The Avoidance of Pre-Bankruptcy Transactions: An Economic and Comparative Approach

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Abstract

Most insolvency jurisdictions provide several mechanisms to reverse transactions entered into by a debtor prior to the commencement of the bankruptcy procedure. These mechanisms, generally known as claw-back actions or avoidance provisions, may fulfil several economic goals. First, they act as an ex post alignment of incentives between factually insolvent debtors and their creditors, since the latter become the residual claimants of an insolvent firm but they do not have any control over the debtor’s assets while the company is not yet subject to a bankruptcy procedure. Thus, avoidance powers may prevent or, at least, reverse opportunistic behaviors faced by factually insolvent debtors prior to the commencement of the bankruptcy procedure. Second, these devices may also prevent the creditors’ race to collect when insolvency threatens. Therefore, the existence of avoidance actions may reduce, at an early stage, the ‘common pool’ problem that bankruptcy law seeks to solve. Third, the existence of avoidance actions may also protect the interests of both the debtor and its creditors as a whole when the former is facing financial trouble and some market participants want to take advantages of this situation. Finally, the avoidance of pre-bankruptcy transactions can also be helpful for the early detection of financially distressed debtors, so it may encourage managers to take corrective actions in a timely manner. As a result of these goals, the existence of avoidance powers can create several benefits.

However, the use—and even existence—of avoidance actions is not costless. On the one hand, the use of these actions may generate litigation costs. On the other hand, the existence of these mechanisms may harm legal certainty, especially in countries in which it is relatively easy to avoid a transaction, usually because bad faith is not required, the look-back period may be too long, or no financial conditions are required to avoid a transaction. Therefore, insolvency legislators should carefully deal with these costs and benefits in order to assure the economic desirability of avoidance powers. On the basis of this exercise, this paper analyzes, from a comparative and functional approach, the optimal way to design claw-back actions across jurisdictions.
1. Introduction

Most jurisdictions provide several mechanisms to challenge transactions entered into by a debtor prior to the commencement of the bankruptcy procedure. These mechanisms, generally known as avoiding powers or claw-back actions, allow the retrospective avoidance of perfectly valid transactions. Thus, bankruptcy law allows the alignment of incentives between factually insolvent debtors and their creditors, since the latter become the residual claimants of the insolvent firm but they do not have any control over the debtor’s assets while the company is not yet subject to a formal bankruptcy procedure. Therefore,

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2 The expression ‘avoiding powers’ was popularized in Thomas H. Jackson, Avoiding Powers in Bankruptcy, 36 STANFORD LAW REVIEW 725 (1984). The expression ‘transaction avoidance’ is generally used in the United Kingdom. See John Armour and Howard Bennett (eds.), VULNERABLE TRANSACTIONS IN CORPORATE INSOLVENCY (Hart Publishing, 2003); Rebecca Parry, James Ayliffe, and Sharif Shivji, TRANSACTION AVOIDANCE IN INSOLVENCIES (Oxford University Press, 2nd Edition, 2011); and Roy Goode, PRINCIPLES OF CORPORATE INSOLVENCY LAW (Oxford University Press, 4th Edition), pp. 519-637. In Australia, these provisions are generally known as ‘claw-back actions’ or ‘avoidance provisions’. See Andrew Keay, AVOIDANCE PROVISIONS IN INSOLVENCY LAW (North Ryde, LBC Information Services, 1997); and Andrew Keay, The Insolvency Factor in the Avoidance of Antecedent Transactions in Corporate Liquidations, MONASH UNIVERSITY 305, 308 (1995). The World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes uses the expression ‘avoidable transactions’. The United Nations Commission on International Trade Law (UNCITRAL) on its Legislative Guide on Insolvency Law uses the expression ‘avoidance proceedings’. This paper uses all of these expressions as synonyms. Likewise, this paper uses these expressions to refer to those actions brought by a debtor in possession or a trustee to avoid transactions entered into prior to the commencement of the bankruptcy procedure. Therefore, it will not be used for other ‘avoiding powers’ generally existing in non-bankruptcy law, or even in bankruptcy for post-petition disposition of the debtor’s assets. Moreover, the study of avoidance powers will be made in the context of corporate insolvencies. Therefore, it will not deal with individuals, even though the powers are usually the same across jurisdictions, and the rationale for allowing the avoidance of transactions entered into by individuals is quite similar than for corporations.

3 The concept of residual claimants and its implications for the design of bankruptcy law is not always clear. Generally, they are identified with those investors who gain or lose at the margin from the actions of the firm. See George G. Triantis and Ronald J. Daniels, The Role of Debt in Interactive Corporate Governance, 83 CALIFORNIA LAW REVIEW 1073, 1100 (1995); Dan Keating, Good Intentions, Bad Economics: Retiree Insurance Benefits in Bankruptcy, 43 VANDERBILT LAW REVIEW 161, 190 (1999). Therefore, those who are mainly exposed to these actions are usually unsecured creditors, and that is many authors argue that they should control the company in distress. See David A. Skeel, Jr., The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases, 78 VANDERBILT LAW REVIEW 461 (1992). Nevertheless, when look at many Chapter 11 cases, it seems this is more theoretical than real, and bondholders are in fact the residual owners for all practical purposes. Douglas Baird and Robert K. Rasmussen, Chapter 11 at Twilight, 56 STANFORD LAW REVIEW 673, 696 (2003). In a seminal work, Professors Douglas Baird and Thomas Jackson argued that ‘the law of corporate reorganizations should focus on identifying the residual owners of the firm, limiting agency problems in representing the residual owners, and making sure that the residual owners has control over the negotiations that the firm must make while it is restructuring’. See Douglas G. Baird and Thomas H. Jackson, Bailganging After the Fall and the Contours of the Absolute Priority Rule, 55 UNIVERSITY OF CHICAGO LAW REVIEW 738, 775 (1988). In any case, and even if there were a consensus about the concept of residual claimants and their ability to govern the company in distress, it is not always easy to determine who the residual claimants are, and who should determine the identity of the residual claimants. See Frank H. Easterbrook, Is Corporate Bankruptcy Efficient? 27 JOURNAL OF FINANCIAL ECONOMICS 411, 416 (1990); Thomas G. Kelch, Shareholder Control Rights in Bankruptcy: Disassembling the Withering Mirage of Corporate Democracy, 52 MARYLAND LAW REVIEW 264, 332 (1993); Scott F. Norberg, Debtor Incentives, Agency Costs, and Voting Theory in Chapter 11, 46 KANSAS LAW REVIEW 507, 554 (1998). Analyzing, from an empirical perspective, the concept and implication of the residual owners of the insolvent firm, see Lynn Lopucki, The Myth of the Residual Owner: An Empirical Study, UNIVERSITY OF CALIFORNIA LAW & ECONOMICS RESEARCH PAPER No 3-11 (2004). The concept of ‘residual claimants’ is usually used to refer to those investors who are allowed to own the company’s residual returns. Therefore, when a firm is able to meet all its debts, the residual claimants of the firm are the shareholders. However, when the value of the company’s assets is greater that the value of the liabilities, the company’s creditors become the residual claimants of the firm. Therefore, if a company is just cash-flow insolvent, or it just defaults in payments, the creditors are not technically the residual claimants of the firm if there are sufficient assets to pay all. However, since these latter circumstances are often linked to a balance-sheet insolvency situation (otherwise, if a company has unencumbered assets should be
the existence of avoidance actions may ameliorate (ex ante) opportunistic behaviors potentially faced by factually insolvent debtors; or, when the deterrence effect of avoidance actions fails, these mechanisms may reverse (ex post) those transactions that, with the benefit of the hindsight bias, the creditors as a whole (or the trustee on their behalf) think that they would have never entered into the transaction, due to the harmful effects potentially generated for the creditors.

Therefore, the existence of avoiding powers may help maximize the value of the firm in several ways. First, avoiding powers may prevent or, if so, reverse various types of opportunistic behaviors usually faced by debtors in the zone of insolvency, such as asset dilution (e.g., siphoning assets to related parties), asset substitution (e.g., pursuing risky projects) or debt dilution (e.g., borrowing more money even when the company has no chance to survive). By solving these opportunistic behaviors (ex ante or ex post), avoiding powers may maximize the value of the firm. Second, these devices may also prevent the race to the debtor’s assets when insolvency threatens. Therefore, the existence of avoidance actions may reduce, at an early stage, the ‘common pool’ problem that bankruptcy law seeks to solve. Third, these actions can also protect the interests of both the debtor and its creditors as a whole when the former is facing financial trouble and some market participants want to take advantages of this situation. Finally, the avoidance of pre-bankruptcy transactions can also be helpful for the early detection of financially distressed debtors. Indeed, the existence of avoiding power may prevent value destroying transactions (including the continuation of distressed firms) by using third parties as ‘gatekeepers’ of the debtor’s financial situation. Namely, the possibility of avoiding a transaction may encourage third parties to ‘second-guess’ whether to deal with a debtor, and if so, under what conditions. When the debtor is financially sound, and the transaction is objectively fair for the debtor, the counterparty should face little (or even no) risk of avoidance. By contrast, when a debtor is facing financial trouble, and the transaction may be harmful for either the creditors as a whole or for the creditors among themselves, there will be high chances that the

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transaction will be avoided in bankruptcy. Therefore, since parties might not be willing to deal with a debtor in distress, the existence of avoiding powers may encourage managers to take corrective actions in a timely manner.

2. Types of avoidance actions around the world

Most insolvency jurisdictions provide a set of avoiding actions. Nevertheless, the way these actions are designed differs around the world. Some jurisdictions provide a single set of avoiding powers that general capture any harmful transaction to the creditors. This is the model followed by many civil law countries, including France, Spain and Italy. The other model is followed by many common law jurisdictions, including Australia, the United Kingdom and the United States, and it consists of a double set of avoiding powers: (i) on the one hand, some actions seek to avoid transactions in which the debtor received a lower (or even no) consideration; and (ii) other actions seeks to avoid transactions in which the debtor put a particular creditor in a better position over its fellows. In this latter jurisdictions, the former type of avoidance actions are usually referred as undervalue transactions (UK) or fraudulent conveyances (US), while the second type of transactions are usually known as unlawful preferences.

Systems with a single set of avoiding powers usually provide a very broad definition of both “harm” and “transactions”. Thus, they can capture similar or even more transactions than those systems with a double set of avoiding powers. Likewise, along with this set of avoiding powers, many jurisdictions provide other specific avoidance actions. Sometimes, these avoiding powers are available outside of bankruptcy (as it happens, for example, with the action pauliana in many civil law countries, or the existence of fraudulent conveyance law in the United States). Other countries also provide specific avoiding powers in bankruptcy (for example, the avoidance of unregistered charges in the US and the UK, or the avoidance of post-petition dispositions o the debtor’s assets, as it is allowed in many jurisdictions). Thought all of these avoiding powers share a similar rationale, we will focus on those avoiding powers generally existing in bankruptcy. Namely, this paper seeks to analyze the economic rationale of avoidance actions in corporate insolvencies, and those aspects that should be considered in order to design a desirable system of avoiding powers. For this purpose, we will analyze the economic problems that avoidance actions seek to solve, and how different jurisdictions address these similar economic problems, in order to be able to assess the economic desirability of each solution.
3. The challenge: justifying the avoidance of perfectly valid transactions

3.1. Introduction

The use of avoiding powers represents a departure from the general law governing commercial transactions. These actions allow the avoidance of completely valid transactions entered into by two parties even in the absence of bad faith. Therefore, these exceptional remedies seem to require a justification beyond the mere situation of bankruptcy—something potentially unknown ex ante. Otherwise, the existence of avoiding powers may do more harm than good, since it could generate legal uncertainty, and parties could be discouraged from entering into transactions—especially in countries with a very ‘lax’ regime of avoidance actions, that is, a system in which it is relatively easy to avoid a transaction.

The challenge, then, from a policy perspective, is to establish a system of avoiding powers that can maximize both ex ante and ex post efficiency. For this purpose, the design of an optimal system of avoidance actions should carefully deal with the trade-off between: (i) the maximization of the value of the firm by discouraging (ex ante) or reversing (ex post) opportunistic behaviors and value-destroying transactions entered into in the zone of insolvency; and (ii) the minimization of the harmful effects potentially generated by the use and even existence of avoiding powers (namely legal uncertainty and litigation costs).

3.2. The nature of the problem

Several factors justify the existence of claw-back actions in bankruptcy. However, all of them can be summarized in three fundamental agency problems: (i) the conflict between shareholders (or managers acting on their behalf) and creditors; (ii) the conflict of managers vis-à-vis shareholder and creditors; and (iii) the conflict among creditors. Thus, by correcting the misalignment of incentives that may arise between all of these corporate constituencies when a company is facing financial trouble, the use of the avoiding powers may help maximize the value of the firm.

3.2.2. Conflicts between shareholders/managers and creditors

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7 Unless otherwise is stated, this paper use managers and directors as synonyms.
When a firm has enough assets to meet its payments, most creditors are not more than contractual counterparties. However, when a firm defaults in payments, its creditors become entitled to seize and sell the company’s assets. In other words, the event of default triggers the creditors’ ability to become real owners of the firm’s assets. For this reason, financial economists usually define debt as contingent rights over the debtor’s assets.

Likewise, when a company is insolvent and the equity has been wiped out, the creditors are, by definition, funding the company’s assets in full. In these circumstances, it could be argued that the creditors become the residual claimants of the firm, since they become entitled to the debtor’s residual assets. However, while the insolvent firm is not yet subject to a formal bankruptcy procedure, the managers still have incentives to keep maximizing the interest of the shareholders, rather than the creditors’, for various reasons. First, shareholders still have the ability to appoint, remunerate and remove the directors. Second, in jurisdictions with controlling shareholders, or in the case of closely held corporations, the managers are usually identified with, or are very close to, the equity’s owners. Third, when a company is facing financial trouble, there are reasons to believe that the managers may lose their jobs (especially, when a company is not economically viable, or where the bankruptcy regime removes the managers to appoint a trustee), and therefore their incentives can be tied to those of the shareholders. Finally, managers’ compensation may be based on the company’s performance, usually through an equity-based (or stock options) plan. Therefore, there are strong reasons to believe the interests of the managers will be aligned with those of the shareholders.


10 Oliver Hart, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE (Clarendon Press, 1995).


Then, the first economic problem that avoiding powers should address is the conflict of interests between shareholders/managers and creditors. Otherwise, value can be destroyed as a result of various opportunistic behaviors of either the debtor or the debtor’s counterparties once the debtor faces financial trouble. Indeed, once insolvency threatens, the debtor may dilute or siphon assets. This problem, generally known as ‘asset dilution’, implies that the debtor may enrich itself (or any other third party of its choice) at the expense of the creditors. This enrichment does not necessarily imply, as it might seem at first, an actual fraud by the debtor. Sometimes, this enrichment of a third party at the expense of the creditors may consist of a lower consideration received by the debtor, as a result of several factors that may include: (i) a lower bargaining power as a result of the debtor’s financial situation; (ii) a lower level of information as a result of either the need for funding or the lack of resources to ask for expert opinions; or (iii) just an unwise or inefficient decision by the managers. Nevertheless, since this lower consideration will harm the debtor’s estate, and therefore the creditors as a whole, bankruptcy law should allow a mechanism to challenge these undervalue transactions entered into by a debtor in financial distress. Hence, even in the absence of fraud, many jurisdictions allow the avoidance of these transactions based on the doctrine of ‘undervalue’ (UK), ‘constructive fraud’ (US), or the ‘harm’ to the creditors (Italy) or to the debtor’s estate (Spain).

A second problem that avoiding powers should address is the perverse incentives potentially faced by the shareholders of financially distressed firms to ‘gamble’ the company once it becomes (balance-sheet) insolvent. This problem, generally known in the economic literature as ‘asset substitution’, relied on the intuition that shareholders, once they have lost everything, may have incentives to undertake very risky investments with a negative net present value (normally, as a result of a very low chances of success), but a very high payoff in the event of success. Thus, if the project succeeds, the shareholders can recover part of (or even all) their investments and they can even make money. Nevertheless, if the project fails (as it is the most likely result), the shareholders will lose nothing –since, as a general rule, they enjoy the company’s limited liability– and the creditors will bear all the losses.

Therefore, this asset substitution can also be understood as a moral hazard (or hidden action) problem that the legislator should address. Ex ante, this problem can be solved or, at least, minimized by providing a directors’ general duty to the creditors in the zone of

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16 Michael C. Jensen and William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 Journal of Financial Economics 305, 333-343 (1976). The company exchanges its few safety assets (e.g., cash) for new risky assets (e.g., investment project) with very low probabilities of success but, if so, it may yield very high returns.
insolvency as it happens in many jurisdictions. Ex post, once the company has undertaken these risky behaviors and they finally harm the creditors (normally, because the project fails and the company becomes insolvent), this problem can be addressed by the use of the avoiding powers or by imposing a tort liability rule linked to the breach of the duty to the creditors.

A third problem that avoidance powers may address between shareholders/managers and creditors consist of reducing (ex ante) or reversing (ex post) the perverse incentives faced by distressed firms to borrow money in a last attempt to solve its financial trouble. Sometimes, these funds can be invested in valuable projects (i.e., projects with a positive net present value), and therefore they can make everybody better off. However, this money can also be used inefficiently, just to pay some pre-existing creditors, or perhaps to overinvest in negative net present value projects (sometimes, as a result of the lack of information or, more probably, the ‘behavioral biases’ that the debtor probably faces when it is in financial trouble). In these circumstances, old creditors maybe worse off, since the new inefficiently used will imply the division of a similar ‘pie’ among more people. Therefore, they may suffer from a ‘debt dilution’ problem. The situation, however, changes from the perspective of the new creditors. In most cases, they will know the financial situation of the debtor, so they will be able to protect themselves (for example, by requiring a security interest). Moreover, when this new debt is used for efficient purposes, most insolvency legislations will also protect these new lenders, normally by allowing them to get a priority in bankruptcy for this ‘fresh money’. But in any case, the design of insolvency law, and those bankruptcy institutions

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18 In the United Kingdom, there is a general duty to minimize the losses to creditors if the company reach a point in which the directors know, or should have known, that there is no reasonable prospect of avoiding an insolvent liquidation. Section 214 of the Insolvency Act. See Paul Davies, Directors’ Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency, 7 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 301 (2006); Rizwaan J. Mokal, An Agency Cost Analysis of the Wrongful Trading Provisions: Redistribution, Perverse Incentives, and the Creditors’ Bargain, 59 THE CAMBRIDGE LAW JOURNAL 335 (2000); Dan Prentice, Creditor’s Interests and Director’s Duties, 10 OXFORD JOURNAL OF LEGAL STUDIES, 1990, pgs. 265 In Germany and Spain, once a company becomes factually insolvent, the board of directors should file for bankruptcy within 3 weeks (Germany) or 2 months (Spain). In Germany, for private companies see § 64(1) GmbHG, and for public corporations see § 92(2) AktG. For an analysis of the German provision, and comparing it with the provision about wrongful trading existing in the United Kingdom, see Thomas Bachner, Wrongful Trading – A New European Model for Creditor Protection? 5 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 293. In Spain see article 5.1 of the Spanish Insolvency Act. However, under the Spanish bankruptcy law, the bankruptcy petition can be substituted for a communication to the bankruptcy court stating that the company is insolvent but it is negotiating an agreement with its creditors. Thus, the company will enjoy a breath period of 4 months to negotiate an agreement with its creditors, while the managers will not incur in liability for a delayed petition, and the creditors will be able to neither enforce their claim (since the debtor will enjoy an automatic stay during this period) nor put the company into bankruptcy. See article 5 bis of the Spanish Insolvency Act 2003. In the United States, the directors do not formally owe a duty to creditors in the zone of insolvency. In Credit Lyonnais Bank Nederland v. Pathe Communications Corp., the Delaware Chancery Court held that the directors should take into account the interest of the creditors as part of the interests of the corporation. However, this decision was reversed by the Delaware Supreme Court in North American Catholic Educ. Programming Found., Inc. v. Gheewalla, arguing that, in the zone of insolvency, a corporation still owes fiduciary duties to the corporation and its shareholders, not its creditors.

19 A way generally used in many jurisdictions to encourage these lenders to provide funding may consist of given them priority in the bankruptcy.
(such as avoiding powers) seeking to align incentives between managers and the residual claimants off the firm, should pay special attention to these problems. A bankruptcy legislation very reluctant to allow creditors to borrow money in the zone of insolvency may generate an ‘underinvestment problem’ –that is, the problem consisting of not investing in those projects that the company should undertake, since they are value-creating. A bankruptcy regime very willing to allow debtor to borrow money in the zone of insolvency may generate an ‘overinvestment problem’ –that is, the problem consisting of investing in those projects that the company should not undertake, since they are value-destroying. In both cases, value can be destroyed for society, and therefore, from a policy perspective, it seems relevant to determine what type of transactions (including loans) can be reversed in bankruptcy.

3.2.3. Conflicts among creditors

Debt is usually defined, in economic terms, as contingent rights over the debtor’s assets. In other words, debt gives creditors the real option to become the owners of the company´s assets. This option will become exercisable when the firm defaults in payments. In these situations, the creditors will be allowed to obtain a court order to seize the assets and, ultimately, to be paid with the proceeds generated by the sale of the firm´s assets. This system of individual enforcement, available to every creditor, may destroy the going concern value of an economically viable business just facing financial trouble. Moreover, creditors unlikely know each other. Therefore, it will be difficult to coordinate their actions. And even if they were able to do so at a reasonably cost, they may have different incentives (for instance, while secured creditors may want to enforce their claims if they are in the money, unsecured creditors potentially out of the money will probably want to keep the firm alive just to see if a lucky event happens). Hence, they will all have incentives to run toward the debtor´s assets, and being the first ones to collect.

If a creditor enforces its claim prior to its fellows, it may recover its claim in full. By contrast, if a creditor enforces its claim after its fellows, it might just recover a part of its claims (or even nothing). This logic leads to a situation in which ‘collect’, using the jargon of game theory, is the dominant strategy for every creditor. Therefore, every creditor will have incentives to enforce their claims. For this reason, and taking into account that value can be destroyed for

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20 See supra note 7.
society if creditors do not cooperate, most jurisdictions provide a state-supplied, mandatory device to cooperate: a bankruptcy procedure.\textsuperscript{21}

In the absence of bankruptcy law, many costs may arise when a debtor defaults \textit{generally} on its obligations, and the company’s assets are not sufficient to pay all. In this situation, the company’s creditors will face a \textit{coordination problem} that may generate several costs to society. First, in those companies whose assets are worth more kept together, the enforcement of the debtor’s assets may destroy going concern value. Second, individual actions may lead to higher efforts (usually measured in litigation costs) that could be saved if individual actions are substituted by a single, collective procedure. Third, asymmetries of information may lead creditors to make inefficient decisions.\textsuperscript{22} Therefore, it would seem socially desirable to provide a system where all creditors can be informed about the debtor’s viability and financial affairs.\textsuperscript{23}

The aforementioned problems can be solved in bankruptcy. Nonetheless, these problems usually arise when a debtor \textit{starts} defaulting – but not \textit{generally} yet. In these circumstances, however, filing for bankruptcy might not always be the best scenario for the creditors, since bankruptcy will diminish the pie available for distribution as a result of the costs associated with bankruptcy procedures.\textsuperscript{24} Therefore, other solutions might be more desirable. One set of instruments potentially used to protect creditors through the preservation of value of the company in distress may provide several devices to facilitate \textit{out-of-court of agreements} – sometimes, under the supervision (or ratification) of a court.\textsuperscript{25} These legal devices may

\textsuperscript{21} This is the rationale behind the mandatory nature of bankruptcy procedures according. See Thomas H. Jackson, \textit{Bankruptcy, Non-Bankruptcy Entitlements, and The Creditors’ Bargain} (1982) 91 \textsc{Yale Law Journal} 857; and Thomas H. Jackson, \textit{The Logic and Limits of Bankruptcy Law} (Harvard University Press, 1986). Another state-supplied solution can be the use of pre-bankruptcy procedures or even out-of-court agreements with some features of bankruptcy law (e.g. automatic stay or cramdown).

\textsuperscript{22} Let’s suppose that a creditor can recover 50% of its claim in liquidation and 75% in reorganization. In this case, it could make sense for them to collaborate. However, this collaboration will unlikely take place unless the creditor has enough information about the outcomes in different scenarios.

\textsuperscript{23} For a contractual approach to the resolution of financial distress, see Robert K. Rasmussen, \textit{Debtor’s Choice: A Menu Approach to Corporate Bankruptcy}, 71 \textsc{Texas Law Review} 51 (1992); Alan Schwartz, \textit{A Contract Theory Approach to Bankruptcy}, 107 \textsc{Yale Law Journal} 1807 (1998). Supporting a privatization of bankruptcy on an empirical basis, see Julian Franks, Oren Sussman and Vikrant Vig, \textit{The Privatization of Bankruptcy: Evidence from Financial Distress in the Shipping Industry}, Working Paper 2015 (available at \texttt{http://www.law.nyu.edu/sites/default/files/Exterritorial_assets_VI_octoberSeptember_2015_Oct28th_NYUver3.pdf}). However, these authors are aware that the shipping industry presents some unique features, and therefore these results should not be generalized to other industries.

\textsuperscript{24} Paul Davies, \textit{Directors’ Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency}, 7 \textsc{European Business Organization Law Review} 301 (2006).

\textsuperscript{25} The distinction between pre-bankruptcy procedures and out-of-court agreements is not always clear. See Jose Garrido, \textit{OUT-OF-COURT DEBT RESTRUCTURING}, World Bank Studies (2015). Many insolvency jurisdictions provide an out-court-agreement supervised (or sanctioned) by the court, such as the UK Scheme of Arrangement, the Italian Debt Restructuring Agreement or the Spanish Refinancing Agreement. Likewise, other jurisdictions such as France or Spain provides a mediation or conciliation proceeding that can be qualified as a pre-bankruptcy procedure.
reduce the costs of bankruptcy, especially in those jurisdictions where the costs of filing may be so high. Therefore they could well serve the interest of the creditors.

A second set of solution may consist of the imposition of fiduciary duties toward the creditors. Nevertheless, in this paper we are more interested in the use of avoiding powers as a mechanism to solve those economic problems potentially arising in the zone of insolvency. Ex ante, avoidance provisions may maximize the value of the firm by discouraging opportunistic behaviors or value destroying transactions when a debtor is facing financial trouble. Ex post, they may maximize the value of the firm by reversing those opportunistic behaviors or value-destroying transactions that coordinated and informed creditors would unlikely have approved.

In this context, we have already analyzed how the use of fraudulent conveyance law contributes to solve those problems between shareholders/managers vis-à-vis creditors arising in the zone of insolvency. Nevertheless, fraudulent conveyance law does not help solve those problems that may arise among creditors. For these cases, most insolvency jurisdictions provide a mechanism to avoid those transactions favoring one creditor over others. In jurisdictions with a multiple set of avoiding powers (e.g., UK, US), these transactions are usually defined as ‘preferences’. By contrast, in jurisdictions with a single set of avoiding powers (e.g., Spain, Italy or Colombia), these transactions are avoided for being harmful not for the creditors as a whole but for some individual creditors.

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26 In some jurisdictions, the direct of costs of bankruptcy may be higher than the indirect costs (especially, if filing for bankruptcy does not have bad connotations), while in those jurisdictions in which bankruptcy has bad connotations will likely be the other way round. For a general overview about the costs of financial distress, see Richard A. Brealey, Stewart C. Myers and Franklin Allen, PRINCIPLES OF CORPORATE FINANCE (McGraw-Hill Irwin, 10th Edition), pp. 447-460. In a pioneering and very early study in this field, Jerold B. Warner, Bankruptcy Costs: Some Evidence, 32 JOURNAL OF FINANCE 337 (1977), showed that direct costs of bankruptcy were 3% to 4% of the pre-bankruptcy market value of total assets in large firms. These figures are relatively consistent with Lawrence A. Weiss, BANKRUPTCY RESOLUTION: DIRECT COSTS AND VIOLATION OF PRIORITY OF CLAIMS, 27 JOURNAL OF FINANCIAL ECONOMICS 225 (1990). However, Gregor Andrade and Steven N. Kaplan, How Costly Is Financial (not Economic) Distress? Evidence from Highly Leveraged Transactions That Became Distressed, 53 JOURNAL OF FINANCE 1443 (1998), argue that the costs of financial distress represents 10-20% of the market value of the firm. These costs, however, seems to be higher in the United Kingdom, at least for small firms. See Julian Franks and Oren Sussman, Financial Distress and Bank Restructuring of Small to Medium Size UK Companies, 9 REVIEW OF FINANCE 65 (2005), reporting that insolvency liquidations subtract 20% to 40% of the company’s proceeds. These authors also argue that bankruptcy costs are higher in small and medium size enterprises. This hypothesis is consistent with many other opinions arguing that for these companies, that usually have more simple capital structures, non-bankruptcy procedures might be more efficient. See Edward R. Morrison, Bankruptcy’s Rarity: Small Business Workouts in the United States, 5 EUROPEAN COMPANY AND FINANCIAL LAW REVIEW 172 (2008); Edward R. Morrison, Bargaining around Bankruptcy: Small Business Distress and State Law 38 JOURNAL OF LEGAL STUDIES 255 (2009). Stuwart C. Gilson, Kose John and Larry H.P. Lang, Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default, 27 JOURNAL OF FINANCIAL ECONOMICS 315 (1990). However, see Karin Thornburg, Bankruptcy Auctions: Costs, Debt Recovery and Firm Survival, 58 JOURNAL OF FINANCIAL ECONOMICS 337 (2000), arguing that the Swedish system is reasonably efficient for small firms. Likewise, the low use of bankruptcy procedures by small and medium size enterprises may also be explained by other reasons apart from their simpler capital structure, as it could a higher likelihood of being in ’economic distress’. Stijn Claessens and Leora F. Klapper, Bankruptcy around the World: Explanations of Its Relative Use, 7 AMERICAN LAW AND ECONOMICS REVIEW 253 (2005).
The use of preference law, as we will refer to those mechanisms consisting of avoiding those transactions that may favor one creditor over its fellows, may reduce opportunistic or value-destroying transactions that may arise by those conflicts among creditors.\textsuperscript{27} Thus, it may help maximize the value of the firm. However, some authors have even argued that preference law fails to prevent this collective action problem in the zone of insolvency. Therefore, this economic goal of preference law should be questioned.\textsuperscript{28} Indeed, it has been argued that preference law, as it is currently designed in many jurisdictions, does not deter grabs in the vicinity of insolvency, since creditors can be better off by grabbing assets. If the company is not finally put into bankruptcy, or the transaction is not finally avoided, they will preserve the preference. Moreover, they will not be worse off if the transaction is finally avoided.\textsuperscript{29} Therefore, grabbing the company’s assets is the dominant strategy for the creditors. For this reason, preference law will not generate any deterrence effect. A simple solution to fix this lack of ‘deterrence’ of preference law may consist of imposing a sanction to the preferred creditor.\textsuperscript{30} However, several reasons may explain why this solution has not been adopted in many jurisdictions.\textsuperscript{31} In the case of ‘adjusting creditors’\textsuperscript{32} this solution may lead to an ex ante increase of the cost of debt, even in those cases where the likelihood of bankruptcy is very low.\textsuperscript{33} Alternatively, it may lead to an underinvestment problem, since many creditors may be reluctant to deal with many debtors, even when they are still financially sound and they want to pursue socially valuable projects. In the case of non-adjusting creditors, the explanation may be a simpler one: these creditors, by definition, do

\textsuperscript{27} Against, see Roy Goode, \textsc{Principles of Corporate Insolvency Law} (2001), p. 571, arguing that preference law is not aimed at protecting the company’s assets, but just to help ensure that one creditor is not given an unfair advantage over others. With a similar view, arguing that the rationale for preference law is to reverse or prevent unjust enrichment, see Andrew Keay, \textit{The Recovery of Voidable Preferences: Aspects of Restoration}, in Francis Rose (ed.), \textsc{Restitution and Insolvency} (Mansfield Press, 2000), p. 251; and Peter Birks and Charles Mitchell, \textit{Unjust Enrichment}, in Peter Birks (Ed.), \textsc{English Private Law} (Oxford University Press, 2000), p. 590.


\textsuperscript{29} In fact, in some jurisdictions, the preferred creditor may end up in a better position than its fellows. For instance, under Spanish bankruptcy law, after avoiding the transaction, the debtor’s counterparty’s claim will be deemed an administrative expense (see article 73.3 Spanish Bankruptcy Act). Therefore, ex ante, this solution may exacerbate the race to the debtor’s assets in the vicinity of insolvency; ex post, it may make all the creditors as a whole worse off, taking into account that, in many circumstances, the debtor will have received cash (in return for the asset that it gave or sold), so it will have to give back cash. Hence, the restitution of the counterparty’s claim as an administrative expense may worsen the debtor’s financial situation, despite the fact that, at least with the avoidance of transactions at an undervalue, the debtor’s estate should increase—otherwise, the transaction should not be avoided either because it was at an ‘undervalue’ or because the residual costs of the avoiding action (see section 3.4 below) recommends not to avoid the transaction.

\textsuperscript{30} For example, by subordinating its claim or by making the preferred creditor to bear the debtor’s attorney fees for the avoidance procedure.

\textsuperscript{31} The subordination is applied in some jurisdictions when there is \textit{bad faith} in the debtor’s counterparty. See, for example, article 73.3 of the Spanish Bankruptcy Act.

\textsuperscript{32} For an analysis of the concept of ‘adjusting’ and ‘non-adjusting’ creditors, see Lucian A. Bebchuk and Jesse M. Fried, \textit{The Uneasy Case for the Priority of Secured Claims in Bankruptcy}, \textit{105 Yale Law Journal} 857 (1996).

\textsuperscript{33} This point was made in Barry E. Adler, \textit{A Re-Examination of Near-Bankruptcy Investment Incentives}, \textit{62 University of Chicago Law Review} 576 (2005).
not have the ability to negotiate the terms of their contracts. Therefore, they will ignore that the debtors is facing financial trouble. Thus, they can be involved in a preference even if they act in good faith. For these legal and economic reasons, I believe, many jurisdictions may have opted for rejecting this approach based on sanctioning 'preferred creditors'.

In their attempts to justify (if so) the desirable of preference law, bankruptcy scholars have provided different arguments. Firstly, it has been argued that preference law helps preserve the pari passu principle in the vicinity of the insolvency. In other words, preference law seeks to maintain an equal (or ‘fair’) distribution of the debtor’s assets among similarly situated creditors. Nevertheless, the preservation of this principle may be costly for the creditors as a whole. Ex post, it may reduce the overall recoveries of creditors, since the use of avoidance powers implies litigation costs but a preference does not generate a clear gain for the debtor’s net assets. Ex ante, it may generate an undesirable increase of the cost of debt, as a result of the smaller pie available for distribution.

Hence, since the preservation of this principle of equality (or ‘fairness’) among creditors may make the creditors as a whole worse off, the use of preference law may even be considered ‘unfair’. For this reason, in those systems where the trustees have a high level of expertise, it may seem desirable to let them decide whether or not to avoid a preference, taking into account the overall effect of the avoidance over the creditors’ returns. Thus, the ex ante function of preference law would be credibly fulfilled and, from an ex post view, preference law would be used in a most efficient way. By contrast, in those jurisdictions where the trustee have a poor level of expertise, or the bankruptcy procedure is managed by the debtor in possession, several reasons may justify the imposition, and not just the chance, of a general duty to avoid any preference given in the vicinity of insolvency –even if this solution might be inefficient. On the one hand, the office-holder may inefficiently (or even arbitrary) decide ex post which preferences should be avoided. Therefore, legal uncertainty can be created ex ante. On the other hand, and this is particularly relevant for those countries with a debtor in possession regime, the possibility of allowing (instead of requiring) the debtor to avoid the transaction may generate perverse incentives in the zone of insolvency. Namely, it

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35 Unless otherwise is provided, this paper will use the terms ‘trustee’, ‘office-holder’, and ‘insolvency administrator’ as synonyms. Likewise, following the UK approach, the term ‘administrator’ may be used for reorganization procedures, while the term ‘liquidator’ may be used for liquidation procedures.

36 This solution should be imposed, unless the creditors decide otherwise. Sometimes, the creditors may prefer to give up part of their recoveries, provided that no one else among its fellows is ‘unfairly’ put in a better position. This hypothesis may be supported by behavioural theories such as the ultimatum game.
may encourage the debtor to favor some creditors (normally related parties or repeat players) over others, since it knows that: (i) if the company does not finally enter into bankruptcy, the preference will keep given; and (ii) if the company finally enters into bankruptcy, they will decide whether or not to reverse the preference that they gave. Therefore, in these letter jurisdictions, it would seem desirable to avoid any preference given in the vicinity of insolvency.

A second explanation for the use of preference law is that it helps maximize the value of the firm by avoiding a specified type of value-destroying transactions: those associated with overinvestment projects. As mentioned above, when a debtor faces financial trouble may have incentives to gamble the firm. For this reason, the existence of fraudulent conveyance law may discourage (ex ante) or reverse (ex post) those risky transactions entered into by a debtor in distress. Nevertheless, these incentives are not usually enough to stop the debtor. Unless other legal devices are used (v. gr., disqualifications or liability for wrongful trading), the debtor still have incentives to bet the firm— as it might have to siphon assets. The situation could change, however, if the debtor’s counterparty is used as a way to monitor those transactions that the debtor should (or should not) undertake. If these transactions are not entered into in fair conditions with a financially sound debtor, the counterparty may be reluctant to enter into the transaction. Otherwise, it can be exposed to a future reversal of the transaction.

In a similar way, it can happen—and here is when preference law could intervene—that the debtor in financial trouble does not want to undertake any new investment project. It just wants to be kept in business. In these cases, it may ask for cash to either a new or preexisting lenders. New lenders may reject to provide funds unless this money is either fully secured or properly invested in an economically viable project (or firm). However, the situation may change with a preexisting creditor. In these cases, when a creditor is out of the money, it might be rational to provide funds—no matter their use—when it receives a security interest not only for the new money but also for part of the preexisting debt. Thus, the creditor may generate or, at least, exacerbated, the overinvestment project. Therefore, the

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37 Challenging this ‘overinvestment hypothesis’, see Erik Gilje, Do Firms Engage in Risk-Shifting? Empirical Evidence, 29 REVIEW OF FINANCIAL STUDIES 2925 (2016). Contrary to what risk-shifting theory predicts, the author finds that firms reduce investment risk when they approach financial distress. Based on an empirical analysis of Swedish firms, Eckbo and Thorburn also reject the overinvestment hypothesis. They find that managers of distressed firms in Sweden invest conservatively. They argue that managers have strong incentives to invest conservatively in order to preserve private benefits of control. See B. Espen Eckbo & Karin S. Thorburn, Control Benefits and CEO Discipline in Automatic Bankruptcy Auctions, 69 JOURNAL OF FINANCIAL ECONOMICS 227, 228 (2003). This assertion, nevertheless, may be inconsistent with the fact that private benefits of control are supposed to be very low in Sweden. For an analysis of private benefits of control across jurisdictions, see Alexander Dyck and Luigi Zingales, Privates Benefits of Control: An International Comparison, 54 THE JOURNAL OF FINANCE 537 (2004).
use of preference law may help maximize the value of the firm by preventing these opportunistic and value-destroying behaviors.\textsuperscript{38}

Finally, the use of preference law can also be justified in efficiency grounds based on its ability to use third parties to act as ‘gatekeepers’ of the debtor. Indeed, by encouraging third parties to ‘second-guess’ whether or not to deal with the creditors, they may have the ability to prevent value-destroy transactions. Nevertheless, it could happen that the debtor in financial trouble is not entering into new transactions, but it just remains in business in the hope that a stroke of luck will come. In these situations, the passivity of the debtor for either filing for bankruptcy or reaching an out-of-court agreement can do more harm than good for society (going concern value can be destroyed as a result of individual debt enforcements, the company may lose key employees, etc.). For this reason, it would seem desirable to encourage creditors to oversee the debtor’s activities in order to make sure that all debtors in the market are financially sound. However, unless creditors are highly exposed to the debtor’s default, they might not have enough incentives to invest time and resources in monitoring the debtor’s activities (especially if they are fully secured). Therefore, it may be desirable to design a legal tool that encourages (ex ante) or compensates (ex post) those creditors for those resources spent in monitoring the debtor’s activities. In this context, the existence of preference law may serve this goal.\textsuperscript{39} Namely, by allowing creditors to take – and preserve – ‘preferences’ received prior to the zone of insolvency, preference law creates incentives on the creditors to oversee the debtor’s activities. Thus, if they invest time and resources in monitoring the debtor’s activities and they encourage the directors to take corrective actions in a timely manner, they may deserve this ‘award’. By contrast, if a creditor just improves its position once a debtor is already insolvent, there are no economic reasons to justify this departure from the general scheme of liquidation in bankruptcy. In these situations, the improvement of a creditor’s position should be deemed a preference, and therefore it should be avoided in bankruptcy.

\textit{3.1.4. Conflicts of managers vis-à-vis shareholders and creditors}

From the seminal work by Adolf Berle and Gardiner Means, the separation of ownership and control in large corporations has defined the way corporate law scholarship has been made in second half of the 20\textsuperscript{th} century. Most scholars started focusing their attention on how to

\textsuperscript{38} This argument was made by Barry E. Adler, \textit{A Re-Examination of Near-Bankruptcy Investment Incentives}, 62 UNIVERSITY OF CHICAGO LAW REVIEW 576 (1995); Barry E. Adler, \textit{Bankruptcy and Risk Allocation}, 77 CORNELL LAW REVIEW 462 (1992); and Alan Schwartz, \textit{A Normative Theory of Business Bankruptcy}, 91 VIRGINIA LAW REVIEW 1203, 1229-1231 (2005).

\textsuperscript{39} This argument was developed by George G. Triantis and Ronald J. Daniels, \textit{The Role of Debt in Interactive Corporate Governance}, 83 CALIFORNIA LAW REVIEW 1073 (1995).
minimize those agency costs existing between managers and shareholders. However, this misalignment of incentives between managers and shareholders has not been generally assumed by bankruptcy law scholars. Perhaps for simplicity, it is generally assumed that managers and shareholders have similar interests, since the shareholders have the ability appoint, pay and remove the directors. Likewise, bankruptcy scholars have not traditionally taking into account the main agency problems existing in jurisdictions with controlling shareholders, that is, those agency costs existing between majority and minority shareholders.

However, unlike it is generally assumed in bankruptcy, the interests of the shareholders might not be aligned with those of the managers, as well as the interest of the controlling shareholders may differ from the interests of minority shareholders. In fact, these conflicts of interest can even been exacerbated when a company is in financial distress, especially if the company is not economically viable, and therefore it will probably be liquidated. Indeed, in jurisdictions with dispersed ownership structures, managers may have (even more) incentives to favor themselves at the expense of the shareholders. They could do so by siphon assets out of the company to themselves, or just by assuming a suboptimal level of risk as a way to preserve their jobs and private benefits of control. Moreover, they may have incentives to favor some creditors over others, just because they are friends or because they can be their future employers. Likewise, in jurisdictions with concentrated ownership structures, controlling shareholders may have (even more) incentives to favor themselves at the expense of minority shareholders. Furthermore, they can also favor some creditors over others, just because they are either friends or repeat players –that is, parties with whom the directors will keep having businesses in the future. In both cases, the use of avoiding powers may prevent (ex ante) or reverse (ex post) the harmful effects generated by the heightened misalignment of incentives between majority shareholders and minority shareholders arising in the zone of insolvency.

41 In fact, in previous sections of this article, we also assumed this fact when we analyzed the conflict of interests of shareholders/managers via-a-vis shareholders.
44 This is a consequence of the higher managerial agency costs existing in these jurisdictions.
4. Constraining the harmful effects of avoiding powers

Avoidance actions may contribute to the maximization of the value of the firm in several ways. Nevertheless, the existence of these actions is not costless. Ex post, the avoidance procedure implies litigation costs. Ex ante, it may generate legal uncertainty, since parties cannot always foresee when their counterparties may enter into bankruptcy in the future. Therefore, they may adjust ex ante the risk (or costs) of avoidance by charging a higher price, even when the likelihood of bankruptcy is very low. Hence, a very 'lax' regime of avoidance actions, that is, when it is too easy to avoid a transaction, avoidance provisions may be very harmful for commercial certainty from an ex ante perspective, but they could create some gains. Ex post, they can help maximize the bankruptcy estate –despite the fact that a higher use of avoiding powers will also lead to higher litigation costs. Ex ante, avoidance powers can credibly fulfil their economic goals (e.g., alignment of incentives between shareholders/managers and creditors, preventing a race to collect, using third parties as gatekeepers, etc.). By contrast, a very ‘tough’ regime of claw-back actions, that is, when it is so hard to avoid a transaction, many gains can be created ex ante (especially in terms of commercial certainty) and even ex post (e.g., saving litigation costs), but value can be destroyed if avoidance actions cannot fully achieve their goals. Therefore, a desirable regime of claw-back actions should be designed by choosing an optimal trade-off between those costs and benefits potentially generated by the use –and even existence– of avoiding powers.

4.1. Minimizing the risk of legal uncertainty

The retrospective avoidance of completely valid transactions may be harmful for legal certainty, and therefore for the promotion of economic growth. For that reason, an efficient design of avoidance provisions should carefully balance those benefits associated with avoiding powers with the costs potentially associated with these exceptional remedies. As it will be analyzed, there are several ways in which avoidance provisions can be designed to minimize legal uncertainty. First, insolvency jurisdictions may limit the maximum period of time in which a transaction can be avoided. Second, insolvency legislations can also protect several types of transactions from avoiding powers. Third, avoidance provisions may protect bona fide third parties. Fourth, even if a transaction were avoidable, insolvency legislators can also provide a range of alternative remedies to the actual reversal of the transaction. Finally, the legislator could also increase the litigation costs (including investigation costs) associated with avoiding powers, so the office-holder –acting in the creditors' interest– could be discouraged or even impeded from exercising the action.
Nevertheless, while most of the aforementioned devices can successfully reduce legal uncertainty in an efficient way, that is why they have been implemented in most jurisdictions, increasing the litigation costs of the avoidance powers does not seem to be economically desirable. Ex ante, it may weaken the beneficial effects of transaction avoidance, since the low risk of avoidance may encourage opportunistic and value-destroying transactions in the zone of insolvency. Ex post, it can reduce the pie available for distribution, if these costs are ultimately borne by the bankruptcy estate. Therefore, as it will be analyzed below, the general policy regarding this latter aspect will be the reduction of litigation costs in avoiding powers, though preserving a proper balance between legal certainty and the use of avoiding powers.

4.1.1. The use of twilight periods

4.1.1.1. The concept and rationale of ‘twilight periods’

The concept of ‘twilight period’ usually refers to the maximum period of time prior to the commencement of the bankruptcy procedure in which a transaction can be challenged. However, since the rationale for the use of avoiding powers requires (or at least assumes) that the creditors should become the residual claimants of the firm, the period of time in which a transaction can be avoided usually includes a financial requirement. Thus, the relevant period of time in which a transaction can be challenged is usually formed by two aspects: (i) a financial requirement; and (ii) a temporal requirement (or ‘twilight period’). In this section, we will focus on this latter requirement. As it will be analyzed, while the financial requirement exists in order to justify, from an economic perspective, the existence of avoiding powers, the temporal requirements’ goal is just to reduce the costs associated with legal uncertainty.

Indeed, twilight periods exist in most insolvency jurisdictions as a way to minimize legal uncertainty. Otherwise, the possibility of avoiding any transaction entered into by a debtor within an unlimited period of time prior to the commencement of the bankruptcy procedure could be harmful for society. It could be argued, however, that the design of an unlimited twilight period may serve several functions. On the one hand, it may allow the avoidance of any transaction entered into by a debtor factually insolvent whose residual claimants are no longer the shareholders but the creditors. On the other hand, it could be argued that this

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46 This paper will use the term ‘twilight period’, ‘suspect period’ or ‘look-back period’ as synonyms.
47 Spain used to have this unlimited twilight period prior to the Insolvency Act 2003.
system may encourage third parties to oversee the debtor’s financial situation, and therefore to create positive externalities in society, since financially distressed debtors would be indirectly forced to take corrective actions if they want to keep in business. Nevertheless, the costs of this solution, in our opinion, may exceed its benefits.

First, not all markets participants have the ability and, in the case of involuntary creditors, in the possibility to bear these costs. There are more efficient devices—such as the use of preference law—to incentivize this ‘collective monitoring’ of the debtor’s activities. Second, the threat of insolvency, and therefore to be left out of business may encourage debtors to bear a suboptimal level of risk, or to borrow a low level of debt. Finally, the possibility of avoiding any transaction entered into by a debtor in financial trouble, no matter when it took place, it may be harmful for legal uncertainty. Therefore, it could lead parties to be reluctant to contract with many debtors, even when they are financially sound—but just, if so, indebted. Thus, an unlimited twilight period does not seem to be an optimal solution for an efficient system of claw-back actions.

4.1.1.2. The length of ‘twilight periods’

The length of the twilight period is also a sensitive issue in the design of avoidance actions. A very long period may be ex post efficient but very harmful ex ante. By contrast, a short twilight period could be useful to promote legal certainty but it might not be helpful to achieve the economic goals associated with avoiding powers.

Most insolvency regimes establish a twilight period no longer than two years from the commencement of the bankruptcy procedure. Therefore, those transactions entered into two years and one day prior to the commencement of a bankruptcy procedure cannot be captured by avoiding powers. However, in most jurisdictions, the length of the twilight period generally depends on several factors, including the type of transaction (preference or transaction at an undervalue), or the type of the counterparty (related or non-related counterparty). For instance, the twilight period of preference in the United Kingdom and the United States is usually shorter that the period to avoid a transaction at an undervalue. This distinction is probably explained by the fact that when a debtor is starting to face

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48 This is the situation, for example, in Italy, Spain, France, the United Kingdom and the United States. This maximum period is also recommended in the Legislative Guide on Insolvency Law prepared by the United Nations Commission on International Trade Law (UNCITRAL).

49 In the United States, the twilight period for preferences is either 90 days (period for related parties) or 1 year (period for non-related parties), while the period for avoiding fraudulent conveyances is always 2 years. In the United Kingdom, the twilight period for preferences is the 6 months while the twilight period for transactions at an undervalue is 2 years.
financial trouble, it may have more incentives to accept any condition required by their counterparties just to avoid the financial disaster. Therefore, there will be more chances to enter into transactions at an undervalue, as a result of the loss of bargaining power of the debtor. Moreover, in the case of gifts, or transactions with no consideration at all for the debtor, the longer twilight period is even more justified, since these transactions usually reveal the debtor’s intention to defraud creditors or its absolute lack of knowledge about its financial situation—otherwise, it would know that it should not be allowed to give up part of its wealth before paying their creditors first. However, when the debtor’s financial situation is getting worse, and there are no chances for survival, it may have incentives to give preferences, as a way to preserve its relationships with friends, future suppliers or future financiers in a possible new business. Therefore, the likelihood of granting preferences may be higher nearer to the commencement of the bankruptcy procedure.

Likewise, and perhaps with a more clear rationale, many insolvency jurisdictions establish different twilight periods according to the type of the debtor’s counterparty. Namely, some jurisdictions extends the twilight period in cases of related parties, as they are supposed to have superior information. Hence, they are in a better position to take some preferences or to dilute/substitute assets at an early stage. However, even though the rationale for protecting creditors from preferences given to, or transactions entered into with, related parties, the way this problem is addressed in bankruptcy differ across jurisdictions. While some jurisdictions, such as the United States, indeed extends the twilight period for related parties, other jurisdictions (or even the same jurisdictions for different type of avoidable transactions) address this problem by either presuming, unless the contrary is shown, the debtor’s state of insolvency or by establishing a list of transactions that, in every case, will be voidable.

4.1.2. The unavoidability of transactions

The possibility of avoiding any transaction enter into in the twilight period can sometimes harm the debtor’s activity, since many suppliers can be reluctant to keep providing goods and services to a financially distressed firm. For this reason, most jurisdictions protect transactions entered into in the ordinary course of business from the use of avoiding powers, provided that they are conducted in good faith and according to ordinary business terms.

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50 See, in this sense, the Legislative Guide on Insolvency Law issued by the United Nation Commission on International Trade (2005).
51 This is the case of United Kingdom for the regulation of transactions at an undervalue.
52 This is the case of France or Spain, where the office-holder finds a list of several defined transactions that can be avoided. In some cases, the debtor’s counterparty will be allowed to show that the transaction was not harmful to the creditors, while for other type of transactions this presumption cannot be rebutted.
Likewise, some financial contracts are also protected from avoiding powers, normally as a result of the negative externalities that the avoidance of these transactions may create in the financial systems. Namely, those financial transactions that are usually protected from avoiding powers are margin or settlement payments made by or to (or for the benefit of) a financial institution. Finally, in some jurisdictions, the lack of knowledge about either the debtor’s financial situation or the harm to other creditors may serve as a defense for the debtor’s counterparty.\footnote{The lack of knowledge of the debtor’s financial situation as a defence to the debtor’s counterparty seems to be available under Germany Law. In the Netherlands, the defence may consists of the lack of knowledge about the damage to other creditors. See Jay Lawrence Westbrook, Charles D. Booth, Christoph G. Paulus and Harry Rajak, A GLOBAL VIEW OF BUSINESS INSOLVENCY SYSTEMS (The World Bank, 2011), pp. 109-110.} In other jurisdictions,\footnote{Spain, the United Kingdom and the United States are example of these jurisdictions.} however, the knowledge of the debtor’s financial affairs does not affect the avoidability of a transaction. Nevertheless, it could have various consequences for the avoidance procedure (e.g., extensions in the twilight period, or proof of the financial requirement), or for the debtor’s counterparty (e.g., subordination of its claim).\footnote{In Spain, for example, the counterparty’s claim can be subordinated when it is shown that it acted in bad faith – and Spanish courts have interpreted the knowledge of the debtor’s financial s situation as bad faith. In the United States and the United Kingdom, the knowledge of the debtor’s financial situation is not directly punished. However, this is the rationale behind to give a harsher treatment in avoidance provisions to the debtor’s related parties. For example, in the United Kingdom, the debtor’s state of insolvency is presumed for related parties in the event of transactions at an undervalue, and the subjective requirement of the ‘desire’ to avoid a preference is also presumed for the avoidance of preferences. In the United States, the twilight period for related parties is not 90 days (general twilight period for preferences) but 1 year.}  

4.1.3. The protection of good faith parties  

Most insolvency jurisdictions provide protection to certain third parties (not usually counterparties) who received property or value in good faith from the debtor’s counterparty.\footnote{For a UK perspective, see John Armour, Transactions at an Undervalue, in John Armour and Howard Bennet (eds.), VULNERABLE TRANSACTIONS IN CORPORATE INSOLVENCY, 46 (2003). For a US approach, see Barry E. Adler, Douglas G. Baird and Thomas H. Jackson, BANKRUPTCY: CASES, PROBLEMS AND MATERIALS (Foundation Press, 4th Edition), pp. 341-352.} Ex ante, bona fide third parties (different than the debtor’s counterparty) may be encouraged ex ante to enter into transactions without any (or a very low) risk of avoidance. Ex post, they will also be protected from suffering the harmful effects potentially generated by the reversal of a transaction. However, this protection is not absolute. First, it usually requires being a third party. Therefore, the debtor’s counterparty is generally excluded. Second, the concept of good faith is generally excluded to related parties, since they will probably have a better knowledge about either the conditions of the transactions or the debtor’s financial affairs. Therefore, the risk of opportunism is higher in these situations. However, since this superior information is not always held by related parties, it would seem desirable to consider the lack of good faith in related parties just as a presumption. Thus, though bearing the burden of proof, they will always have the chance to show otherwise.
4.1.4. The facilitation of alternative remedies to restitute the transaction

Even when it has been determined that a transaction is avoidable, several circumstances may make the avoidance of the transaction either impossible or undesirable. For instance, under some circumstances, the property may already be in someone else´s hands. In other situations, the value of the assets received by a debtor can be lower than the amount that it gave. However, if the debtor paid the transaction in cash, and therefore this cash should return to the debtor´s counterparty, the avoidance of transaction may hamper rather than improve the financial situation of a debtor with liquidity problems. Likewise, from the counterparty’s perspective, the fact that a bona fide transaction can be reversed at some point in the future can reduce its incentives to enter into commercial transactions ex ante. For this reason, some insolvency jurisdictions may provide a set of remedies that can substitute the factual return of the asset (or preference) received by the debtor’s counterparty. The most common –and likely desirable– mechanism to fulfill this role consists of substituting the reversal of the transaction for the exceeded value received by the counterparty. However, this remedy is not always available. For instance, when the counterparty received a guarantee, there is not value to be returned. In these situations, an available remedy may be to discharge the company’s obligation to guarantee the debt. Therefore, from a policy perspective, it seems desirable to provide a set of alternative remedies to the actual avoidance of the transaction, especially when this reversal may do more harm than good for either the debtor or a bona fide third party different than the debtor´s counterparty.

4.1.5. Temporal limitations for the exercise of avoiding powers

Finally, another way to reduce legal uncertainty in the context of avoiding powers is by limiting not only the time in which a transaction can be challenged but also the period in which the action can be exercised. This limitation in the use of avoiding powers may act, then, as a complementary for the twilight period. Thus, while the twilight period provides temporal limits prior to the commencement of the bankruptcy procedure, this temporal limitation for the exercise of the action applies after the commencement of the bankruptcy procedure.

57 In the US, 2 years (546(a)(1). In Spain, for example, this is a controversial question. The law does not say anything. However, if a reorganization plan has been approved, the exercise of claw-back actions (or even ongoing claw-back actions) can be stopped, provided that the agreement between the debtor and its creditors says so. This solution was proposed and approved in Nozar, one of the largest bankruptcy cases in Spain.
4.1.6. The financial situation of the debtor at the moment of entering into the transaction

The primary role of avoidance action is to protect the creditors when they become the residual claimant of the firm but they do not have yet any formal control of the debtor’s assets. This event technically happens when the value of the company’s assets is less than the value of the company’s liability, and therefore a company is balance-sheet insolvent. In these situations, the shareholder’s equity has been wiped out, and the company is entirely funded by the creditors.

Nevertheless, the concept of balance-sheet test embraces several issues. First, a balance-sheet is formed by assets, liabilities and equity. The equity is generally defined as the difference between assets and liability. However, these latter concepts are not easy to define. In most cases, it will depend on the application of generally accepted accounting principles. Nevertheless, there are different approaches to value assets and liabilities.58 For example, in some jurisdictions with more conservative accounting rules (traditionally continental Europe, though this situation is changing as a result of the influence of the IFRS), a contingency may be accounted as a liability in the balance-sheet, while the same concept could be just explained in the notes to the financial statements in other jurisdictions. Likewise, and perhaps more importantly, the assets can be valued in different ways. In many jurisdictions, some assets can (or even have to) be registered on an historical basis, while other jurisdictions (or even the same ones59) may impose a yearly valuation of some assets according to their market values.

Moreover, a more crucial issue is whether the company’s assets should be valued on a going concern or a break-up basis.60 This latter decision will normally depend on the stage of the company (operation or liquidation), or, at least, on its viability. In general, companies outside of bankruptcy are usually valued on a going concern basis, unless there is enough evidence to show that the company has no viability at all. In these latter circumstances, the valuation on a break-up basis not also seems to be more appropriate, but also more protective of the creditors’ interests, since it allow them know who much they will perceive in a hypothetical (and likely sure) liquidation.

59 The International Financial Reporting Standards (IFRS) allows this possibility for land and intangible assets.
By contrast, the valuation of a company inside of bankruptcy should generally depend on the type of procedure (reorganization or liquidation), or, in those jurisdictions with a single-entry bankruptcy procedure (e.g., Spain or Germany), on the viability of, and steps taken by, the company. For instance, if the debtor presents a feasible reorganization plan, or a valuation of the company’s assets, and it may be inferred that the company has going concern value, there are reasons to believe that this company should be reorganized (since it would be worth more alive). Therefore, it would make sense to value the company on a going concern basis. By contrast, if a company has filed for bankruptcy reporting operating losses, and it has no economic viability at all, it should be valued on a liquidation (or break-up) basis. This latter valuation should be based on market rather than accounting values, and it should include the costs of liquidation.61

If a preference or transaction at an undervalue took place when the value of the company’s assets was, and after the transactions remains, greater than the value of the liabilities (i.e., when the company was balance-sheet solvent), bankruptcy law should not intervene. Unless the debtor commits fraud, the debtor should be free, in these situations, to manage their wealth at its own convenience. However, some jurisdictions allow the avoidance of a transaction when a company has positive net assets but it is cash flow insolvent. This is the case of the United Kingdom, where the financial requirement to avoid a transaction can be satisfied by several concepts of insolvency, including both balance sheet and cash flow insolvency.62 In the United States, the relevant test seems to be the balance-sheet-test.63 Nevertheless, along with this ‘insolvency test’, the US Bankruptcy Code also allows the possibility to avoid transfers, and assume constructive fraud, when the debtor is left with “an unreasonably small capital” or was incurring debts that it knew it could not repay as they came due.64 Other jurisdictions, such as Australia, seem to favor a cash-flow (or commercial) insolvency test, generally defined as the debtor’s inability to pay its debts as they become due.65 Finally, there are jurisdictions, including the United Kingdom, where the relevant test

62 See section 240(2), in relation to section 123, of the Insolvency Act. For an analysis of the concept of corporate insolvency in the United Kingdom, see Roy Goode, Principles of Corporate Insolvency Law (Oxford University Press, 4th Edition), pp. 109-147. In the case law, see BNY Corporate Trustee Services Ltd v Eurosail, resolved by the UK Supreme Court in 2013. In this decision, the Supreme Court reverse a decision of the Court of Appeal holding that balance sheet insolvency was deemed to be when the company in question had reached “the point of no return”.
63 See § 101(32)(A) of the US Bankruptcy Code. For municipalities, however, the relevant test is the cash-flow insolvency test. See § 101(32)(C).
can be satisfied regardless of the debtor’s financial situation, but just proving some external facts such as an unsatisfied, undisputable debt

All of these relevant tests can be justified somehow for the purposes of avoidance actions. However, while the balance-sheet test offers the most vigorous explanation, since it is the only situation when the creditors factually are the new residual claimants of the firm, the cash-flow insolvency test and the proof of some external facts may also have several advantages. Namely, the use of a cash-flow test can be useful for both the debtor and the creditors in at least two ways. First, when the debtor’s assets are greater than the liabilities, it is usually able to raise funds—at least, by granting a security interest over the unencumbered assets. However, there are circumstances in which this might not be possible (for example, because there is a credit freeze in the economy), and the debtor immediately needs cash. In this event, creditors can take opportunistic actions to take advantage of the debtor’s financial situation. Therefore, it might make sense to use a cash-flow insolvency test to protect (primarily) the debtor.

Second, when a debtor is cash-flow insolvent but the value of the company’s assets is greater than the liabilities, the debtor will probably default in payments. Therefore, the creditors can enforce their claims and will be able to seize and sell the assets. In these situations, value can be destroyed when the company’s assets are worth more on a going concern basis. Hence, the use of a cash-flow insolvency test may be socially desirable for many provisions in bankruptcy, including the avoidance of transactions.

On the other hand, the use of some externals facts to satisfy the financial requirement for the exercise of avoiding powers can also fulfil several economic goals. First, creditors not always have the ability to know the debtor’s financial situation. Sometimes, it is costly for them to gather and analyze this financial information. In other cases, this information cannot even be available if the debtor has not filed its financial statements. Sometimes, this lack of information may be due to the fact that the debtor might not be required to disclose financial statements (as it happens with small firms in various jurisdictions). In other circumstances, the period to disclose this information has been expired yet. And, in the worst scenario, the debtor required to disclose this information might be voluntarily postponing this disclosure.

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66 This test is used very often in many jurisdictions to allow creditors to file for bankruptcy. Despite the fact that, as a result of this test, a solvent company could be undesirable put into bankruptcy, it seems desirable for several reasons. On the one hand, it facilitates third parties to put a likely insolvent debtor into bankruptcy, since they do not usually have the ability to know their internal financial situation, but just what they observe from either (i) their financial statements; or (ii) the debtor’s behavior in the market. On the other hand, the risk of being putting into bankruptcy, and therefore assuming the cost of bankruptcy, encourages solvent debtor to meet their payments in a timely manner.
because it may fear the market’s reaction. Therefore, in many circumstances, the only available information that many market participants may have about the debtor’s financial situation is what they can just infer from the debtor’s actual behavior in the market. Thus, the use of external facts may help protect creditors.

Second, these external facts can also act as positive externalities to society. On the one hand, the imposition of several consequences as a result of a default in payments may encourage the debtor to pay its debts when it is in fact able to do so. On the other, once of the debtor is defaulting not because it wants but because it is unable to pay its debts as they become due, the existence of these external factors will efficiently serve to encourage the managers to take corrective actions (e.g., promoting an out-of-court restructuring, or filing for bankruptcy).

4.2. Minimizing litigation costs

The existence of an effective system of avoidance actions is not costless. As stated above, it may create legal uncertainty. However, once the system is in place, the use of avoiding powers can also generate costs. In fact, under some circumstances, the existence of litigation costs can make the creditors worse off when using avoiding powers.\(^{67}\) Therefore, for a transaction avoidance system to be efficient, insolvency legislators should minimize these litigation costs associated with avoidance actions. There are several ways in which insolvency jurisdictions may minimize these costs. The most common way across jurisdictions is by using a set of presumptions. Thus, the transactions will be avoided (or some elements to exercise the transaction will be fulfilled), unless otherwise is shown. Likewise, some jurisdictions also require subjective requirements to avoid the transactions. For example, in the United Kingdom, the avoidance of preferences given to non-related parties requires to proof that the debtor had the ‘desire’, and not just the ‘intention’, to prefer the creditor. If this desire is not proved, the transaction cannot be avoided. And courts have defined ‘desire’ as a subjective and very narrow requirement, arguing that if, for example, a person chooses the lesser of two evils, that is not a ‘desire’ but just an intention.\(^{68}\) At first glance, this subjective requirement seems to increase litigation costs. However, as long as this requirement makes impossible (and not just difficult) in practice to avoid a preference given to a non-related party under UK insolvency law, this subjective requirements has in

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\(^{67}\) The most common example can be given by the avoidance of a pre-petition debt (preference). The money given to the preferred creditor is recovered, but the debt also returns to the company’s balance. However, since the avoidance procedure implies litigation costs, the company’s net assets will be reduced in the amount of the litigation costs.

\(^{68}\) See section 239 Insolvency Act. In MC Bacon, Lord Miller J. distinguished intention and desire by arguing that “intention is objective, desire is subjective. A man can choose the lesser of two evils without desiring either.”
fact served to reduce litigation costs in avoidance procedures regarding preferences. Finally, and perhaps more importantly, one of the most significant costs of the avoidance procedure is the attorney’s legal fees. Therefore, legal systems should also define how to deal with this issue.

4.2.2. The use of presumptions

4.2.2.1. Avoidable transactions

Many insolvency jurisdictions—especially in civil law countries—provide a set of defined transactions that can be avoided. Sometimes, these transactions will be deemed harmful with no exceptions. Therefore, they will always be able to be challenged. In other cases, however, the transaction can only be deemed harmful unless the debtor’s counterparty shows otherwise. These transactions are usually identified with some common transactions that commonly take place in the vicinity of insolvency (transactions with no consideration, security interest for an antecedent debt, etc.). Likewise, transactions entered into with a related party to the debtor can be also deemed avoidable, unless the debtor’s counterparty shows that the transaction was not harmful.

Therefore, when the legislation provides a set of avoidable transactions, it will be easier for the office-holder to identify and challenge the transaction. Nevertheless, since it is not possible to define all type of transactions, these systems should still provide—as they generally do—a general clause of avoidance. For example, in Italy or Spain, despite the fact that the legislator provides a set of avoidable transactions, there is also a general provisions stating that it will be avoidable any harmful transaction for either the creditors (Italy) or the company’s assets (Spain). Thus, these systems allow getting the benefits associated with a system of a defined set of avoidable transactions, but reducing the risk of not being able to challenge a harmful transaction that might not be included in these presumptions.

4.2.2.2. Financial requirements

A more powerful way to reduce litigation costs may consist of presuming, under some circumstances, the financial requirement that justify the existence of twilight periods: that is, the debtor’s state of insolvency. However, defining this moment might not be an easy task, since a debtor does not usually become insolvent in a specified moment of time. The debtor’s inability to pay debts usually arises as a result of several events that might take place in several moments of time. Nevertheless, many insolvency provisions, such as
transaction avoidance, are precisely based on such a moment in which the company becomes (or it is supposed to become) insolvent, since it is when the creditors become the residual claimants of the firm.

The determination of this financial condition implies, on the one hand, investigation costs. Then, if the result of this investigation is challenged by the debtor’s counterparty, it can also imply litigation costs. Therefore, since these costs may be ultimately borne by the creditors, many countries have found several ways to reduce these costs associated with determining the debtor’s state of insolvency. Some jurisdictions establish a fixed period of time in which the debtor is deemed to be unable to pay its debts, unless the contrary is shown. Thus, by the use of this presumption, the investigation costs associated with proving the debtor’s state of insolvency will be moved from the office-holder (and therefore the bankruptcy estate) to the debtor’s counterparty.

Other jurisdictions, however, go beyond this presumption (or this iuris tantum presumption), and establish a fixed period of time in which, regardless of the debtor’s financial situation, it is always possible to challenge a transaction. For this reason, in these latter situations, the period should no longer be considered as a ‘twilight period’ (or, if so, as an iuris et iure twilight period) but as an ‘avoidance period’. The rationale for this latter choice seems very straightforward: it reduces (actually, it deletes) both investigation and litigation costs associated with determining whether or not the debtor was insolvent at the moment of entering into the transaction. However, despite these benefits, the adoption of this solution may arise several problems. First, unless the twilight period is very short, it can seriously harm legal uncertainty. Second, it could increase moral hazard, since some solvent debtor foreseeing financial trouble may have incentives to undertake risky investment projects, or even to underinvest in information in order to make efficient decisions, taking into account that: (i) if the transaction goes well, it can be very profitable; and (ii) if the transaction goes bad, and the company becomes insolvent, they can always avoid the transaction. Finally, the

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69 The procedural costs associated with claw-back actions are usually borne by the debtor’s estate. However, in some jurisdictions not all benefits generated by transaction avoidance are received by the debtor’s estate. For example, in Spain, office get an extra fee over the increase of net assets recovered by the use of claw-back actions (1% of the net assets recovered for the benefit of the estate).
70 This is the case of the US Bankruptcy Code for both kind of avoidance actions (preferences and fraudulent conveyances).
71 This solution is adopted in the United Kingdom for the avoidance of transactions at an undervalue entered into with a related party.
72 For this reason, Spain does not technically have a ‘twilight period’ but an ‘avoidance period’.
73 In some jurisdictions, the debtor’s state of insolvency is substituted by other financial conditions that also imply an impairment of the debtor’s financial situation. This is the case of the United States for the avoidance of fraudulent conveyances, where the debtor’s state of insolvency can be substituted by other financial requirement such as a reasonable small capital. See § 548 (a)(1)(B)(ii)(II) of the US Bankruptcy Code.
74 This is not the case of Spain, where the ‘avoidance period’ is always 2 years, no matter the type of transaction (preference or fraudulent conveyances) or the type of counterparty (related or non-related party).
avoidance of completely valid transactions only seems to be justified when a company is, or is about to be, insolvent.\textsuperscript{75} If a company is solvent, the managers should be able to run the business for the primary interest of the shareholders.

In our opinion, a combination of both systems seems the most desirable solution. For example, for a short period of time prior to the commencement of the bankruptcy procedure (e.g., three to twelve months), the legislator may impose an ‘avoidance period’. Thus, the system could effectively reduce both investigation and litigation costs, but minimizing the costs associated with this solution. Nevertheless, if the legislator wants to leave the door open to capture harmful transactions beyond such period, it seems more desirable to provide a ‘twilight period’ in which the debtor’s state of insolvency may be presumed, unless otherwise is shown. Thus, the office-holder would be able to challenge, without bearing any investigation cost regarding the debtor’s financial situation, those harmful transactions potentially entered into by a debtor beyond the ‘avoidance period’. In any case, the length of the twilight period should also be limited (for example, up to two years). Otherwise, avoidance provisions may inefficiently increase legal certainty, and therefore it could be harmful for society.

4.2.2.4. Bad faith

The fact of being a good or bad faith counterparty may imply several consequences in avoidance actions – and, in general, in bankruptcy. Sometimes, it may imply longer twilight period. In other situations, it could affect to the third party’s right to preserve or, if so, return the property. In some jurisdictions, the claim held by bad faith counterparties may even be subordinated after the transaction is avoided.\textsuperscript{76} Therefore, it seems relevant to determine the concept of good and faith counterparties, at least, for the purposes of avoiding provisions. These concepts, however, are very controversial. There is not a clear definition of good and bad faith, and this definition can also be different depending on the context. For this reason, it would seem plausible to provide some guidelines or presumptions, as a way to reduce both legal certainty and litigation costs. In many jurisdictions, the concept of \textit{bad faith} is usually referred to those market participants who know what is going on. That is, in the context of avoidance actions, they have the knowledge, among other aspects, about: (i) whether the transaction was at an undervalue; (ii) whether the transfer or security interest received from the debtor was a preference; (iii) whether the debtor was in financial trouble;

\textsuperscript{75} In several jurisdictions, the financial requirement to avoid the transaction not only covers those situations in which the debtor is factually insolvent, but also those situations in which, as a result of the transaction, the debtor becomes insolvent. The United Kingdom and the United States, for example, follow this approach.

\textsuperscript{76} This is the solution, for example, in Spain. See article 73.3 of the Insolvency Act.
or (iv) especially for third parties different from the debtor’s counterparty, whether the property acquired comes from any of the aforementioned situations.77

Nevertheless, it is costly —when not, sometimes, impossible— to prove these elements. For this reason, some insolvency jurisdictions provide some presumptions of bad faith counterparties. These presumptions are usually linked to the condition of related parties, since they are in a better position to have this information. However, not always a related party has that information, or even if it has the information, it is used for a bad purpose. For this reason, it would seem desirable to allow the counterparty to prove its good faith, for example, by showing independent opinions about the value of its consideration, or by proving that it did not have the ability—or even the chance—to have that information. By contrast, the concept of good faith is not usually defined. Most jurisdictions presume the fact that people act in good faith. Thus, it can be inferred that a party acts in good faith unless: (i) a presumption of bad faith is met and cannot be rebutted; or (ii) another wrongful behavior is shown.

4.2.3. Subjective requirements

Some jurisdictions may require subjective requirements to avoid the transactions. For example, in the United Kingdom, the avoidance of preferences given to non-related parties requires to proof of a ‘desire’, and not just the ‘intention’, to prefer the creditor. When these requirements make impossible, and not just difficult, in practice to avoid a transaction, they can reduce rather than increase litigation costs. In fact, this might even be the intention of the UK legislator: to abolish the possibility of avoiding preferences given to non-related parties.78 Therefore, in practice, UK insolvency law only allows the avoidance of preferences to related parties.79 This solution, at first glance, may seem ‘odd’. However, some scholars have supported this solution based on efficiency grounds. Namely, they have argued that, unlike transactions at an undervalue, the avoidance of preference does not create any clear gain for the company’s net assets. Therefore, since the avoidance of a preference generates

77 In the US, for example, see Manhattaan Investment Fund. In this case, the Court held that, for a sophisticated lender, fail to act diligently in a timely manner is bad faith. In M&L Business Mach, the court stated that good faith includes not only honest belief, the absence of malice and the absence of design to defraud or to seek an unconscionable advantage but also freedom knowledge of circumstances with ought to put the holder on inquiry. 78 I am grateful to John Armour for suggesting this hypothesis on his corporate insolvency course at Oxford. 79 Indeed, under UK law, preferences given to non-related parties are virtually unavoidable. For an analysis of the requirement to avoid preferences under UK insolvency law, see Adrian Walter, Preferences, in John Armour and Howard Bennett (eds.), Vulnerable Transactions in Corporate Insolvency (Hart Publishing, 2003), pp. 159-170; Rizwaan J. Mokal, Corporate Insolvency Law: Theory and Application (Oxford University Press, 2005), pp. 316-338. For related parties, however, it will be enough to prove that (i) the transaction put a creditor in a better position and; (ii) the preference was made in the twilight period in which the debtor was, or as a result of the transaction became, insolvent. See Adrian Walter, Preferences, in John Armour and Howard Bennett (eds.), Vulnerable Transactions in Corporate Insolvency (Hart Publishing, 2003), pp. 123-181.
litigation costs, the avoidance of a preference can reduce the pie available for distribution. In these situations, therefore, the use of preference law could make the creditors as a whole worse off. Hence, it would make sense, from a policy perspective, to minimize the use of preference law.

In our opinion, however, the higher or lower use of preference law should be left to the creditors. According to traditional law and economic theories, creditors will probably favor the use of avoiding powers when they can get a higher return. Nevertheless, as shown in the ultimatum game, people may care about fairness. Therefore, some creditors may prefer to reduce their returns, provided that some of other fellows do not unfairly improve their position in the scheme of distribution. The question, then, rely on how to design the default rule that, in our opinion, should govern preference law. The answer should depend on the quality, reliability and independence of those people in charge of exercising the avoidance action. In jurisdictions with a debtor in possession regime, or where the office holder does not have enough expertise, it could make sense to impose a duty to avoid any preferences, unless the creditors say otherwise. By contrast, in jurisdictions with an independent, qualified office-holder it would make sense to let the trustee decide whether or not to avoid a transaction. In order to make its judgment, however, it should be helpful to provide him with some guidelines, based on the overall effect of the avoidance for the creditors, the conditions in which the preference was given, and the identity of the preferred creditor. Thus, if, as a result of the litigation costs, the avoidance of the preference makes the creditors as a whole worse off, or the preference was given in suspicious circumstances, or the recipient was a related parties, the office-holder should exercise the action. In any other circumstances, it might make sense not to exercise the action.

80 See Alan Schwartz, A Normative Theory of Business Bankruptcy, 91 VIRGINIA LAW REVIEW 1203, 1229-1238 (2005). This assertion assumes that the bankruptcy estate always bears litigation costs. However, this assertion might not be true in those jurisdiction in which the loser must (or, under some circumstances, can be required to) pay the other party's attorney fees.

81 In this game, a person (the Proposer) is asked to propose an allocation of a sum of money between herself and the other player (the Responder). The Responder then has a choice. He can either accept the amount offered to him by the Proposer, leaving the rest to the Proposer, or he can reject the offer, in which case both players get nothing. According to traditional economic theory, the proposer may just offer any sum of money greater than 0. However, experimental studies show that proposers usually offered forty-fifty percent of the sum of money to allocate. See Werner Güth, Rolf Schmittberger and Bernd Schwarze, An Experimental Analysis of Ultimatum Bargaining, 3 JOURNAL OF ECONOMICS, BEHAVIOR AND ORGANIZATIONS 367, 371-72, 375 tbls.4 & 5 (1982). For an excellent explanation of the ultimate game, see Cristine Jolls, Cass R. Sunstein and Richard Thaler, A Behavioral Approach to Law and Economics 50 STANFORD LAW REVIEW 1471, 1489-1493.

82 The ultimatum game, however, may also be interpreted under the assumptions of traditional economics. Firstly, it could be argued that an equal distribution offered by the Proposer may be the rational choice for this player. Indeed, in the absence of a reasonably equal distribution, the Responder may reject the offer, and if so, the Proposer may receive nothing. Therefore, it could be a way to minimize risk (or to assure profits). Secondly, and this is especially true for transactions with repeat player in the context of business relationships, it could also be argued that the 'fair' distribution of the sum of money is made just because the Proposer wants to keep happy to their counterparts (suppliers, costumers, etc.). Therefore, it might be both rational and efficient for the Proposer to offer a similar allocation of the sum of money.
4.2.4. Lawyers' fees

Despite the importance of the aforementioned costs of avoiding powers, the most important (or, at least, the most visible) cost arising in every avoidance procedure are the attorney’s legal fees.\footnote{As pointed out in Arturo Bris, Alan Schwartz, and Ivo Welch, *Who Should Pay for Bankruptcy Costs?*, 34 *The Journal of Legal Studies* 295, “the magnitude of direct professional expenses in bankruptcy can be significant. Warner (1977) finds that the direct costs of bankruptcy—compensation provided to lawyers, accountants, consultants, and expert witnesses—are about 4 percent of the market value of the firm 1 year prior to the default. Altman (1984) calculates these costs to be about 7.5 percent of firm value using a broader sample of 19 bankrupt companies from 1974 to 1978. In a sample of 22 firms from 1994, Lubben (2000) calculates the cost of legal counsel in Chapter 11 bankruptcy to represent 1.8 percent of the distressed firm’s total assets, with percentages above 5 in some cases. In the average case, the debtor spends $500,000 on lawyers, and creditors spend $230,000. LoPucki and Doherty (2004) study a sample of 48 cases from 1998 to 2002, mostly from Delaware and New York cases, and report that professional fees were 1.4 percent of the debtor’s total assets at the beginning of the bankruptcy case. Evidence from administrative fees from 105 Chapter 11 cases from the Western District of Oklahoma in Ang, Chua, and McConnell (1982) suggests that administrative fees are about 7.5 percent of the total liquidating value of the bankrupt corporation’s assets. Weiss (1990) and Betker (1997) have similar estimates. Fees can be large in absolute terms for large, complex bankruptcies. Advisors (whom we call experts) to MCI, the former WorldCom, Inc., have applied to collect about $600 million in fees, and Enron’s Chapter 11 plan estimates that fees to bankruptcy advisors’ will ultimately reach $995 million (Pacelle 2004).” In the context of avoidance powers, these costs can also be substantial, depending on several factors, such as the amount, the complexity or the number of challenged transactions. These litigation costs can actually lead to an undesirable reduction of the pie available for distribution, especially when the challenged transaction is a preference —where the avoidance does not necessarily imply, unlike transactions at an undervalue, an increase of the company’s net assets. See Alan Schwartz, *A Normative Theory of Business Bankruptcy*, 91 *Virginia Law Review* 1203, 1229-1231 (2005).} In this context, the rule governing attorney’s fees in avoiding powers vary across jurisdictions. Moreover, they can also depend on the procedural rules existing in a particular jurisdiction.\footnote{For an overview of the systems, see Giuseppe Chiovenda (translated by Juan de la Puente), *La Condena en Costas*, Madrid, 1928, p. 210. Torino, 1901; Steven Shavell, *Suit Settlement, and Trial: A Theoretical Analysis under Alternative Methods for the Allocation of Legal Costs*, 11 *The Journal of Legal Studies* 55 (1982).} For example, in the United States, the general rule in procedural law is that each party pays for its own litigation costs. In the United Kingdom, the party who loses the trial pays the other party’s attorney’s fee. In other countries, there is an intermediate rule. For instance, in Spain, each party pays for its own litigation costs, but the court can impose the loser to pay for the other party’s legal fees —and it will usually do so— when it acted with recklessness or bad faith. Therefore, since bankruptcy law do not usually modify these procedural rules, the legal fees of avoidance actions usually respond to the same scheme.

Thus, in the United States, the use of avoiding powers will always generate a cost for the bankruptcy estate. Under this scenario, the office-holder should assess whether the avoidance action will generate a gain for the creditors. If not, as it may happen with the avoidance of some preferences, it should not exercise the action. Nevertheless, since the risk of opportunism to give preferences may be higher in jurisdictions with a debtor in possession or in those systems where the office-holder is not an independent, qualified professional, our suggestion is that, unless the shareholders say otherwise, every
preference should be avoided, even if it makes the creditors as a whole worse off. Otherwise, the system could create perverse incentive in the vicinity of insolvency, and preference law would not effectively fulfill its economic goals.

By contrast, in jurisdictions with an independent, qualified office-holder managing the company in distress, this decision should be made by the office-holder based on some criteria mentioned above (e.g., conditions in which the preference was given, identity of the debtor’s counterparty, etc.). If there are indicia of bad faith, or the preference was given to a related party, the preference should be avoided, even if it makes the creditors as a whole worse off. Therefore, from a policy perspective, in systems with a debtor in possession regime, or with a non-qualified, independent office-holder, the avoidance of preferences should be imposed as a default rule. Therefore, preferences should be avoided, unless otherwise is provided by the creditors. By contrast, in systems with qualified, independent office-holders, the trustee should have the ability to decide whether or not the exercise an avoidance action, based on several indicia provided by the legislator.

The assessment of whether or not to exercise the action will be more difficult in jurisdictions where the costs of the attorneys’ fees are not clearly known ex ante, as it happens in the United Kingdom or Spain. In these jurisdictions, the office-holder should make a double effort in deciding whether or not to exercise the action.85 Under these regimes, the office-holder should also assess the likelihood of winning or losing the avoidance procedure. Thus, only when the net effect of the avoidance procedure is positive for the debtor’s net assets, measuring costs and benefits in terms of expected value, the avoidance action should be exercised.

4.3. Minimizing the risk of opportunism of shareholders vis-à-vis bona fide counterparties: financial conditions for the exercise of avoidance actions

Despite the general benefits created by the existence of avoiding powers, these devices can also be used opportunistically by the debtor, especially in systems with a debtor in possession regime. For this reason, several mechanisms should be provided to reduce any attempt to exercise avoiding powers opportunistically—normally, at the expense of the debtor’s counterparties. As it will be analyzed, the use of avoiding powers should be limited to those situations in which the value of the debtor’s assets is lower than the value of the

85 For this reason, sometimes could be efficient to assign the action to a qualified third party specialized in avoidance actions willing to bear all the litigation costs (including the investigation costs) in return for a percentage of the net gains generated by the action.
debtor’s liability at the moment of exercising the avoidance procedure. Otherwise, the bankruptcy estate would be sufficient to pay all creditors (and the debtor may be in bankruptcy just because it is facing liquidity problems), and therefore the use of avoiding powers may create several costs for society.

As seen above, most jurisdictions require the debtor to be insolvent (or a similar financial condition) at the moment of entering into the avoidable transaction. Otherwise, the use of avoiding powers might not be fully justified, since the creditors would not have become the residual claimant of the firm. Nevertheless, not many jurisdictions pay the same attention to the debtor’s financial conditions at the moment of exercising the avoidance procedure. The reason, we believe, is that they seem to assume that debtor is insolvent (otherwise, it might not make sense to open an insolvency proceeding), and therefore, this requirement does not seem to be needed—at least explicitly. However, the debtor may and, in some jurisdictions such as Germany and Spain, even must file for bankruptcy in situations where the value of its assets is greater the value of its liabilities, but it is just facing liquidity problems. In these situations, where the shareholders might be still in the money, the use of avoiding powers may be in the exclusive interest of the shareholders.

Therefore, ex ante, the avoidance of these transactions could create moral hazard, since the debtor may have incentives to make inefficient decisions knowing that: (i) in the transaction goes well, they can make (or save) money; and (ii) if the transaction goes bad, and the company becomes insolvent, they can still avoid the transaction. Moreover, from an ex post perspective, the avoidance of these transactions can even create an unjust enrichment for the shareholders at the expense of the debtor’s counterparty. Therefore, an efficient transaction avoidance system should take into account these considerations, and it should limit the use of avoiding powers to those situations in which the value of the assets is less than the value of the debtor’s liabilities. Nevertheless, since the valuation of an asset may

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86 In Colombia, for example, the debtor’s balance-sheet insolvency is a formal requirement to exercise an avoidance action (see article 74 of the 2006 Colombian Insolvency Act). In Spain, it used to be a requirement under the old bankruptcy regime. See José Ramírez, La Quiebra, Derecho concursal español, tomo II, 1ª Edición, Barcelona (1998). For an analysis of the new article 71 of the 2003 Spanish Insolvency Act, pointing out that the debtor’s balance-sheet insolvency is irrelevant to exercise an avoidance action, see the decision of the Commercial Court of Cádiz of June 30, 2010. The debtor’s state of insolvency will be relevant, however, for other avoiding powers existing outside of bankruptcy (and therefore, not analyzed in this article) as it is the actio pauliana existing in article 1111 of the Spanish Civil Code.

87 According to Van Hemmen, 69.02% of companies subject to a formal bankruptcy procedure in Spain in 2011 had positive net assets. This percentage was similar in 2010, and even greater in 2009, where 86.6% of the companies in bankruptcy had positive net assets. See Estefan Van Hemmen, Estadística Concurso 2011: el concurso de acreedores en cifras (2012) Colegio de Registradores de la Propiedad, Bienes Muebles y Mercantiles de España, pp. 17-18. We must note, however, that these data reflect accounting values. Therefore, letting aside the event of accounting fraud, it would be possible to find companies with positive net assets on an accounting basis but balance-sheet insolvent on a market basis.

88 For a comparative analysis of the concept and requirements of unjust enrichment, see Jason M. Neyers, in Mitchell McInnes and Stephen G. Pitel (eds), Understanding Unjust Enrichment (Oxford, Hart, 2004).
vary along the bankruptcy procedure, it would seem reasonable to establish that the value of the company’s assets should be slightly *higher* than the value of the company’s liabilities, just to make sure that the company’s assets will be sufficient to pay the company’s liabilities in a future, hypothetical liquidation. \(^{89}\)

### 4.4. Minimizing other residual costs of avoidance actions

The exercise of an avoidance action involves the assessment of several costs and benefits. Most of them have been described above. However, there are still some residual costs that can depend on the specific circumstances of the debtor, and the office-holder should know and assess these costs. For instance, the debtor may sometimes have positive net assets but it will face liquidity problems. In these circumstances, the use of avoiding powers could make the debtor worse off. Let’s suppose that the debtor sells an asset in the zone of insolvency for €100, when the market value was $150. In return, the debtor received cash. If the transaction is avoided, the debtor will recover the asset, but, under some insolvency regimes, it may be required to give the money back. \(^{90}\) Therefore, even though this transaction can increase (at least, from an ex ante perspective) the bankruptcy estate, it could be harmful for the ex post maximization of the value of a *viable firm* with liquidity problems. Moreover, as mentioned we analyzed the financial requirements to exercise the action, in these circumstances where the debtor’s net assets are below zero, the avoidance of the transaction may create moral hazard and unfair enrichment for the shareholders at the expense of the debtor’s counterparties.

Hence, the exercise of a claw-back action may imply some *residual costs*. Several factors may affect the desirability of an avoidance action. Though these costs may depend on several circumstances, they may include the current financial situation of the debtor, the type of consideration given to the counterparty, the length of the avoidance procedure, the overall effect of the transaction on creditors’ recoveries, or the perverse incentives that an improper use of avoiding powers may generate ex ante. For this reason, it will be crucial the role and the expertise of the person in charge of deciding whether or not to exercise the action, in order to make sure that the action will be socially desirable.

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\(^{89}\) For instance, it would seem reasonable that the avoidance action will not be exercised if the value of company’s assets is 20% greater than the value of the company’s liabilities.  
\(^{90}\) For instance, under Spanish bankruptcy law, unless it is shown that the debtor’s counterparty acted in bad faith, the counterparty’s claim will be deemed an *administrative expense* (see article 73.3 Spanish Insolvency Act). Therefore, the return of this money may make the debtor—and therefore the creditors as a whole—worse off.
5. Conclusion

This paper provides a comprehensive analysis of claw-back action from a comparative and functional approach. It analyzes the underlying rationale for the existence of claw-back actions, the costs that avoidance provisions may generate, and the ways several jurisdictions may address similar problems arising in the context of avoiding powers. It has been argued that the existence of avoiding powers in bankruptcy can create several benefits. However, the use—and even existence—of avoidance actions is not costless. On the one hand, the use of these actions may generate litigation costs. On the other hand, the existence of these mechanisms may harm legal certainty, especially in countries in which it is relatively easy to avoid a transaction, usually because bad faith is not required, the look-back period may be too long, or no financial conditions are required to avoid a transaction. Therefore, insolvency legislators should carefully deal with these costs and benefits in order to assure the economic desirability of avoidance powers. On the basis of this exercise, this paper has analyzed, from a comparative and functional approach, the optimal way to design claw-back actions across jurisdictions.