to decrease due to the improved predictability of the legal disputes. However, it might also be that creditors attempt to

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<sup>24</sup> Keay I (n 8).

<sup>25</sup> *ibid* 99.

<sup>26</sup> *ibid*.

<sup>27</sup> *ibid*.

<sup>28</sup> *ibid* 100.

<sup>29</sup> *ibid*.

<sup>30</sup> *ibid*.

<sup>31</sup> *ibid* 101.

<sup>32</sup> *ibid* 102.

protect themselves from the risk of avoidance by increasing interest rates.<sup>33</sup> Second, harmonised rules may benefit powerful creditors more than small ones.<sup>34</sup>

Third, having harmonised rules at the EU level would mean that any modification has to be made at a centralised level.<sup>35</sup> The procedural times of the EU legislator are longer than the average national ones.<sup>36</sup> This, in addition to a 'one size fits all' approach, is likely to damage local interest.<sup>37</sup>

More relevant points for assessing the feasibility of a full harmonisation emerge looking at possible obstacles to the harmonisation process. Among them, Keay first points out that there are relevant differences among the member states both concerning the avoidance regimes in general, and the responses to particular issues.<sup>38</sup> On a small scale, this study confirms that there are relevant differences among the member states analysed.

At the general level, the member states analysed organise the avoidance claims differently. Although the English, German, and Italian systems cover similar issues, the modalities in which these issues are addressed differ quite substantially. England presents separate claims for transactions at an undervalue, preferences, and transactions defrauding creditors.<sup>39</sup> Instead, Germany distinguishes the avoidance claims incongruent coverage, transactions immediately disadvantaging the insolvency creditors, wilful disadvantage and gratuitous benefit.<sup>40</sup> In contrast, Italy distinguishes between acts voided by law – gratuitous acts and payments of due debts - and acts that can be voided by courts when the insolvency practitioner brings a revocatory action to Court.<sup>41</sup>

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<sup>33</sup> *ibid.*

<sup>34</sup> *ibid* citing J Westbrook, 'Avoidance of Pre-Bankruptcy Transactions in Multinational Bankruptcy Cases' (2007) 42 *TexIntlLJ* 899, 903.

<sup>35</sup> *ibid.*

<sup>36</sup> Mucciarelli (n 8) 198.

<sup>37</sup> *ibid.*

<sup>38</sup> *ibid.*, 101.

<sup>39</sup> English Insolvency Act 1986, Sections 238, 239, and Section 423.

<sup>40</sup> Insolvency Order of 5 October 1994 (Federal Law Gazette I p. 2866), which was last amended by Article 24 (3) of the Act of 23 June 2017 (Federal Law Gazette I p. 1693) hereinafter *InsO*, Sections 130, 131, 132, 133, 134.

<sup>41</sup> Legge fallimentare, i.e. Insolvency Statute by Royal Decree 16.03.1942 n 267 reformed by law Statute 11.12.2016 n 232, Articles 64, 65 and 67.

Besides the differences in organising the claims within their insolvency systems, some of the countries in the analysis also provide additional claims that do not fall under the categories subject of the study. The English system, for instance, provides rules on extortionate credit transactions<sup>42</sup> and the avoidance of certain floating charges.<sup>43</sup> Similarly, Germany law has some additional transaction avoidance actions that cannot be qualified as either transaction at an undervalue, preference nor transaction defrauding creditors.<sup>44</sup>

Also, concerning more specific issues, the member states in analysis present different approaches. For instance, the approaches of the analysed countries differ regarding the relevance given to subjective and objective criteria. Italy and Germany adopt a more objective approach to transaction avoidance in insolvency. Germany requires a particular subjective state of the debtor only in the case of transaction detrimental to creditors.<sup>45</sup>

At the same time, both Italy and Germany require a certain degree of awareness of the counterparty of the transaction. Although this is still a subjective criterion, it is more manageable in terms of proof.<sup>46</sup> Indeed, it does not look at the intention of the party but only at their knowledge which can be more easily inferred from external factual clues.<sup>47</sup> In contrast, England requires the desire to prefer in preferences and a specific purpose in transactions defrauding creditors.<sup>48</sup> Similarly, the three member states

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<sup>42</sup> Insolvency Act (n 39) Section 244.

<sup>43</sup> *ibid*, Section 246.

<sup>44</sup> InsO (n 40) Section 135 Loans Replacing Equity Capital, Section 136 Silent Partnership, Section 137 Payments on Bills of Exchange and Cheques, Section 141 Executable Deed, Section 142 Cash Transactions, Section 144 Claims of the Party to the Contested Transaction, Section 145 Transactions Contested and Enforced against Legal Successors.

<sup>45</sup> *ibid*, Section 133.

<sup>46</sup> de Weijts (n 8) 222.

<sup>47</sup> BGH judgment of 24.05.2007 IX ZR 97/06 OLG Munich ([lexetius.com/2007](http://lexetius.com/2007), 1696) para 29; BAG judgment of 29.01.2014 6 AZR 345/12 ([lexetius.com/2014](http://lexetius.com/2014), 646) para 61; BGH judgment of 20.11.2008 IX ZR 188/07 *Schleswig-Holstein* ([lexetius.com/2008](http://lexetius.com/2008), 3632) para 16; See Manocchi e Fioretti, 'La Tenuta della Presunzione nelle Revocatorie di Atti a Titolo Oneroso, nota all'Ordinanza n 1404 del 26.01.2006 della Suprema Corte di Cassazione' <[http://www.mflaw.it/media/Newsletter-MF-n-04\\_2016-La-tenuta-dellapre-sunzione-nelle-revocatorie-di-atti-a-titolo-oneroso.pdf](http://www.mflaw.it/media/Newsletter-MF-n-04_2016-La-tenuta-dellapre-sunzione-nelle-revocatorie-di-atti-a-titolo-oneroso.pdf)> accessed 27.10.2020.

<sup>48</sup> Insolvency Act (n 39) Sections 239 and 423.



analysed present substantial differences in the suspect periods adopted, ranging from three months to ten years.<sup>49</sup>

These differences, however, should not be considered as an obstacle to the harmonisation process but rather its logical precondition.<sup>50</sup> The purpose of harmonisation is to bring uniformity where this is lacking.<sup>51</sup> If the national provisions were similar to begin with, the process of harmonisation would not be necessary.

The peculiarities of each legal system, however, might reflect local instances. A full harmonisation that obliterates such differences may negatively impact the national insolvency systems. In these cases, the harmonisation may create legislative gaps regarding local issues. This is also highlighted by Keay, who suggests that harmonisation may prevent member states from dealing with local concerns and abuses.<sup>52</sup> This is a problem that may be addressed by a partial harmonisation that allows member states to deal with local issues in local insolvencies. The proposal of a partial harmonisation will be discussed in details in the following section.

A third relevant obstacle identified by Keay is the lack of a common understanding of the policy issues underlying the avoidance claims.<sup>53</sup> There seems to be a common understanding of the rationale of preferences in the three countries in the analysis: Concerning the three countries at stake, they share the view that preferences safeguard the *pari passu* or *par condicio creditorum* principle. Indeed, they all consider preference claims as a tool to re-establish the equal treatment of the creditors infringed by the preferential transaction.<sup>54</sup> Further studies will be needed to confirm that the other member states share a similar view.

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<sup>49</sup> Insolvency Act (n 39) Section 240; InsO (n 40) Section 130,131,132,133, and 134; Legge fallimentare (n 41) Articles 64, 65, 66 and 67.

<sup>50</sup> Eva J Lohse, 'The Meaning of Harmonisation in the Context of European Union Law – a Process in Need of Definition' in Mads Andenas and Camilla Baasch Andersen (eds) *Theory and Practice of Harmonisation* (Edward Edgar 2012) 282, 283.

<sup>51</sup> Martin Boodman, 'The Myth of Harmonization of Laws' (1991) 39 AmJCompL 699, 705; John Goldring, 'Unification and Harmonisation of the Rules of Law' (1978) 9(3) FLRev 284, 289.

<sup>52</sup> Keay I (n 8) 102.

<sup>53</sup> Ibid 101.

<sup>54</sup> England, Report of the Review Committee on Insolvency Law and Practice (1982) Cmnd 8558 (Cork Report) para 1209; Germany, Thomas Bachner *Creditor Protection in Private Companies: Anglo-German Perspectives for a European Legal Discourse* (CUP 2009) 57; Italy, Cassazione 04.12.1972 n 3491; Cassazione 05.04.2002 n. 4842.

Instead, the national doctrines regarding transactions at an undervalue, and transactions detrimental to the creditors do not converge. More importantly, the rationale behind these provisions is not clear even at the national level. On the one hand, the English scholarship has failed to identify a definite rationale of transactions at an undervalue. It has been suggested that the scope of the provision might be to reverse a situation of unjust enrichment or to serve the *pari passu* principle.<sup>55</sup>

Although the latter theory seems sounder, a clear and commonly accepted rationale of the provision is still missing. Similarly, the Italian scholarship has been tentative about the rationale of Article 64 l.f. on gratuitous acts, swinging between a punitive scope and a protective purpose of the action.<sup>56</sup>

On the other hand, the matter is even more complex concerning transactions detrimental to creditors. In England, the action's rationale is identified as to maximise the value of the insolvency estate and prevent the depletion of the assets.<sup>57</sup> However, the scope of application of the claim is limited to transactions that intentionally disrupt the proper functioning of the credit system.<sup>58</sup>

Also in Germany, the scholarship has struggled to find precise policies underpinning the claim beside the general safeguard of the creditors from prejudice.<sup>59</sup> In addition, there are ongoing discussions concerning the nature of the action. Similarly, the issue emerges among the Italian scholarship that has been questioning the nature and scope of the action for decades. Moreover, the academic debate is mimicked by the Italian jurisprudence that is incoherent on the topic at times.<sup>60</sup>

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<sup>55</sup> John Armour and Howard Bennet, *Vulnerable Transactions in Corporate Insolvency* ( Bloomsbury Publishing 2003) 41; Rebecca Parry, James Ayliffe and Sharif Shivji, *Transaction Avoidance in Insolvencies* (Oxford University Press 2011) paras 2.27-2.28 and 2.33.

<sup>56</sup> Riccardo Riedi, 'Azioni di Inefficacia e Azione Revocatoria nel Fallimento' in Vincenzo Vitalone, Ugo Patroni Griffi and Riccardo Riedi (edn) *Le azioni Revocatorie: La Disciplina, Il Processo* (UTET 2014) loc2729 ff; Luciano Matteo Quattrocchio, 'Analisi del novellato art. 64 l.f.' (2016) 2 *Diritto ed Economia dell'Impresa* 392.

<sup>57</sup> Parry,(n 55) para 2.28 and 2.31; Andrew Keay and Peter Walton, *Insolvency Law: Corporate and Personal* 2<sup>nd</sup> edn (Jordans 2008) 570; Andrew Keay, *McPherson's Law of Company Liquidation* (3rd edn, Sweet and Maxwell 2013) para 11-109.

<sup>58</sup> Insolvency Act (n 39) Section 423.

<sup>59</sup> Thorsten Patrick Lind, *Zur Auslegung von § 133 InsO, insbesondere im System der Anfechtungstatbestände* (2006 Tenea Verlag) 54 ff.

<sup>60</sup> Cassazione 11.11.2003 n 16915; Cassazione 18.01.1991 n 495; Cassazione 08.03.1993 n 2751; Cassazione 28.04.2004 n 8096; Cassazione 08.07.2004 n 12558; Cassazione 16.03.2005 n 5713;

An attempt to build a framework of commonly understood principles across the EU member states has been carried out by the Conference on European Restructuring and Insolvency Law (CERIL).<sup>61</sup> The CERIL Report on Transactions Avoidance Laws focuses on the common principles rather than the differences that the Member States display in their avoidance regimes.<sup>62</sup>

In particular, it investigates the principle of equal treatment of creditors and the principle of protection of trust. The latter is considered to be relevant in all transaction avoidance actions while the former can be found only in claims against other creditors of the same debtor.<sup>63</sup> Moreover, the study reports that the relevance of the principle of equal treatment has been called into question by several authors.<sup>64</sup>

The CERIL Report is an interesting discussion of two principles that may be deemed common across jurisdictions and may help justify the essence of transaction avoidance. It is, however, a pilot study with substantial limitations in its focus. First, the focus is limited to only two principles among others. Therefore, it does not provide a complete overview of all the common principles that come into play within the topic of transaction avoidance.

Second, the study addresses nine countries out of the twenty-eight member states. Therefore, it cannot be said that the study proves that the two principles in the analysis are truly common among all member states. Ultimately, the lack of a common understanding, the predicaments within the national approaches as well as the necessity to respond differently to local instances may constitute the main obstacles to harmonisation in practice.

On the one hand, the lack of common understanding and the lack of a solid foundation within the national doctrines may undermine the implementation of harmonised rules. In the absence of a clear understanding of the rationale of transaction avoidance rules, the national judges might apply their own theoretical legal frameworks to the

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Cassazione 28.03.2006 n 7028; Cassazione 10.11.2006 n 24046; Cassazione 26.02.2010 n 4785; Cassazione 08.03.2010 n 5505; Cassazione 19.12.2012 n 23430; Cassazione 12.12.2014 n 26216.

<sup>61</sup> Report on Transactions Avoidance laws: "Clash of Principles: Equal Treatment of Creditors vs. Protection of Trust" (CERIL Report 2017-1) < <http://www.ceril.eu/projects/kopie-avoidance-actions/>> accessed 27.10.2020.

<sup>62</sup> *ibid* 1.

<sup>63</sup> *ibid* 4.

<sup>64</sup> *ibid* 14 (mentioning Rizwaan Jameel Mokal, Adrian Walters and Rolef de Weijts).

harmonised rules. Indeed, the evolution of the law is generally a slow process that mirrors a socio-cultural transformation.<sup>65</sup> A vertical imposition of rules may face not only open political resistance but also an unconscious bias in the application of the new rules with cultural bias.<sup>66</sup> This issue hinders the scopes of harmonisation as it may lead to divergence in practice where the aspiration is to bring convergence among the legal systems.

This hypothetical divergence of application of harmonised rules would bring inconsistencies and unpredictability of the outcomes of legal disputes which could damage the functioning of the internal market. The CJEU could address the issue of interpretation through preliminary rulings<sup>67</sup>

The intervention of the Court, however, is limited to specific questions that are referred to it. The system would lack effective guidance on general questions of interpretation. Additionally, this might open the floodgates of the CJEU to interpretative questions, placing upon the Court an unmanageable burden and leading to procedural delays.

On the other hand, the peculiarities of the national systems may address local issues of different nature. Laws respond to factual phenomena which may encompass cultural, legal, sociological, economic and political instances.<sup>68</sup> Moreover, all these factors are often implicit in the mind of the national legislator, and they are not always discernible.<sup>69</sup> It is not feasible that a full harmonisation would take into account all the local peculiarities of all the member states. Additionally, even if the process could take into account all the peculiarities, the result would most likely an incoherent and unworkable set of rules.<sup>70</sup>

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<sup>65</sup> See generally Brian Tamanaha, 'The Primacy of Society and the Failures of Law and Development' (2011) 44(2) *CornellIntlLJ* 209, 213.

<sup>66</sup> *ibid* 214.

<sup>67</sup> Preliminary rulings are decisions of the Court of Justice of the European Union (EU) the interpretation of EU law, given in response to a request from a court or tribunal of one of the Member States. These contribute to the harmonious interpretation of EU law across the EU territory. See Consolidated version of the Treaty on the Functioning of the European Union OJ C 326, Article 267.

<sup>68</sup> Kurt Wilk, 'Law and the State as Pure Ideas: Critical Notes on the Basic Concepts of Kelsen's Legal Philosophy' (1941) *Ethics* 51(2) 158.

<sup>69</sup> Philip Sales, 'Legislative Intention, Interpretation, and the Principle of Legality' (2019) *Statute Law Rev* 40(1) 53.

<sup>70</sup> Keay II (n 8) 95.

Assuming, however, that the harmonised rules would disregard the local issues, these would be left unregulated. Within this foreseeable regulatory gap, bad practices could emerge, disrupt the functioning of the national insolvency systems and undermine the uniformity of the legal responses of the legal systems.<sup>71</sup> Where the process of harmonisation seeks unity and clarity, a full harmonisation with these premises may bring to significant divergences in other parts of the law, which ultimately would undermine the scope of harmonisation.

On the other side, the current EIR(R) issues could be addressed either by harmonisation of transaction avoidance rules or through reform of private international law rules. The present study does not go into the details of a possible PIL reform. However, even if a comprehensive PIL reform addresses all the current issues within the EIR(R), other possible issues may arise in regards to the law applicable to the vulnerable transaction. Indeed, the overall EU PIL framework displays gaps in the matter of property law, trust, agency and arbitration, which may become relevant concerning transaction avoidance.<sup>72</sup>

Moreover, a PIL solution could come from the burdensome task to improve the EU PIL system overall, increasing coordination among the EU PIL instruments. A reform to improve the horizontal coherence of the present EU PIL patchwork has been discussed at the EU institutional level.<sup>73</sup> There are various policy options. On the less invasive end of the spectrum, it has been suggested that the PIL framework can be completed with the current approach of regulating specific matters in different Regulations. On the other side of the spectrum, it has been proposed to modify the EU PIL system with the creation of a European Code of Private International Law.<sup>74</sup> Both options, however, require great legislative efforts and a foreseeable long period of time.

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<sup>71</sup> *ibid.*

<sup>72</sup> Kramer (n **Error! Bookmark not defined.**) 49 ff.

<sup>73</sup> *ibid.*

<sup>74</sup> *ibid.*

### 3. A Compromise Solution

As both a full harmonisation and a PIL reform display significant shortcomings, it is worth exploring a third solution which is a compromise between both approaches. A third approach could encompass a partially harmonised transaction avoidance framework. Partial harmonisation can have two meanings.<sup>75</sup> On the one hand, partial harmonisation can mean that the EU regulates general aspects of the topic, and the member states address the details not covered by the EU legislative acts.<sup>76</sup>

On the other hand, partial harmonisation can also mean that the harmonised rules provided by the EU apply only to cross-border scenarios, while member states provide rules to be applied in domestic cases.<sup>77</sup> This study suggests harmonising transaction avoidance with the latter approach.

This approach provides substantive unified rules to be applied in cross-border circumstances. On the other hand, the proposal suggests that private international law rules should modulate when the harmonised rules should be applied. This current section addresses the formulation of PIL rules, and it analyses its advantages and shortcomings. In contrast, the following section (Section 8.4) will focus on the formulation of possible substantive harmonised rules to be applied to cross-border transactions.

New private international law rules could be used to replace the current mechanism of articles 7 and 16 of EIR(R). Article 7 EIR(R) provides that the law of the state of the opening of the proceedings governs the rules relating to transaction avoidance.<sup>78</sup> In contrast, article 16 EIR(R) dispenses an exception when the vulnerable transaction is governed by the law of another Member State and that law does not allow the transaction to be challenged.<sup>79</sup> Under these two conditions, the vulnerable transaction is safe from the application of transaction avoidance rules of the law of the proceedings.

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<sup>75</sup> Bartolomiej Kurcz, 'Harmonisation by Means of Directive: Never-ending Story' (2001) EBLR 287, 296.

<sup>76</sup> Ellen Vos, 'Differentiation, Harmonisation and Governance' in Bruno de Witte, Dominik Hanf, Ellen Vos (eds), *The Many Faces of Differentiation in EU Law* (2011 Intersentia) 149.

<sup>77</sup> Kurcz (n 75) 296.

<sup>78</sup> Regulation 2015/848 (n 5) Article 7(m)

<sup>79</sup> *ibid* Article 16.

A possible reform could replace Article 16 EIR(R) with a provision prescribing that cross-border transactions should be governed by the harmonised rules on transaction avoidance. This would mean that transactions that are undertaken locally would be regulated by the law of the proceedings, while the harmonised rules would govern transactions having a cross-border dimension.

### **3.1. The Cross-Border Character of Vulnerable Transactions**

In order to avoid legal uncertainty, the reformed provision should specify when a transaction could be deemed cross-border under the EIR(R). The concept should be constructed with two conditions. First, a transaction should be deemed cross-border when at least one of the parties of the transaction have their habitual residence or centre of main interest in a member state other than the one of the proceedings. Second, a transaction should be deemed cross-border when the law applicable to the transaction is different from the law of the opening of the proceedings.

Each condition should be considered individually sufficient to qualify the transaction as a cross-border one, in order to achieve consistency of application between primary and secondary proceedings. Otherwise, it might happen that EU rules would apply to the main proceedings and local rules would apply to secondary proceedings and vice versa.

Moreover, in order to avoid repeating the current issues of Article 16 EIR(R) and the consequent legal uncertainty, the provision should specify how to identify the law applicable to the transaction.<sup>80</sup> This should be a preliminary step to ascertain the cross border character of the transaction.

For the identification of the law applicable, the harmonised claims should be considered related to the contractual matter. These harmonised claims should be considered related to contractual matters rather than torts. First, generally claims concern transactions between parties that formally or informally can be deemed a contract. Second, these types of claims - including transaction detrimental to creditors - are conceived to reconstruct the insolvency estate and not to recover damages.

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<sup>80</sup> Alexander (n 13) 18.

Third, from a utilitarian perspective, the characterisation of the claims as contractual allows the application of more various and developed connecting factors. Indeed, the contractual characterisation of transaction avoidance claims would allow borrowing principles to determine the applicable law from the Rome I Regulation. Under Article 4 and following, the Regulation provides general principles to determine which law governs particular transactions in the absence of a choice of law.

For instance, the Regulation provides that:

- (a) a contract for the sale of goods shall be governed by the law of the country where the seller has his habitual residence;
- (b) a contract for the provision of services shall be governed by the law of the country where the service provider has his habitual residence;
- (c) a contract relating to a right in rem in immovable property or to a tenancy of immovable property shall be governed by the law of the country where the property is situated;
- (d) notwithstanding point (c), a tenancy of immovable property concluded for temporary private use for a period of no more than six consecutive months shall be governed by the law of the country where the landlord has his habitual residence, provided that the tenant is a natural person and has his habitual residence in the same country;
- (e) a franchise contract shall be governed by the law of the country where the franchisee has his habitual residence;
- (f) a distribution contract shall be governed by the law of the country where the distributor has his habitual residence.<sup>81</sup>

Additional contracts are regulated by Rome I that could provide a comprehensive legal framework to apply in the proposed Article 16 EIR(R).<sup>82</sup>

The identification of the law governing the transaction would be functional only to the qualification of the transaction as a cross-border one. Once the court identifies that the

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<sup>81</sup> Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the Law Applicable to Contractual Obligations (Rome I) [2008] OJ L 177/6, Article 4.

<sup>82</sup> *ibid*, Article 5 ff.



law applicable to the transaction is different from the one of the proceedings, both the law of the proceedings and the law applicable to the transaction should subside in favour of EU law.

To explain the application in practice of the formulated theory, an example can be provided as follows: A German Company has a secondary establishment in Spain. Two months before the opening of the insolvency proceedings, the German company grants a security right to a German Bank over assets located in Spain. Subsequently, the main proceedings are opened in Germany, and territorial proceedings are opened in Spain.

According to the proposed PIL rules, the EU harmonised rules will apply to the circumstances. If the German insolvency practitioner intends to challenge the transaction, they would have to verify the residence of the parties, which in the case corresponds to the law of the proceedings. Additionally, they will have to verify which law is the one governing the transaction. According to the rules set out in Rome I, the law applicable to rights in rem related to immovable property is the law of the place where the assets are located. In the case, this would be Spain. Once verified that the law applicable to the transaction is different from the law of the proceedings, EU transaction avoidance should apply.

Similarly, if the Spanish insolvency practitioner wishes to challenge the transaction in the Spanish territorial proceeding, they will apply the same mechanism. As a result, the law applicable to the transaction coincides with the law of the proceedings, but the COMI of the parties does not correspond to the place of the territorial proceedings. Therefore, also in case of a claim brought in the territorial proceedings, the rules applicable to transaction avoidance would be the harmonised ones.

### **3.2. Party autonomy and the Choice of Law**

Particular attention should be reserved to the choice of law clauses which are contractual clauses by which the parties decide the law applicable to a contract or part of it.<sup>83</sup> This type of clauses is an expression of party autonomy that has assumed

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<sup>83</sup> David McClean and Veronica Ruiz Abou-Nigm, *Morris: The Conflict of Laws* (9<sup>th</sup> edn Sweet&Maxwell 2016) 15-003.

predominant relevance in private international law in the past century.<sup>84</sup> Currently, there seems to be a consensus among the scholarship that the applicability and the enforcement of choice of law clauses should be the rule rather than the exception.<sup>85</sup>

However, party autonomy is a sore point in the context of transaction avoidance, as in practice, these clauses may prevent the application of transaction avoidance rules.<sup>86</sup>

Generally, party autonomy has the potential to disrupt the maximisation of the value of the estate and the provisions on transaction avoidance attempt to balance the purposes of insolvency law with the principle of contractual freedom.<sup>87</sup> Moreover, in the context of a proposed partial harmonisation, choice of law clauses may hinder the application of harmonised rules, making the whole process of harmonisation pointless.

It must be noted that party autonomy is not absolute, and the ability to express a choice of law can be limited in certain circumstances.<sup>88</sup> In particular, the choice of law option can be limited in favour of mandatory rules and the protection of consumers, employees and other weaker parties.<sup>89</sup> In formulating a proposal of a partial harmonisation that applies only in cross-border scenarios identified through PIL rules, it should be considered whether party autonomy should be allowed or should be limited.

On the one hand, under the current EU PIL framework, party autonomy is not limited in the choice of law against transaction avoidance regimes. In *Vinylys Italia SpA in liquidation v Mediterranea di Navigazione SpA*,<sup>90</sup> the CJEU held that the EIR does not derogate from the principle of party autonomy.<sup>91</sup> The decision has been justified on

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<sup>84</sup> Mathias Reimann, 'Savigny's Triumph: Choice of Law in Contracts Cases at the Close of the Twentieth Century' (1999) 39 *VaJIntIL* 571, 575.

<sup>85</sup> Patrick Borchers, 'Categorical Exceptions to Party Autonomy in Private International Law' (2008) *TuLRev* 1645, 1646.

<sup>86</sup> Lawrence Westbrook, 'Choice of Avoidance Law in Global Insolvencies' (1991) 17 *BrookJIntIL* 499.

<sup>87</sup> de Weijts (n 8).

<sup>88</sup> Symeon Symeonides, 'The Scope and Limits of Party Autonomy in International Contracts: A Comparative Analysis' in Franco Ferrari & Diego P. Fernández Arroyo (eds.), *The Continuing Relevance of Private International Law and New Challenges* (forthcoming 2019) < <http://dx.doi.org/10.2139/ssrn.3359988> > accessed 27.10.2020.

<sup>89</sup> *ibid*, 41 ff.

<sup>90</sup> Case C-54/16 *Vinylys Italia S.p.A. in fallimento v. Mediterranea di Navigazione S.p.A.* ECLI:EU:C:2017:433 [2016] OJ C 156.

<sup>91</sup> *ibid* para 46.

the fact that the EIR is to be considered *lex specialis* in relation to the Rome I Regulation.<sup>92</sup>

Moreover, the EIR(R) does not contain a rule similar to article 3(3) Rome I that invalidates the choice of law clauses that prejudice the application of mandatory provisions.<sup>93</sup> Although the EIR(R) does not encompass a provision similar to Article 3(3) Rome I, the judgments has missed an opportunity to bring coherence within the EU PIL system.<sup>94</sup> In addition, the Court did not address the issue of whether transaction avoidance rules could be deemed mandatory rules under Article 9 Rome I and therefore justify a limitation of the party autonomy.

On the other hand, it seems worth exploring whether EU harmonised rules could be considered mandatory rules and therefore allowing the limitation of party autonomy. Mandatory rules are those that 'must be applied regardless of whatever law is applied to the contract, whether or not that choice of law is the result of party stipulation.'<sup>95</sup> These type of rules are substantive rules embodying public policies principles that apply in cross-border scenarios 'by-passing the ordinary choice of law rules.'<sup>96</sup>

Mandatory rules can be identified as those rules that serve a public policy and which rationale is to serve crucial public interests of a country such as its socio-economic or political organisation.<sup>97</sup> In general, mandatory rules 'are essentially matters of economic regulation designed to protect the public from negative externalities that would harm the public if the parties were to violate these rules.'<sup>98</sup> In other words, these rules are designed to safeguard not only the interests of the parties involved in the transactions but also the interests of other categories of persons external to the transaction.<sup>99</sup>

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<sup>92</sup> *ibid* para 48.

<sup>93</sup> *ibid* para 50.

<sup>94</sup> Case C-54/16 *Vinyls Italia S.p.A. in fallimento v. Meditteranea di Navigazione S.p.A.* Opinion of the AG Maciej Szpunar ECLI:EU:C:2017:164, para 123.

<sup>95</sup> Borchers (n 85) 1651.

<sup>96</sup> Symeon Symeonides, 'American Choice of Law at the Dawn of the 21<sup>st</sup> Century' (2001) 37 *Willamette L. Rev.* 1, 33-34.

<sup>97</sup> Rome I Regulation (n 81) Article 9(1).

<sup>98</sup> Henry Mather, 'Choice of Law for International Sales Issues Not Resolved by the CISG' (2001) 20 *J.L. & Com.* 155, 202.

<sup>99</sup> Borchers (n 85) 1652.

Transaction avoidance rules could be deemed mandatory rules in the sense that are functional to purposes of insolvency law which embodies a series of public policies (e.g. fair distribution). Moreover, transaction avoidance rules protect the interests of the general body of creditors that are external parties to the transaction. Therefore, it could be argued that transaction avoidance should be deemed mandatory rules that should not be overridden by choice of law clauses

On the other hand, whether EU rules can have a mandatory qualification in conflicts of laws should be assessed. The issue here relates to the fact that mandatory rules are generally identified as protecting public policies of states. Instead, in the case of harmonised rules, the public policies would be those of an international organisation such as the EU.

In practice, many EU mandatory rules originate from Directives.<sup>100</sup> Moreover, in *Ingmar GB Ltd v Eaton Leonard Technologies*,<sup>101</sup> the CJEU clarified that the mandatory rules of the case – Article 17 of the Directive 86/653<sup>102</sup> - could not be derogated even when a party of the relationship is established outside the territory of the EU.

Therefore, it is established that EU rules can be mandatory. In the case of the harmonisation of transaction avoidance, the mandatory nature of the proposed EU rules cannot, however, be inferred from the same public policies reasons that emerge at the national level (e.g. fair distribution).

Indeed, the EIR(R) has not harmonised rules on distribution, and the Member states are free to establish the ranking that better fit their internal policies. Nevertheless, the mandatory nature of the harmonised rules could be based on other policies such as the predictability of the legal outcomes, protection of the creditors' interest and more generally the enhancement of proper functioning of the internal market.<sup>103</sup>

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<sup>100</sup> H L E Verhagen, 'The Tension Between Party Autonomy and European Union Law: Some Observations on *Ingmar GB Ltd V Eaton Leonard Technologies Inc*' (2002) 51(2) ICLQ 135, 136.

<sup>101</sup> Case C-381/98 *Ingmar GB Ltd V Eaton Leonard Technologies* [2000] ECLI:EU:C:2000:605 ECR I-09305. The case dealt with the mandatory nature of the guarantee granted by the directive over certain rights to commercial agents after termination of agency contracts. See Case C-381/98 para 14.

<sup>102</sup> Council Directive 86/653/EEC on the Coordination of the Laws of the Member States Relating to Self-employed Commercial Agents [1986] OJ L 382.

<sup>103</sup> Jay Lawrence Westbrook, 'Theory and Pragmatism in Global insolvency: Choice of law and Choice of Forum' (1991) Am. Bankruptcy Law Rev. 457. Keay I (n 8).

Moreover, if one compares the present proposal of harmonisation with a prospective full harmonisation, it can be noted that the latter would reduce the choice of law applicable in any case. Indeed, a full harmonisation would remove the laws to be chosen altogether by replacing all national rules with EU rules. If the full option can be contemplated, then a partial harmonisation formulated as in the present study should not create logical issues. If the EU transaction avoidance rules are deemed mandatory, the choice of law expressed by the parties should be void. Consequently, the chosen law should be substituted by the harmonised rules.

A second issue to be analysed relating to party autonomy is whether the parties could opt in the harmonised framework. The parties could opt-in the EU transaction avoidance regime either directly (i.e. through a choice of law that selects EU law) or indirectly (i.e. through a choice of law that selects the law of another country).

The favour towards EU rules can be justified based on the equivalence of the EU and national systems and efficiency of the internal market. On the one hand, the national and EU system could be deemed equivalent to the national systems as they perform the same function.<sup>104</sup> Moreover, it could be argued that both types of systems (European and national systems) attempt to balance the interests of the insolvency's estate and those of the third parties.

On the other hand, primacy should be given to the EU rules as they seek to regulate cross-border transaction avoidance uniformly. In turn, this uniformity serves the scopes of legal certainty and support the proper functioning of the internal market.<sup>105</sup> However, the possibility to opt-in the supranational system may give rise to abusive use of Union law.

The abusive use of EU law may happen when the parties opt for the harmonised rules – whether directly or indirectly – with the sole purpose of avoiding national regulations. The abuse of Union law can be defined as ‘a gain seeking, artificial and undesirable choice of law made by a private individual.’<sup>106</sup>

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<sup>104</sup> Esin Orfici, ‘Methodological Aspects of Comparative Law’(2006) 8 Eur J Law Reform 29, 32.

<sup>105</sup> Keay I (n 8) 96.

<sup>106</sup> Alexandre Sayde, ‘Defining the Concept of Abuse of Union Law’ (2014) 33 (1) Yearb. Eur. Law 138, 138.

The concept of abuse of law is compounded of three elements. First, the parties should seek to 'attract positive legal consequences'<sup>107</sup> through the choice of law. Second, the choice of law should be artificial, in the sense that the only possible explanation for the choice of law is the 'regulatory benefit sought.'<sup>108</sup> In practice, this happens when the parties choose a law that is not connected to the transaction by any other factors than the choice itself. Third, the choice of law is not desirable in the circumstances. The third element is a 'teleological assessment'<sup>109</sup> that evaluates 'the nature of the law affected by the alleged abuse of law.'<sup>110</sup> Therefore, the judge will have to assess whether the choice of law frustrates particular interests protected by the national system.

The EU doctrine of abuse of Union law could be used to limit party autonomy in transaction avoidance further. As a consequence, the parties can choose the harmonised rules either directly or indirectly but not without conditions. When the transaction is fully domestic, and the harmonised rules have been chosen only to avoid national regulations, the competent judge will have to assess if the choice is desirable in the circumstances.

In particular, if the national law further protects the interest of the claimant (which is an external party to the vulnerable transaction), the judge should apply the national law. This is because the focus of the harmonised rules should be to balance the interest at stake in cross-border scenarios. They should be dismissed in fully domestic cases when they deprive the claimant of the rights they would otherwise enjoy under the national law.

To summarise the proposal of partial harmonisation may conflict with party autonomy. On the hand, the harmonised rules should be deemed mandatory in order to guarantee their consistent application. On the other hand, the parties can opt-in the harmonised rules as long as the choice does not constitute an abuse of EU law.

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<sup>107</sup> *ibid* 143.

<sup>108</sup> *ibid* 139.

<sup>109</sup> *ibid* 153.

<sup>110</sup> *ibid*.

### **3.3. Benefits and Drawbacks**

Any proposal entails benefits and drawbacks. The proposal of partial harmonisation seeks to bring uniformity and enhance legal certainty in cross-border situations. Moreover, it might foster the convergence of the national legal systems on transaction avoidance.

Additionally, the proposal provides an answer to the issues emerging in the current transaction avoidance regime, and it respects the EU principles of subsidiarity and proportionality. On the other side, the proposal is complex and may display different treatment between nationals of the country of the insolvency proceedings and non-nationals.

First, the proposal seeks to bring uniformity to the rules applicable in cross-border transaction avoidance. The proposal entails that the only law applicable to cross-border transaction avoidance will be the EU harmonised rules, which content will be discussed in section 5 of this article. This should increase the predictability of the outcome of the disputes arising in the insolvency context.

It is acknowledged that the proposal still displays some degree of uncertainty in the sense that, theoretically, it provides two possible laws applicable to transaction avoidance. However, once the transaction is characterised as either domestic or cross-border, the problem of the duplicity of law applicable should be resolved.

Moreover, such duplicity would still account as an improvement of predictability in comparison with the current situation. Indeed, within the current system, there are twenty-seven laws potentially applicable to the vulnerable transaction because there are twenty-seven EU Member States. At the same time, the duplicity of laws is intentional as it embodies an attempt to balance the necessity of legal certainty in cross-border scenarios with local particularisms. Indeed, the partial harmonisation seeks to allow the member states to address local concerns when the disputes over the vulnerable transactions have a domestic character.

Second, a partial harmonisation may foster the convergence of the transaction avoidance regimes of the EU member states. The convergence of laws is the

alignments of policies and regulations among different legal systems.<sup>111</sup> It may be induced by competition and emulation among legal systems, by international economic integration, or by a centralised harmonisation of laws.<sup>112</sup>

The development and the implementation of supernatural regulation on transaction avoidance may spring the debate on the policy issues underpinning the EU and national rule on the topic. In turn, such a foreseen academic and jurisprudential debate may create a fertile ground for a future complete harmonisation. Alternatively, the legal discourse and the possible consequent legal reforms may bring the topic to a convergence among the member states' policies as far as rendering unnecessary a further harmonisation.<sup>113</sup>

Third, the proposal respects the principles of subsidiarity and proportionality, which are two cardinal principles of the EU.<sup>114</sup> Concerning the principle of subsidiarity, article 5 TEU provides that in areas of non-exclusive competences, the centralised action of the EU institutions is permitted only 'insofar the objectives of the action cannot be sufficiently achieved by the member states.'<sup>115</sup> Indeed, the objective of the proposed harmonisation is to regulate cross-border transaction avoidance in order to enhance legal predictability. This could not be achieved sufficiently at the national level.

More remarkably, it can be argued that a proposal of partial harmonisation is a more proportionate response to the current issue of transaction avoidance than a proposal of total harmonisation. Under article 5 TEU, the EU legislative intervention must not go beyond 'what is necessary to achieve the objective of the treaties.'<sup>116</sup>

Partial harmonisation balances the objective of safeguarding the proper functioning of the internal market,<sup>117</sup> with the respect for local differences. In comparison with the

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<sup>111</sup> Ian F. Fletcher, 'Perspectives on Harmonisation of Insolvency Law in Europe' in Ian F. Fletcher and Bob Wessels, *Harmonization of Insolvency Law in Europe*, Report for the Netherlands Association of Civil Law 2012 107, 108.

<sup>112</sup> *Ibid.*, Eva Lohse (n 9) 291.

<sup>113</sup> Similar phenomenon can be appreciated in competition law. See Kati Cseres, 'Comparing Law in Enforcement of EU and National Competition Laws' (2010) 3 *Eur. J. Leg. Stud.* 7.

<sup>114</sup> See Paul Craig and Grainne De Búrca, *Eu Law: Text, Cases and Materials* (6<sup>th</sup> edn. Oxford University Press 2015) 171 ff.

<sup>115</sup> Consolidated Version of the Treaty on European Union (TEU) [2008] OJ C115/13, Article 5.

<sup>116</sup> *ibid.*

<sup>117</sup> *ibid.* Article 3.



proposal of total harmonisation, it constitutes a less invasive measure within the national legal system, leaving some room for manoeuvre to the national legislator regarding domestic disputes.

On the other side, the proposal can be subject to some criticism. It is acknowledged that the current proposal is based on complex legal reasoning. As a preliminary step, it requires to identify the cross-border character of the transaction. Secondly, it entails the appraisal of the law that theoretically would apply to the transaction. In particular, the second step requires an in-depth assessment of the limits to the party autonomy imposed by the proposal. Only then the harmonised rules will apply.

However, judges should be familiar with the legal reasoning behind the EU principles of PIL. Moreover, it is suggested that PIL mechanism within the insolvency regulation should be supported by the reference to the principles of the Rome I Regulation. This reference not only should resolve the issues of vagueness and uncertainty of the current Article 16 EIR, but also provide clarity and predictability in the application of the proposed compromise.

#### **4. How to Implement the Proposal**

As the proposal entails a combination of two approaches (i.e. PIL rules and harmonised substantive rules), its implementation requires a two-step procedure. First, the PIL provision of Article 16 EIR(R) should be reformed. Second, the substantive rules on transaction avoidance should be designed and implemented through a regulation.

On the one side, Article 16 EIR(R) should be reformed to implement new PIL rules. In particular, the text of the provision could resemble the following:

Regulation n xx/20yy on harmonised transaction avoidance rules shall apply to cross-border transactions.

Transactions are deemed to be cross-border transactions where at least one of the parties to the transaction have their habitual residence or centre of main interest in a member state other than where the proceedings are opened or when the law applicable to the transaction is different from the law of the opening of the proceedings

For the purposes of paragraph 2, the law applicable to the transaction shall be identified with reference to Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I).

The harmonised rules on transaction avoidance shall be deemed mandatory rules from which parties cannot choose to derogate. On the other side, substantive rules should be implemented in a separate instrument. As expressly mentioned in the model PIL rules, such an instrument should be a regulation. The EU institutions can enact legislation either through regulations or directives.<sup>118</sup> Article 114 on the Treaty of the Functioning of the European Union (TFEU) specifies that ‘the measures for the approximation of the provisions laid down by law’ (i.e. harmonising instruments) should be adopted according to the ordinary legislative procedure (OLP).<sup>119</sup> Both regulations and directives can be adopted by means of the (OLP).<sup>120</sup>

Regulations are legislative acts that are entirely binding and directly applicable.<sup>121</sup> Regulations have the benefit of not requiring a national enactment and therefore provide a speedier implementation of legislation.<sup>122</sup> At the same time, they are rigid legislative measures that cannot easily be used to implement procedural and substantive rules in the disparate legal and procedural settings of the member states.<sup>123</sup>

In contrast, directives are binding only regarding the goals and objectives to be achieved while they allow the member states to choose the form and method of implementation.<sup>124</sup> Therefore, they require the member states to enact national legislation to implement the directive’s content.<sup>125</sup> Directives display the advantage to

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118 TFEU (n 67) Article 288.

119 *ibid* Article 114.

120 *ibid* Article 294.

121 Craig and De Búrca (n 114) 107.

122 *ibid*.

123 *ibid* 108

124 *ibid*.

125 *ibid*.

be flexible.<sup>126</sup> They allow adjusting the form and method of implementation according to the political, administrative and social framework of the individual member states.<sup>127</sup>

However, leaving space of action to the national legislators often means that the implementation of the rules is delayed, sometimes considerably.<sup>128</sup> In addition, directives lack the so-called horizontal direct effect.<sup>129</sup> The principle of direct effect provides that EU law is directly applicable to the member states and confers rights and obligation to the EU citizens.<sup>130</sup> The direct effect qualifies as either vertical, which concerns the relationship between the state and the individual, or horizontal, which relates to the relationship among private individuals.<sup>131</sup>

It is established that directives may have vertical direct effect when – after their time-limit for implementation has expired- they are sufficiently clear, precise and unconditional.<sup>132</sup> In contrast, directives do not have horizontal direct effect because they are binding only for the member states which they are addressed to.<sup>133</sup>

In the case of non-transposition of a hypothetical harmonising directive, private individuals would not be able to rely on the harmonised rules. The issue of non-transposition, combined with the lack of horizontal, direct effect has the potential to create discrimination issues among the citizens of different member states. Moreover, it would undermine the scope of the harmonisation disrupting the goal of uniformity and predictability.

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<sup>126</sup> *ibid.*

<sup>127</sup> *ibid.*

<sup>128</sup> Gerda Falkner, Oliver Treib, and others, *Complying with Europe: EU Harmonisation and Soft Law in the Member States* (Cambridge University Press 2005) 12.

<sup>129</sup> Case 152/84 *Marshall v Southampton & South West Hampshire Area Health Authority* ECLI:EU:C:1986:84, [1986] ECR I-00723.

<sup>130</sup> Case 26/62 *NV Algemene Transport- en Expeditie Onderneming van Gend & Loos v Netherlands Inland Revenue Administration* ECLI:EU:C:1963:1 [1963] ECR English special edition 00001.

<sup>131</sup> Elspeth Berry, Matthew Homewood and Barbara Bogusz, *EU Law* (3<sup>rd</sup> edn Oxford University Press 2017) 118.

<sup>132</sup> Case 26/62 (n 130); Case 9/70 *Franz Grad v Finanzamt Traunstein* ECLI:EU:C:1970:78, [1970] ECR I-00825; Case 41/74 *Yvonne van Duyn v Home Office* ECLI:EU:C:1974:133, [1974] ECR I-01337; Case 148/78 *Pubblico Ministero v Ratti* ECLI:EU:C:1979:110, [1979] ECR I-01629.

<sup>133</sup> Case 8/81 *Ursula Becker v Finanzamt Münster-Innenstadt* ECLI:EU:C:1982:7 [1982] ECR I-00053.

Additionally, the indirect nature of the directives gives rise to a risk of improper transposition.<sup>134</sup> In the context of transaction avoidance, where similar claims are already regulated at the national level, the risk of improper transpositions seems to be significant.<sup>135</sup> Because the member states already have an internal regulation concerning transaction avoidance, they may end up infusing their national doctrines and approaches into the transposed harmonised rules.

This possibly biased implementation would undermine the uniform application of the harmonised rules. Although there are examples of stricter directives that dictate the details of the rules to be put in place,<sup>136</sup> such use of directives has been severely criticised.<sup>137</sup> Moreover, the issues of risk of late transposition and lack of horizontal direct effect are intrinsic characteristics of directives, which make them a non-ideal instrument of harmonisation.<sup>138</sup>

A regulation, therefore, seems the most appropriate instrument to implement harmonised rules.<sup>139</sup> However, the rigidity of the legislative instrument should be taken into careful consideration in formulating the substantive rules. Indeed, these need to be able to fit within different insolvency law frameworks.

Most likely, the suitability of EU rules could be assessed through the regulatory policy of *better regulation*. Better regulation encompasses 'strategic planning, impact assessment, consultation and evaluation'<sup>140</sup> In particular, a series of consultation with the major stakeholders (such as businesses, insolvency practitioners, judges) may help adjust the content of the rules to a neutral character that fits within different legal systems.<sup>141</sup>

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<sup>134</sup> Bernard Steunenberg, 'Turning Swift Policy-making into Deadlock and Delay: National Policy Coordination and the Transposition of EU Directives' (2006) 7 Eur. Union Politics 293.

<sup>135</sup> Robert Thomson, 'Same Effects in Different Worlds: the Transposition of EU Directives' (2009) 16 J. Eur. Public Policy 1.

<sup>136</sup> E.g. Directive 2000/36/EC of the European Parliament and of the Council of 23 June 2000 relating to Cocoa and Chocolate Products Intended for Human Consumption OJ L 197, 03.08.2000, 19.

<sup>137</sup> Mgr Bartłomiej Kurcs, 'Harmonisation by Means of Directives – Never-ending Story?' (2001) 12 EBLR 287, 290.

<sup>138</sup> *ibid.*

<sup>139</sup> Keay I (n 8) 91.

<sup>140</sup> Elisabeth Golberg, 'Better Regulation: European Union Style' 2018 M-RCBG Associate Working Paper Series No. 98, 3 < <https://www.hks.harvard.edu/centers/mrcbg/publications/awp/awp98>> accessed 27.10.2020.

<sup>141</sup> *ibid.* 96.

Such a Regulation could find its legal basis in Article 4 TFEU, which described the sphere of competences the EU shares with the member states.<sup>142</sup> In particular, Article 4 TFEU specifies that the EU has shared competences concerning the ‘economic, social, and territorial cohesion’.<sup>143</sup> The proposed regulation on partially harmonised transaction avoidance rules seeks to enhance the economic cohesion within the internal market through a reform that improves legal certainty in cross-border insolvencies.

## 5. The Substantive Harmonised Rules on Transaction Avoidance

This study seeks to put forward a blueprint for substantive harmonised rules to apply exclusively to cross-border scenarios. The proposal of harmonisation is limited to three most common types of claims: preferences, transactions at an undervalue and transactions detrimental to creditors. Before discussing the possible content of such hypothetical provisions, two preliminary issues must be considered. First, the study considers which acts or transactions fall within the scope of application of the harmonised rules. Second, it examines the element of insolvency as a prerequisite of the harmonised claims.

Concerning the first issue, the concept of a legal act must be clarified. Currently, there is no common legal theory of legal acts in the European Union.<sup>144</sup> On the one side, continental civil law countries generally have their own legal theories of what a legal act is.<sup>145</sup> On the other side, the concept is alien to the common law system of the U.K. Although the concept is used within the English version of the EIR, it is not an original concept of English law, and it lacks a solid legal theory behind it.<sup>146</sup> Moreover, the English insolvency system refers to legal transactions rather than legal acts.<sup>147</sup> However, in the English language, the terms are synonyms.<sup>148</sup>

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<sup>142</sup> TFEU (n 67) Article 4.

<sup>143</sup> *ibid.*

<sup>144</sup> Jaap Hage, ‘What is a legal Transaction?’ in Del Mar and Bankowski (eds.), *Law as Institutional Normative Order* (Ashgate 2009) 103 ff.

<sup>145</sup> *ibid.*

<sup>146</sup> *ibid.*

<sup>147</sup> Insolvency Act (n 39) Sections 238 and 423.

<sup>148</sup> Hage (n 144)

As mentioned, the concept of the legal act is used in Article 7(m) and 16 EIR(R). The application of the concept is left to the theoretical framework of the member states. In particular, the consideration of whether the facts of a case constitute a legal act belongs to the court opening the insolvency proceedings, which applies the national doctrine to the facts of the case. This approach may seem problematic in the application of the harmonised rules. Depending upon the theoretical framework applied, certain acts could escape the scope of application of the harmonised rules.

However, there have been attempts to define a legal act that abstracts from the specific regulation of the national law. The legal act (i.e. legal transaction, *Rechtsgeschäft*, *atto giuridico*) can be intended as ‘the means by which legal subjects can change the legal position of themselves or other persons.’<sup>149</sup> Such a definition is very broad as to encompass a great variety of acts by which the legal transaction can be performed. Therefore, it can be used in the context of transaction avoidance to enhance the scope of the application of the harmonised rules.

The second issue in the formulation of the content of the substantive transaction avoidance rules is the determination of insolvent status.<sup>150</sup> Generally, in the application of transaction avoidance claims, the vulnerability of the transactions depends upon the debtor’s insolvent status. In the countries analysed in this study, this objective element is generally required for transactions at an undervalue and preferences.<sup>151</sup> In contrast, the element is not generally encompassed in transactions detrimental to creditors.<sup>152</sup>

The requirement of the debtor’s insolvency in transactions at an undervalue, and preferences is relevant in safeguarding the principle of contractual finality (legal certainty of the transaction).<sup>153</sup> Indeed, it limits the application of the avoidance rules to those transaction undertaken in the deviant circumstances of insolvency. However, in the formulation of the harmonised rules, the establishment of insolvency can be troublesome as the member states do not apply a single approach to it.<sup>154</sup>

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<sup>149</sup> *ibid.*

<sup>150</sup> Keay II (n 8) 95.

<sup>151</sup> See *supra* Section 7.3.2.1.

<sup>152</sup> *ibid.*

<sup>153</sup> de Weijis (n 8) 222.

<sup>154</sup> Keay (n 8) 95-96.

For the purposes of the current proposal, the cash flow test should be used as it allows an easier and more precise determination of the insolvency status.<sup>155</sup> Under this approach, a transaction could and should be challenged if at the time it was undertaken, the debtor was unable to meet their debts as they fall due or became unable as a result of the transaction.<sup>156</sup>

### **5.1. Transactions at an Undervalue**

A harmonised provision on transactions at an undervalue should seek to restore the insolvency estate when a transaction is undertaken by the debtor and a third party and where the third party had provided no consideration or a consideration considerably below market value. The provision should seek to balance the interest of the integrity of the insolvency estate with the principles of legal and contractual certainty.<sup>157</sup> This balancing exercise can be achieved through the restoration of the integrity of the estate as if the transaction had not taken place with some adjustments that safeguard the contractual position of the third party.

On the one hand, the restoration of the estate depends upon the legal consequence of the claim. In practice, it can be achieved in two ways. Under a first approach, the claim of transactions at an undervalue could reverse the transaction through the imposition on the counterparty of a duty to restore the assets to the insolvency's estate.<sup>158</sup>

This approach may interfere with the different regimes concerning property rights adopted in the member states, which often reflect legal-political choices of the member states.<sup>159</sup> Such interference may, therefore, undermine the results of harmonisation as the legal consequences of the claim may depend upon the legal theories adopted by the member states in regard to property rights.

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<sup>155</sup> Kubi Udofia, 'Establishing Corporate Insolvency: The Balance Sheet Insolvency Test (March 19, 2019). Available at SSRN: <https://ssrn.com/abstract=3355248> accessed 27.10.2020.

<sup>156</sup> *ibid.*

<sup>157</sup> de Wejs (n 8) 221.

<sup>158</sup> John Armour and Howard Bennet (eds) *Vulnerable Transactions in Corporate Insolvency* (Hart 2003) para 2.127.

<sup>159</sup> Bram Akkermans, 'The European Union Developments of European Property Law,2 < [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1888294](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1888294)> accessed 27.10.2020.

At the same time, the counterparty might have a claim against the insolvency's estate for the amount performed under the vulnerable transaction. The issue, in this case, would be the rank of the counterparty's claim in the distribution. The ranking of the claims in insolvency is a matter close to the political and national interests of the estate.<sup>160</sup>

Such an approach may, therefore, have two drawbacks. On the one side, its interference with the national regimes and interests may cause political resistance in the implementation of the rules. On the other side, even if the controversial rule could be adopted, its consistent application throughout the member states might be undermined by the different legal regimes of the member states.

Under the second approach, the third party should be required not to restore the assets but to pay the difference between the amount paid and the market value of the assets at the time the transaction took place.<sup>161</sup> Such an approach provides a simpler solution that could be more easily achieved throughout the EU member states.

The suspect period should be relatively short in order to facilitate the judges' assessments.<sup>162</sup> As de Wejis suggests, the suspect period for transactions at an undervalue could be of one year from the moment of the opening of the proceedings.<sup>163</sup> Additionally, it could be extended to two years for related parties, which identity would be later discussed.

On the other hand, the balance between the interests at stake requires to consider whether subjective criteria should be adopted in relation to either of the parties of the transaction. The application of the subjective criteria is problematic in practice. It requires the judge to investigate the intention of the parties which can only be inferred from factual elements that are up to interpretation. In order to keep the legal reasoning as linear as possible and avoid disparities of treatment depending upon the legal

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<sup>160</sup> Federico M. Mucciarelli, 'Not Just Efficiency: Insolvency Law in the EU and Its Political Dimension' (2013) 14 EBOR 175, 180.

<sup>161</sup> *Walker v WA Personnel Ltd* [2002] BPIR 621

<sup>162</sup> *Keay II* (n 8) 100.

<sup>163</sup> *de Wejis* (n 8) 226.



traditions of the courts, the most suitable solution would be to disregard the subjective criteria in transactions at an undervalue.<sup>164</sup>

It can be argued that an objective approach is more efficient both in terms of resources and time spent by the insolvency practitioner on the matter. However, at the same time, a completely objective approach would put the counterparty of the transaction in a limbo of legal uncertainty for one year after the transaction.<sup>165</sup> To temper the legal uncertainty, the counterparty could be equipped with a defence that adopts some subjective elements.<sup>166</sup>

The counterparty could prove that they were unaware of the debtor's factual insolvency at the time of the transaction. Such defence should be argued according to national, international and cross-border business practices. This approach should limit the defence to those circumstances where the counterparty could not have known of the insolvency. In contrast, the party should not be allowed to escape the application of the provision when they should have been aware of the insolvency had they made the proper enquires.

The possible harmonised provision on transactions at an undervalue could be formulated as follows:

#### **Article 1. Transactions at an undervalue**

Any cross-border legal transaction undertaken by the debtor with a counterparty where the debtor has received no consideration or a consideration significantly below market value can be challenged by the insolvency practitioner.

The transaction can be challenged if concluded in the year prior to the request of the opening of the insolvency proceedings. The period shall be extended to two years if the counterparty to the transaction is a party related or connected to the debtor.

The consideration at market value due at the time of the transaction shall be restored to the insolvency estate by the counterparty.

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<sup>164</sup> *ibid*, Keay II (n8) 97 ff.

<sup>165</sup> *ibid*.

<sup>166</sup> Keay (ii) 98.

In any case, the transaction is valid and unaltered if the counterparty proves that they were not aware of the factual insolvency of the debtor.

## **5.2. Unfair Preferences**

The harmonised provision on preferences should challenge transactions that occurred between the insolvent debtor and one or more of their creditors before the opening of the insolvency proceedings. Not all transactions occurred at the eve of insolvency proceedings should be challenged as this would paralyse the activity of businesses. The only transactions that should be challengeable are those that place the creditor in a better position than the one they would have been in the statutory distribution.

The limitation of the scope of application of the provision can be reached by either subjective criteria (as it is in England<sup>167</sup>) or by objective criteria (as it is in Germany<sup>168</sup>). However, the adoption of subjective criteria at the EU level may lead to difficulties in challenging the preferential transactions and inconsistencies of application. It is possible and preferable that a harmonised rule on preferences is based on exclusively objective criteria.

The limitation of the scope of application of the provision can be achieved by qualifying the situation in which the vulnerable transaction is undertaken and the transaction itself. First, the application of the provision can be limited by the requirement of factual insolvency. The only transactions that should be challenged are those that had occurred when the debtor was already factually insolvent. This limitation reflects the exceptional nature of preferences a rule instrumental to the collective purposes of insolvency. At the same time, it also limits the applicability of the rule to exceptional circumstances, supporting legal certainty of the transactions concluded under normal business life.<sup>169</sup>

Second, the scope can be limited by qualifying the transaction that can be challenged. The only transactions that should be challenged should be those that produce an unfair result. In other words, the provision should challenge the transaction in which the parties attempt to contract out of the insolvency regulation. This can be easily

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<sup>167</sup> Insolvency Act (n 39) Section 239.

<sup>168</sup> InsO (n 40) Section 130 and 131.

<sup>169</sup> Keay II (n 8) 95.

achieved by looking at the terms of the original agreement between the debtor and the creditor. When the transaction at the eve of insolvency deviates from the time and manner, in which the obligation should have been performed, then it should be challengeable.

Alternatively, when the parties do not specify the terms of the obligation, the insolvency practitioner and the courts could refer to the practices of the ordinary course of business to determine whether the transaction produces an unfair result. The latter criterion has been adopted as a possible defence in case of preferential transactions in the U.S. Bankruptcy Code.<sup>170</sup> Under the current proposal, the criterion might be used to establish whether the transaction can be deemed an anomaly, and therefore, vulnerable.

The granting of security as a form of preference may be a problematic aspect of preferences.<sup>171</sup> Indeed, security rights are not harmonised at the EU level. Therefore, every member state presents substantially different security rights. Before a possible harmonisation of the security rights at the EU level, a harmonised rule on preference should seek to challenge all those securities rights qualified as such by national law that (i) are granted within the suspect period; (ii) when the debtor was already factually insolvent; and that (iii) ameliorate the position of the creditor in the distribution system.

Third, the application of the provision on preferences should be limited in time. The suspect period should be limited to six months prior to the opening of insolvency proceedings. Eleven out of twenty-eight member states already adopt such timeframe for preference,<sup>172</sup> suggesting that six months may provide a reasonable balance between the interest of the insolvency proceedings and the principle of legal certainty.

Additionally, the provision on preference, like the one on transactions at an undervalue, should address related party, for which the suspect period could be increased to one year. The provision should also safeguard payment and securities granted for purposes of refinancing. Both of this topic will be dealt with in section 8.5.4.

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<sup>170</sup> U.S. Bankruptcy Code, Title 11, Section 547.

<sup>171</sup> Gerard McCormack and Reinhard Bork (Eds.), *Security Rights and the European Insolvency Regulation* (Intersentia 2017).

<sup>172</sup> McCormack, Keay and Brown (n 8) 143 ff.

Concerning the effects of the challenge, the claims should put the creditor in the position it would have been if the transaction had not taken place. It is suggested that such a result could be achieved as for transactions at an undervalue with the payment by the creditor to the insolvency estate of what received from the debtor. Similarly, the securities granted should be made invalid by a court ruling. The possible harmonised provision on preference could be formulated as follows:

### **Article 2. Preference**

Any cross-border legal transaction undertaken by the debtor with one or more of their creditors shall be challenged when:

- (i)* The transaction was undertaken within six months prior to the opening of the proceedings;
- (ii)* The debtor was factually insolvent at the time the transaction was undertaken;
- (iii)* The transaction provided payment or security for a previously established debt in a manner that is not compliant with the terms of the original transaction between the debtor and the creditor or with the practices of the ordinary course of business.

The creditor shall restore its position as it would have been had the transaction not occurred.

The creditor benefitting from the transaction can prove that they were not aware of the factual insolvency of the debtor at the time the transaction occurred.

The terms of paragraph 1.1. shall be extended to 1 year when the transaction is undertaken by the debtor with one or more related parties.

### **5.3. Prejudicial Transactions to Creditors**

Prejudicial transactions to creditors should address transactions undertaken by the debtor with the intention to prejudice the creditors. This could be deemed a residual provision as it seeks to challenge those transactions that are prejudicial to the creditors, although not necessarily at an undervalue or preferential. Like Germany and

Italy, most member states provide for a provision of transaction defrauding creditors based on the Roman *actio pauliana*.<sup>173</sup>

Based on the common Roman tradition, a harmonised provision on transaction prejudicing creditors should encompass: (i) the prejudice to the creditors; (ii) the prejudicial intention of the debtor and; (iii) the third-party awareness of the prejudice.<sup>174</sup> Therefore, these three elements should be considered individually.

The concept of prejudice relates to the potential financial loss the creditors could suffer because of the debtor transaction. Although such prejudice can take place in different forms, in practice, it should be deemed realised when the debtor alters the assets available for future potential distribution to the creditors.

The prejudice should be deemed to take place when the debtor alters their estate in a way that makes it more difficult for their creditor to successfully claim and enforce their rights against the insolvency's estate. However, the prejudicial outcome should be challenged and reversed only when accompanied by the debtor's intention to prejudice. Such a limitation to the scope of application of the provision appears necessary to ensure the contractual freedom of the debtor.<sup>175</sup>

As it has already been remarked, the subjective criteria find difficult application in practice. Therefore, it is suggested that the prejudicial intention of the debtor could be anchored to more ascertainable elements. In this context, the German experience provides some insight in designing the prejudicial intention in the harmonised provisions.<sup>176</sup> Within the concept of intention, the German system encompasses the so-called *dolus eventualis*.<sup>177</sup>

This mental element is a concept that can be placed between intention and awareness. It can be understood as the mental position of someone who knows the effects of their actions; they do not necessarily seek them but nevertheless undertakes the act and accept the foreseen effects. Such an extension of the concept of intention

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<sup>173</sup> McCormack (n 8)159; S.H.A.M. Hendrix, *Transaction Avoidance in Insolvency Law: Past, Present and Future of the Actio Pauliana* (CELSUS 2019)

<sup>174</sup> Hendrix (n 173) 125.

<sup>175</sup> Ilaria Pretelli, *Cross- Border Credit Protection against Fraudulent Transfer of Assets: Actio Pauliana in the Conflict of Laws* (2011) 13 Yearbook of Private International Law 589, 600.

<sup>176</sup> Bachner (n 54) 69.

<sup>177</sup> *ibid.*

allows a simpler regime of proof for insolvency practitioners. Indeed, they will only have to prove that the debtor was aware that the transaction would have prejudiced the creditors, but they recklessly undertook the detrimental transaction.

Moreover, the harmonised provision should take into consideration the position of the counterparty of the transaction as their interests need to be balanced against the interests of the insolvency's estate.<sup>178</sup> The general interest of the counterparties is to be able to rely on the contractual finality of the transaction and not to be put in a worse position.<sup>179</sup> Therefore, in support of the principle of legal certainty, the provision should target only those transactions where the counterparty was aware of either the intention of the debtor or its financial situation.

It would be burdensome for the insolvency practitioner to prove that the counterparty was aware of the debtor's intention. It could be sufficient to require the counterparty to be aware of the debtor's factual insolvency. The latter could be more easily inferred from factual clues by both the counterparty first and the insolvency practitioner at the later stage.

Additionally, as subjective criteria already limit the scope of application of the provision, the time limitations can be more relaxed than the other provisions. The suspect period could be of five years from the opening of the proceedings, extended to ten years in case of transactions concluded with related parties. Currently, the suspect periods in the member states range from six months in Malta to 10 years in Germany.<sup>180</sup> The period of five years seems reasonable in balancing the interest of the insolvency with the principle of contractual finality.

The effects of the claim should be similar to those provided for transaction at an undervalue and preferences. Therefore, the counterparty should be asked to restore the debtor's estates to the position it would have been if the transaction had not taken place. The party should be asked to repay to the estate the amount that has exited the debtor's estate at the expenses of the creditors.

### **Article 3. Transactions Detrimental to Creditors**

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<sup>178</sup> Pretelli (n 175) 617.

<sup>179</sup> de Weijts (n 8) 221

<sup>180</sup> McCormack (n 8) 160.

Any transaction undertaken by the debtor with 5 years before the opening of the proceedings shall be challenged when:

- (i) the debtor intended to prejudice their creditors or was aware that the transaction would have prejudiced the creditors and;
- (ii) one or more creditors are worse off in the exercise of their claims against the debtor because of the transaction;
- (iii) the counterparty was aware of the factual insolvency of the debtor.

In these circumstances, the counterparty of the prejudicial transaction shall restore the debtor's estate the amount it would have been within the estate if the transaction had not taken place.

#### **5.4. Miscellaneous**

As it was necessary to provide some preliminary consideration about the concepts of insolvency and legal transactions, the proposal needs to address a few residual points. First, the study needs to address the concept of related parties, which are parties that are related, connected or associated with the insolvent debtor.<sup>181</sup>

Their particular relationship with the debtor places them in a position of advantage in comparison to the other parties of the insolvency. On the one hand, they generally have access to more information than the other parties involved in the insolvency proceedings. Secondly, potentially, they have more opportunities to manipulate the circumstances or collude with the debtor to profit from the debtor's insolvency or at least limit its negative impact on them.<sup>182</sup>

Almost all member states provide different definition or lists of subjects that can be included in the category.<sup>183</sup> The present study puts forward a list -inspired by the English approach to related parties<sup>184</sup>:

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<sup>181</sup> Ibid 137.

<sup>182</sup> Ibid 138.

<sup>183</sup> Ibid.

<sup>184</sup> Parry, Ayliffe and Shivji (n 57) para 4.142.

#### **Article 4. Related parties**

- a. The debtor's spouse or registered civil partner at the time of the transaction;
- b. A debtor's relative intended as lineal and collateral ascendants and descendants including parents, grandparents, siblings, aunts and uncles, nephews and nieces and first degree cousins;
- c. A relative (as intended in point b) of the debtor's spouse or civil partner;
- d. The spouse or civil partner of a relative of the debtor's spouse or civil partner;
- e. A member of a partnership with the debtor or with their spouse or civil partner;
- f. The debtor's employee or employer;
- g. The trustee or beneficiary of a trust or analogous relationship where the debtor is involved;
- h. The directors or shadow directors of the insolvent company (the debtor);
- i. A company under the control of the debtor or of their related parties;
- j. A company member of the same group of companies as the insolvent company;
- k. The directors or shadow directors of a company member of the same group of companies as the insolvent company;
- l. A party related to the director of a company member of the same group of companies of the insolvent company.

The list should be deemed not exhaustive and could be expanded by the CJEU, where reasons of foreseeability and fairness require. The expansion would support the maximum coverage of parties that have the potential to disrupt the efficient development of the insolvency proceedings.

The other topic that the study needs to address is refinancing, which is particularly relevant in the application of transaction at an undervalue and preference. Refinancing



(i.e. new and interim financing) is the finance provided in support of restructuring plans in order to avoid liquidation and allow the debtor to continue the business.<sup>185</sup>

The refinancing is potentially at odds with transaction avoidance.<sup>186</sup> The new financing generally occurs either within insolvency or in pre-insolvency scenarios where the debtor is already in financial distress. The awareness of such circumstances allows the new financier to protect themselves from the risk of insolvency with securities that will affect the distribution in case of future insolvency proceedings.<sup>187</sup> Nevertheless, it is commonly acknowledged that refinancing should be safeguarded from the application of transaction avoidance.<sup>188</sup> Otherwise, the businesses in financial distress would risk underinvestment issues or would have to face higher borrowing costs.<sup>189</sup>

The issue is recognised in the Directive on restructuring and insolvency.<sup>190</sup> Article 17 and 18 of the proposal of the Directive provide for the protection of new and interim financing. Article 17 specifies that new and interim financing should be encouraged and protected unless additional grounds are provided by the national law.<sup>191</sup> The text has been slightly modified from the original proposal. The proposal suggested that the financing should be protected unless realised fraudulently or in bad faith.<sup>192</sup>

For consistency purposes, the proposal suggests adopting the same rules with minor adjustments due to the nature of the measure proposed (i.e. a regulation). Moreover, it seeks to keep the exception of bad faith encompassed in the proposal of the directive as it is more specific than the current provision that ground the exception on additional generic grounds provided by the national law.

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<sup>185</sup> Commission Recommendation of 12 March 2014 on a new approach to business failure and insolvency, III, 6(e).

<sup>186</sup> Roland de Weijts, Evert J.R. Verwey and Others, 'Financing in Distress Against Security from an English, German and Dutch Perspective: a Walk in the Park or in a Mine Field?' (2012) 3 IIR 21.

<sup>187</sup> Aurelio Gurrea-Martinez, 'The avoidance of Pre-Bankruptcy Transaction: an Economic and Comparative Approach'(2018) Chi.-Kent. L. Rev 711.

<sup>188</sup> *ibid.*

<sup>189</sup> *ibid* 722.

<sup>190</sup> Directive 2019/1023 of the European Parliament and of the Council of 20.06.2019 on Preventive Restructuring Frameworks, on Discharge of Debt and Disqualifications, and on Measures to Increase the Efficiency of Procedures Concerning Restructuring, Insolvency and Discharge of Debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency).

<sup>191</sup> *ibid* Article 17.

<sup>192</sup> Proposal for a Directive of the European Parliament and of the Council on Preventive Restructuring Frameworks, Second Chance and Measures to Increase the Efficiency of Restructuring, Insolvency and Discharge Procedures and Amending Directive 2012/30/EU COM/2016/0723 final - 2016/0359 (COD)

## **Article 5. Protection for new and interim financing and other restructuring-related transactions**

Transactions that are reasonable and immediately necessary for the negotiation of a restructuring plan shall not be subject to the harmonised rules on transaction avoidance unless such transactions have been carried out fraudulently or in bad faith.

Transactions carried out to further the negotiation of a restructuring plan confirmed by a judicial or administrative authority or closely connected with such negotiations are not subject to the harmonised rules on transaction avoidance in the context of subsequent insolvency procedures, unless such transactions have been carried out fraudulently or in bad faith.

Transactions enjoying the protection referred to in paragraph 1 shall include:

- a) the payment of fees for and costs of negotiating, adopting or confirming a restructuring plan;
- b) the payment of fees for and costs of seeking professional advice closely connected with the restructuring;
- c) the payment of workers' wages for work already carried out without prejudice to other protection provided in Union or national law;
- d) any payments and disbursements made in the ordinary course of business other than those referred to in points (a) to (c).

Transactions that are reasonable and immediately necessary for the implementation of a restructuring plan, and that are carried out in accordance with the restructuring plan confirmed by a judicial or administrative authority, or closely connected with such implementation shall not be declared void, voidable or unenforceable as an act detrimental to the general body of creditors in the context of subsequent insolvency procedures, unless such transactions have been carried out fraudulently or in bad faith, irrespective of whether such transactions were deemed to be in the ordinary course of business.

## 6. Harmonised Rules of Transaction Avoidance outside Insolvency Proceedings

England, Germany and Italy provide for a claim of transaction avoidance also outside the framework of insolvency law.<sup>193</sup> Similarly, most European Union member states encompass this type of claims within their domestic regulation.<sup>194</sup> In particular, almost all member states provide for a claim to be brought by a creditor against a third party that seeks to set aside a transaction made between the debtor and a third party that frustrates the enforcement of the creditor's rights.<sup>195</sup>

Additionally, the EU private international law system has struggled to deal with this type of claims.<sup>196</sup> For a long time, the so-called *actio pauliana* was deemed outside the scope of application of Rome I and Rome II.<sup>197</sup> Therefore, the determination of the law applicable to these claims was left to domestic private international law rules of the member states, without a homogenous regulation at the EU level.<sup>198</sup>

Recently, the CJEU has revised the issue, deciding that this type of action is governed by the Rome I Regulation.<sup>199</sup> Accordingly, the law applicable to the claim will be the law governing the contract between the debtor and the creditor who seek to set aside the transaction between the debtor and the third party. This new approach undermines the legal certainty for the third party. Indeed, the third party cannot foresee the law applicable to their own transaction as this is determined with reference to a contract they are not part of. Consequently, they cannot foresee whether their transaction would stand against this type of claims.

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<sup>193</sup> Insolvency Act () Section 423; Anfechtungsgesetz of 20 May 1879 (RGI 277). *Italian Civil Code* Articles 2901-04.

<sup>194</sup> Kristin Van Zwieten, 'Related Party Transactions in Insolvency' (2018) 401 ECGI Working Paper Series in Law, 6.

<sup>195</sup> *ibid* 10.

<sup>196</sup> Casasola (n 1).

<sup>197</sup> Joaquín J. Forner Delaygua, 'Derecho Europeo: La acción Pauliana bajo el TJCE (una opinion discrepante de *Reichert II*) in Forner Delaygua (ed), *La protección del crédito en Europa: La acción Pauliana* (Bosh 2000) 144.

<sup>198</sup> *ibid*; Laura Carballo Piñeiro, 'Acción Pauliana e Integración Europea: Una Propuesta de Ley Aplicable' (2012) 54(1) *Revista Española de Derecho Internacional* 43, 46; Pretelli (n 175) 629.

<sup>199</sup> Case C-337/17 *Feniks Sp. z o.o. v Azteca Products & Services SL* [2018] ECLI:EU:C:2018:805.

At the same time, if the approach of the CJEU was to change under Rome II, the law applicable could be the law governing the vulnerable transaction between the debtor and the third party. Also this approach, however, would be problematic in practice. The creditor who brings the claim is an external party to the vulnerable transaction. Therefore, it would be difficult to determine which law is applicable to the vulnerable transaction.<sup>200</sup>

The proposal for the harmonisation of transaction avoidance could be useful in solving the impasse created by the private international law approach. In particular, it can enhance the legal certainty for all the parties involved in the claim. The provision on prejudicial transactions to creditors proposed in this study could be extended to circumstances outside the insolvency framework. Indeed, the proposed provision is modelled on the Roman tradition, and there are similar provisions in several member states inside and outside the insolvency framework.<sup>201</sup>

### **6.1. When does the Harmonised Rule on Transactions Detrimental to Creditors Apply outside Insolvency Proceedings?**

The harmonised rule transactions detrimental to creditors should be used exclusively in cross border scenarios as it is provided for the claims arising in the insolvency context. The reasons for keeping the rule only partially harmonised are the same as illustrated in section 2. National civil avoidance claims differ in rationale and effects. Moreover, Italy and Germany lack a solid legal theory underlining these claims.

Therefore, it is suggested that a partially harmonised rule on transaction avoidance outside insolvency may be more respectful of the legal autonomy of the member states. Additionally, the purpose of a unified rule for cross-border transactions should be to enhance the foreseeability of the outcomes of the dispute in cross-border scenarios. A full harmonisation could be deemed to go beyond what is necessary to achieve this goal.

Outside the procedural framework of insolvency, the rule should apply when a transaction that prejudices the rights of the creditors has a cross-border character. This can be deemed to occur: (i) when the parties of the transaction are domiciled in

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<sup>200</sup> Piñeiro (n 198).

<sup>201</sup> Van Zwieten (n 194); Pretelli (n 175).

two different member states or, (ii) when the law applicable to the transaction is not the law of the jurisdiction where the claim is brought.

In these circumstances, the creditor who needs to bring a claim may not know the law governing the vulnerable transaction. Within the insolvency proceedings, the insolvency practitioner is facilitated in gaining access to the details of the transaction undertaken by the debtor. In contrast, in civil proceedings, the claimant has limited rightful investigation powers on the debtor's business. However, a claimant should be able to learn the domicile of the potential defendant as a precondition of bringing the claim to the defendant's forum under Brussels I.<sup>202</sup>

At the same time, the counterparty of the vulnerable transaction can rely more on the contractual finality of the transaction concluded with the debtor. Indeed, they should need to check their transaction only against their national law for domestic claimants and against the harmonised rule against cross-border creditors.

Also outside insolvency proceedings, the harmonised rules on transaction avoidance should be deemed to supersede the ordinary choice of law rules. Indeed, these rules are designed to safeguard the interests of parties external to the transaction, which rights may be prejudiced by a choice of applicable law.<sup>203</sup>

## **6.2. The Substantial Rules**

The harmonised rule on transaction avoidance outside insolvency proceedings should be modelled on the provision of prejudicial transactions to creditors. It can be questioned whether the requirement of factual insolvency is appropriate in the civil application of the claim. As highlighted in section 5, the factual insolvency refers to the situations where the debtor's liabilities exceed their assets or when the debtor is unable to pay their debts as they fall due.

In transactions detrimental to creditors, the element of factual insolvency emerges only as part of the subjective criteria of the counterparty. In particular, the proposal

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<sup>202</sup> Regulation (EU) No 1215/2012 of the European Parliament and of the Council of 12 December 2012 on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial matters (recast) [2012] OJ L351/1, Article 3.

<sup>203</sup> Van Zwieten (n 194) 13.

suggests that the transaction is vulnerable only if the counterparty is aware of the factual insolvency of the debtor.

Such a requirement should be kept also in civil proceedings as it limits the application of the claim to exceptional situations where the debtor is not paying the creditor. Such a claim is a restriction of the debtor and third party's contractual freedom and therefore should be limited to special circumstances.<sup>204</sup> In this way, the proposal attempts to balance the contractual freedom of the debtor with the interests of the creditors to exercise and enforce their rights.

### **Article 6. Prejudicial transactions to creditors outside insolvency proceedings**

A claim under Article 3 can also be brought in civil proceedings when:

- (i) the parties of the transaction are domiciled in two different member states, or
- (ii) the law applicable to the transaction is not the law of the jurisdiction where the claim is brought.

It is suggested that the member state provides a detailed procedural ruled to allow the operation of the claim in civil proceedings, as they will better fit within the different procedural settings of the member states.

## **7. Conclusion**

The paper has sought to put forward a proposal for the harmonisation of transaction avoidance at the EU level, both within and outside the insolvency proceedings. In doing so, the study has first critically analysed the state of the art in relation to the harmonisation of transaction avoidance. It has considered and critically review the scholarship developed up to date. Such critical analysis has highlighted the shortcomings of a full harmonisation and questioned the feasibility of such a proposal.

Having assessed the full harmonisation option as unfeasible, this study has put forward a compromise solution. The proposed compromise suggests enacting a Regulation that partially harmonises transaction avoidance. It is suggested that such

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<sup>204</sup> Pretelli (n 175).

regulation should be coordinated with the EIR(R) by private international law principles that delimit their scope of application. The proposal seeks to apply substantively harmonised avoidance rules to cross-border transactions.

Within the insolvency framework, the proposal suggested to qualify the transaction as cross-border (i) when at least one of the parties of the transaction have their habitual residence or centre of main interest in a member state other than the one of the proceedings; (ii) when the law applicable to the transaction is different from the law of the opening of the proceedings.

Once the transaction is qualified as cross-border, the harmonised rules shall apply. The proposal has focused on harmonised rules on transactions at an undervalue, preferences and transactions detrimental to creditors. In designing the harmonised rules, this study sought to balance several interests and principles. In particular, the proposal has sought to balance:

- i. The contractual freedom of the parties;
- ii. the interests of the insolvency's estate in maximising the returns to creditors;
- iii. the principle of contractual finality relied upon the counterparty of the vulnerable transaction;
- iv. the principle of procedural efficiency and;
- v. The principle of predictability of the outcomes of the legal dispute.

In this balancing exercise, the proposal suggested that the harmonised rules are to be considered mandatory rules. Such a choice partially limits the contractual freedom of the parties, but it enhances the principle of predictability of the outcomes of the legal dispute and favours the maximisation of the returns to the creditors.

Moreover, the rules have been designed based on objective criteria such as the suspect periods and the factual insolvency of the debtor. In contrast, the proposal has dismissed the subjective criteria in transactions at an undervalue and preferences in favour of the principle of procedural efficiency.

Subjective criteria have been adopted in transactions detrimental to creditors in order to safeguard the principle of contractual freedom of the debtor. Additionally, in support of the principle of procedural efficiency, the subjective criterion proposed

encompasses the so-called *dolus eventualis*, which can be more easily inferred from factual clues.

Furthermore, the proposal has addressed the issue of related parties who have a peculiar position in the triangular relationship of the claim. In this regard, the proposal has suggested a non-exclusive list of possible related parties based on the English approach.

At the same time, the proposal has considered the relationship between transaction avoidance rules and financing that is necessary for the implementation of restructuring plans. For consistency purposes, it is suggested that the current proposal aligns to the proposal for a directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures.

On the other side, the proposal has suggested extending the application of the provision on prejudicial transactions to creditors to cases outside the formal insolvency framework. Such an extension could solve the current issues in the application of private international law principles to this particular type of claims. Also outside the insolvency proceedings, the proposal has sought to balance the principle of contractual freedom of the debtor and the interests to contractual finality of the third party and the interest to the predictability of the outcomes of the legal dispute of the creditor.

Finally, the study has suggested that this proposal could be the first step into a future full harmonisation of the topic. Indeed, a partial harmonisation may facilitate the convergence of the legal regimes of the member states towards completely unified rules of transaction avoidance within and outside the insolvency framework.