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The avoidance of pre-bankruptcy transactions: An economic and comparative approach

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GURREA-MARTINEZ, Aurelio. The avoidance of pre-bankruptcy transactions: An economic and comparative approach. (2018). *Chicago Kent Law Review*. 93, (3), 711-750.
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Published in Chicago Kent Law Review, 2018, 93 (3), pp. 711-750.
https://scholarship.kentlaw.iit.edu/cklawreview/vol93/iss3/5

THE AVOIDANCE OF PRE-BANKRUPTCY TRANSACTIONS: AN ECONOMIC AND COMPARATIVE APPROACH*

AURELIO GURREA-MARTÍNEZ†

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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,[1] allow the retrospective avoidance of perfectly *valid*

1. The expression "avoiding powers" was popularized in Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725 (1984). The expression "transaction avoidance" is generally used in the United Kingdom. *See* VULNERABLE TRANSACTIONS IN CORPORATE INSOLVENCY (John Armour & Howard Bennett eds., 2003); REBECCA PARRY ET AL., TRANSACTION AVOIDANCE IN INSOLVENCIES (2d ed. 2011); ROY GOODE, PRINCIPLES OF CORPORATE INSOLVENCY LAW 519–637 (4th ed. 2011). In Australia, these provisions are generally known as "claw-back actions" or "avoidance provisions." *See* ANDREW KEAY, AVOIDANCE PROVISIONS IN INSOLVENCY LAW (1997). 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) in its Legislative Guide on Insolvency Law uses the expression "avoidance proceedings." *See* U.N. COMM'N ON INT'L TRADE LAW, LEGISLATIVE GUIDE ON INSOLVENCY LAW, at 135–52, U.N. Sales No. E.05.V.10 (2005) [herein-

transactions. Thus, bankruptcy law allows the ex post alignment of incentives between factually insolvent debtors and their creditors, since the latter become the residual claimants of the insolvent firm but they did not have any control over the debtor´s assets while the company was not yet subject to a formal bankruptcy procedure.[2] Therefore, the existence of avoidance actions may ameliorate (ex ante) or otherwise reverse (ex post) opportunistic behaviors potentially faced by factually insolvent debtors.[3] In other words, when the deterrence effect of avoidance actions fails, these mechanisms allow creditors (or the trustee on their behalf) to challenge those

after LEGISLATIVE GUIDE ON INSOLVENCY LAW]. 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 or any other specific actions. Moreover, the study of avoidance powers will be made in the context of corporate insolvencies. Therefore, it will not deal with individuals.

2. The concept of residual claimants and its implications for the design of bankruptcy law is not always clear. Generally, residual claimants are identified with those investors who gain or lose at the *margin* from the actions of the firm. *See* George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CALIF. L. REV. 1073, 1100 (1995); Dan Keating, *Good Intentions, Bad Economics: Retiree Insurance Benefits in Bankruptcy*, 43 VAND. L. REV 161, 190 (1990). Therefore, those who are mainly exposed to these actions are usually *unsecured creditors*. That is why many authors argue that unsecured creditors should control the company in distress. *See* David A. Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461, 480–81 (1992); *see also* Douglas Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 695–96 (2003). In a seminal work, Professors Douglas Baird and Thomas Jackson also argued that "*the law of corporate reorganizations should focus on identifying the residual owner* [of the firm]*, limiting agency problems in representing the residual owner, and making sure that the residual owner has control over the negotiations that the firm must make while it is restructuring.*" Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738, 775 (1988) (emphasis added). 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 J. FIN. ECON. 411, 415 (1990); Thomas G. Kelch, *Shareholder Control Rights in Bankruptcy: Disassembling the Withering Mirage of Corporate Democracy*, 52 MD. L. REV. 264, 332 (1993); Scott F. Norberg, *Debtor Incentives, Agency Costs, and Voting Theory in Chapter 11*, 46 KAN. L. REV. 507, 536 (1998); *see also* Lynn M. LoPucki, *The Myth of the Residual Owner: An Empirical Study*, 82 WASH U. L.Q. 1341 (2004) (analyzing, from an empirical perspective, the concept and implication of the residual owners of the insolvent firm). Technically, creditors will become the residual claimant of a firm when a company is *balance-sheet insolvent* on a market basis. However, unless otherwise is stated, this paper will assume, for simplicity, that creditors are the residual claimants of any insolvent firms—no matter the type of insolvency. How to define insolvency will be discussed below.

3. Robert Charles Clark, *The Duties of the Corporate Debtor to its Creditors*, 90 HARV. L. REV. 505 (1977); Jackson, *supra* note 1; Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829 (1985); Daniel D. Prentice, *The Effect of Insolvency on Pre-Liquidation Transactions*, *in* COMPANY LAW IN CHANGE: CURRENT LEGAL PROBLEMS 69, 75–78 (B.G. Pettet ed.,1987); John Armour, *Transactions at an Undervalue*, *in* VULNERABLE TRANSACTIONS IN CORPORATE INSOLVENCY, *supra* note 1, at 37, 46.

transactions that they would have never entered into if they (instead of the debtor) had been running the insolvent firm.[4]

Therefore, the existence of avoiding powers may create several benefits. First, they may prevent or, if so, reverse various types of opportunistic, value-destroying behaviors usually faced by debtors in the zone of insolvency, such as *asset dilution* (i.e., siphoning assets, usually to related parties), *asset substitution* (i.e., pursuing risky projects even if they have a negative net present value), and *debt dilution* (e.g., borrowing money even when the company has no chance to survive). Thus, the existence of avoidance powers may help maximize the value of the firm, not only ex post (i.e., once the company is in bankruptcy) but also ex ante, since it may discourage market participants to enter into transactions with an insolvent debtor.

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.[5] 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, and it may encourage the managers to take corrective actions in a timely manner. As it was mentioned, the existence of avoiding power may prevent value destroying transactions (including the continuation of distressed firms). One way to do so is by using third parties as "gatekeepers" of the debtor's financial situation.[6] In other words, the possibility of avoiding a

4. This decision made ex post may create a problem of hindsight bias, that is, the inclination, after an event has occurred, to think that the outcome was predictable, despite the fact that there was no objective basis for predicting the result at the moment of making the decision. *See, e.g.*, Neal J. Roese & Kathleen D. Vosh, *Hindsight Bias*, 7 PERSP. ON PSYCHOL. SCI. 411 (2012); Baruch Fischhoff, *Hindsight ≠ Foresight: The Effect of Outcome Knowledge on Judgment Under Uncertainty*, 1 J. EXPERIMENTAL PSYCHOL. 288 (1975); DANIEL KAHNEMAN, THINKING FAST AND SLOW 202–04 (2011); Baruch Fischhoff, *For Those Condemned to Study the Past: Heuristics and Biases in Hindsight*, *in* JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 335–52 (Daniel Kahneman et al. eds., 1982). Hence, people—and creditors, judges, and trustees are not an exception—tend to bias their judgments in favor of the outcome. Therefore, in this context, as the company will be already insolvent, the hindsight bias will incentivize creditors, judges, and trustees to think that the transaction potentially challenged was harmful ex ante, even if it, at the moment of entering into the transaction, it looked reasonable. Therefore, efforts should be paid to judge the transaction according to the information available ex ante. If the transaction did not look harmful ex ante, it should *not* be avoided.

5. THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW, 7–9 (1986). *But see* Barry E. Adler, *A Re-Examination of Near-Bankruptcy Investment Incentives*, 62 U. CHI. L. REV. 575 (1995).

6. Triantis & Daniels, *supra* note 2; Armour, *supra* note 3, at 47.

transaction at some point in the future will likely 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 transaction will be avoided in bankruptcy. In these latter circumstances, the debtor's counterparty will unlikely enter into the transaction, due to the high risk of avoidance. Therefore, by using third parties as "gatekeepers," market participants may be warned about the debtor's financial trouble, and managers may be incentivized to take corrective actions in a timely manner.

2. Types of Avoidance Actions Around the World

Most insolvency jurisdictions provide a set avoidance provisions. Nevertheless, the way avoidance actions are designed differs around the world. Some jurisdictions provide a *single* avoidance action that generally capture any *harmful transaction* to the creditors. This is the model followed by many civil law countries, including France, Spain, and Italy. The other general model of avoidance actions is followed by many common law jurisdictions, including Australia, the United Kingdom, and the United States. This latter model consists of a *double* set of avoiding powers: (i) 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. Under this second model to design avoidance powers, the former type of actions are usually referred as *undervalue transactions* (U.K.) or *fraudulent conveyances* (U.S.), while the second type of transactions are usually known as *unlawful preferences*.

Systems with a single avoidance action 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 general set of avoiding powers, many jurisdictions (including the same ones) may provide other 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* bankrupt-

cy (for example, the avoidance of unregistered charges in the United States and the United Kingdom, or the avoidance of post-petition dispositions of the debtor's assets, as it is allowed in many jurisdictions). Even though all of these avoiding powers share a similar rationale, this paper will be focused 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, it will be analyzed the economic problems that avoidance actions seek to solve, and how different jurisdictions address these similar problems. Thus, we will be in a better position to assess the economic desirability of each solution in order to draw conclusions about the most desirable way to design claw-back actions across jurisdictions.

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 may avoid 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, that is, when the transaction takes place. Otherwise, the existence of avoiding powers may generate legal uncertainty, since 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. Therefore, the design of avoidance actions may have a direct impact in the promotion of investments and economic growth in a country.

The challenge, then, from a policy perspective, is to establish a system of avoiding powers that can maximize the value of insolvency firms (ex post efficiency) without harming legal certainty (ex ante efficiency). For this purpose, the design of an optimal system of avoidance actions should carefully deal with the trade-off between: (i) the gains generated by discouraging or otherwise reversing opportunistic behaviors and value-destroying transactions entered into in the zone of insolvency; and (ii) the costs associated with the use and even existence of avoiding powers (e.g., 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) conflicts between shareholders (or managers acting on their behalf) and creditors; (ii) conflicts of managers[7] vis-à-vis shareholder and creditors; and (iii) conflicts 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 (and even existence) of avoiding powers may generate several benefits for society.

3.2.1. Conflicts Between Shareholders/Managers and Creditors

When a firm has enough assets to meet its payments, most creditors are not more than contractual counterparties.[8] 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.[9] For this reason, financial economists usually define debt as *contingent rights* over the debtor's assets.[10]

Likewise, when a company is balance-sheet insolvent and therefore the shareholders have lost their investments, the company is, by definition, entirely financed by the creditors. 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.[11] 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.[12] Second, in

7. Unless otherwise is stated, this paper use managers and directors as synonyms.

8. John Armour et al., *Transactions with Creditors*, *in* REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 109, 115 (3d ed. 2009).

9. *See* George G. Triantis, *The Interplay Between Liquidation and Reorganization in Bankruptcy: The Role of Screens, Gatekeepers, and Guillotines*, 16 INT'L. REV. L. & ECON. 101, 103 (1996); Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921, 922 (2001); Robert K. Rasmussen, *Secured Credit, Control Rights and Options*, 25 CARDOZO L. REV. 1935 (2004); RIZWAAN JAMEEL MOKAL, CORPORATE INSOLVENCY LAW: THEORY AND APPLICATION 306–07 (2005).

10. *See generally* OLIVER HART, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE (1995).

11. Paul Davies, *Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency*, 7 EUR. BUS. ORG. L. REV. 301, 311 (2006); Clark, *supra* note 3; MOKAL, *supra* note 9; Prentice, *supra* note 3, at 69–89.

12. MOKAL, *supra* note 9.

jurisdictions with controlling shareholders, or more generally in any closely held corporations, the managers are usually identified with, or are very close to, the equity's owners.[13] 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 when a bankruptcy regime removes the managers and appoints a trustee. Thus, their incentives can be tied to those of the shareholders.[14] Finally, the compensation packages of corporate directors 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.

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.[15] 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 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 (sometimes, due to the lack of resources to gather and analyze information); or (iii) just an unwise or inefficient decision by the managers (often incentivized by the rush to get cash).

These transactions, generally known as *fraudulent conveyances* (U.S.) or *undervalue transactions* (U.K.) in those countries with a double set of avoiding powers, should be challenged for several reasons. On the one hand, this lower consideration *harms* the debtor's assets, and therefore the creditors as a whole. On the other hand, it helps prevent or otherwise reverse opportunistic behaviors by the debtor and other market participants.

A second problem that avoiding powers should address is the perverse incentives potentially faced by the shareholders of financially distressed

13. *Id.* at 307.

14. Rizwaan J. Mokal, *An Agency Cost Analysis of the Wrongful Trading Provisions: Redistribution, Perverse Incentives and the Creditors' Bargain*, 59 CAMBRIDGE L.J. 335, 350 (2000); Horst Eidenmüller, *Trading in Times of Crisis: Formal Insolvency Proceedings, Workouts and the Incentives for Shareholders/Managers*, 7 EUR. BUS. ORG. L. REV. 239, 243 (2006).

15. Armour, *supra* note 3.

firms to "gamble" the firm once it becomes (balance-sheet) insolvent. This problem, generally known as "asset substitution,"[16] relied on the intuition that shareholders, once they have lost everything, may have incentives to undertake very risky investments even if they have a negative net present value.[17] Thus, if the project succeeds, the shareholders can recover part (if not all) of their investments. Nevertheless, if the project fails (as it is the most likely result), the shareholders will lose nothing—since, at least in corporations, they will be protected through the limited liability—and the creditors will bear all the losses.[18] Therefore, this situation cannot be allowed by the legislator. Ex ante, this problem can be solved or, at least, minimized by providing a directors' general *duty to the creditors* in the zone of insolvency as it happens in many jurisdictions.[19] Ex post, once the company harms the creditors (normally, because it pursues value-destroying projects that ultimately make the company insolvent or more 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.

16. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 333–43 (1976). The company exchanges its few safety assets (e.g., cash) for new risky assets (e.g., investment projects).

17. These projects usually have a very high probability of failure. However, in case of success, they can be very profitable.

18. Armour, *supra* note 3, at 46–47.

19. In the United Kingdom, there is a general duty to minimize losses for creditors once the company reaches a point at which the directors know, or should have known, that there is no reasonable prospect of avoiding an insolvent liquidation. Insolvency Act 1986, c. 45, § 214 (Gr. Brit.). *See* Davies, *supra* note 11, at 317; Mokal, *supra* note 14; D.D. Prentice, Comment, *Creditor's Interests and Director's Duties*, 10 OXFORD J. LEGAL STUD. 265 (1990). In Germany and Spain, once a company becomes factually insolvent, the board of directors should file for bankruptcy within three weeks (Germany) or two months (Spain). In Germany, see Gesetz betreffend die Gesellschaften mit beschrinkter Haftung [GmbHG] [Act on Limited Liability Companies], Apr. 20, 1892, RGBL I at 477, as amended, § 64(1) (Ger.), https://www.gesetze-im-internet.de/englisch_gmbhg/index.html [https://perma.cc/2WWH-V36C], and Aktiengesetz [AktG] [Stock Corporation Act], Sept. 6, 1965, BGBL I at 1089, as amended, § 92(2) (Ger.), https://www.gesetze-im-internet.de/aktg/BJNR010890965.html [https://perma.cc/YLT7-6NKK]. For a comparative analysis of Germany and the United Kingdom, see Thomas Bachner, *Wrongful Trading—A New European Model for Creditor Protection?*, 5 EUR. BUS. ORG. L. REV. 293 (2004). In Spain, see the Spanish Insolvency Act, art. 5.1 (B.O.E. 2003, 13813). However, under the Spanish bankruptcy law, the bankruptcy petition can be suspended for four months if the insolvent debtor tells the courts that it is insolvent, but it is negotiating an out of court agreement with its creditors. *See id.* art. 5. 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*., No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991), 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 Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007), arguing that, in the zone of insolvency, a corporation still owes fiduciary duties to the corporation and its shareholders, not its 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.[20] 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 (including investing in the distressed firm itself, when it has no economic viability). In these circumstances, *old creditors* will end up worse off, since there will be a "pie" (sometimes smaller) to be divided among more people. Therefore, they may suffer from a "debt dilution" problem.

This situation, however, may change for the *new creditors*—at least, in the case of professional lenders. Indeed, if these new creditors were aware of the financial situation of the debtor, they may protect themselves (for example, by requiring a security interest). Moreover, if this new debt is used for value-creating purposes, many jurisdictions allow these lenders to be protected in bankruptcy through a priority for this new ("fresh") money. An insolvency jurisdiction 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. An insolvency regime very willing to allow debtors 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 or, if so, protected in bankruptcy.

3.2.2. Conflicts Among Creditors

In economic terms, debt is usually defined as contingent rights over the debtor's assets. In other words, debt gives creditors an *option* to become the owners of the company's assets.[21] This option will become exercisable when the firm defaults in payments. In these situations, the creditors

20. A way generally used in many jurisdictions to encourage lenders to provide funding may consist of giving them *priority* in the bankruptcy.

21. *See* JACKSON, *supra* note 5.

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 these assets.

This system of individual enforcement, nevertheless, may destroy the going-concern value of an economically viable business just facing financial trouble. Moreover, it should be kept in mind that creditors unlikely know each other. Therefore, it will be difficult to coordinate their actions. Moreover, if they were able to do so at a reasonably cost, other problems may arise. For example, creditors may have different incentives. Indeed, 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. Likewise, creditors will unlikely trust each other. Hence, they will all have incentives to run toward the debtor's assets and being the first ones to get paid. This leads to the "common pool problem," which is a form of prisoner's dilemma, stated by Thomas Jackson: 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 will generate 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 society if creditors do not cooperate, most jurisdictions provide a state-supplied, mandatory device to cooperate: a bankruptcy procedure.[22]

In the absence of bankruptcy law, many costs may arise when a debtor defaults *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 *coordination problem* that may generate several costs to society. First, in 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.[23] Therefore, it would seem socially desirable to pro-

22. This is the rationale behind to the mandatory nature of bankruptcy procedures. *See* Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857(1982); JACKSON, *supra* note 5. 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).

23. Let's suppose that a creditor can recover fifty percent of its claim in liquidation and seventy-five percent in reorganization. In this case, it could make sense for them to collaborate. However, this collaboration will unlikely take place in the real world.

vide a system where all creditors can be informed about the debtor's viability and financial affairs.[24]

The aforementioned problems can be solved by putting a company in bankruptcy. Nonetheless, these problems usually arise when a debtor *starts* defaulting—not *generally* yet, though. 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.[25] Therefore, other solutions might be more desirable. One set of solutions may consist of *out-of-court of agreements*—sometimes, under the supervision (or ratification) of a court.[26] These devices may reduce the costs of bankruptcy.[27] Therefore they could well serve the interest of the creditors.

24. For a contractual approach to the resolution of financial distress, see Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51 (1992), and Alan Schwartz, *A Contract Theory Approach to Bankruptcy*, 107 YALE L.J. 1807 (1998). Supporting a privatization of bankruptcy, see Julian Franks et al., *The Privatization of Bankruptcy: Evidence from Financial Distress in the Shipping Industry* (European Corp. Governance Inst., Finance Working Paper No. 505/2017, 2017), http://ecgi.global/sites/default/files/working_papers/documents/5052017.pdf [https://perma.cc/98K8-6KA4]. However, these authors are aware that the shipping industry presents some unique features, and therefore these results should not be generalized to other industries.

25. Davies, *supra* note 11, at 337.

26. The distinction between pre-bankruptcy procedures and out-of-court agreements is not always clear. *See* Jose M. Garrido (Senior Counsel, World Bank Group [WBG]), *Out-of-Court Debt Restructuring*, WBG Rep. No. 66232 (Jan. 12, 2012), http://documents.worldbank.org/curated/en/417551468159322109/pdf/662320PUB0EPI00turing09780821389836.pdf [https://perma.cc/GF8R-TQJE]. Many insolvency jurisdictions provide an out-court-agreement supervised (or sanctioned) by the court, such as the U.K. Scheme of Arrangement, the Italian Debt Restructuring Agreement or the Spanish Refinancing Agreement. Likewise, other jurisdictions, such as France or Spain, provide a mediation or conciliation proceeding that can also be qualified as a pre-bankruptcy procedure.

27. For a general overview about the costs of financial distress, see RICHARD A. BREALEY ET AL., PRINCIPLES OF CORPORATE FINANCE 447–60 (10th ed. 2011). In a pioneering and very early study in this field, see Jerold B. Warner, *Bankruptcy Costs: Some Evidence*, 32 J. FIN. 337, 344–46 (1977), showing that the direct costs of bankruptcy were three to four percent 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 J. FIN. ECON. 285 (1990). However, Gregor Andrade & Steven N. Kaplan, *How Costly Is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions That Became Distressed*, 53 J. FIN. 1443 (1998), argue that the costs of financial distress represent ten to twenty percent of the market value of the firm. These costs, however, seem to be higher in the United Kingdom, at least for small firms. *See* Julian Franks & Oren Sussman, *Financial Distress and Bank Restructuring of Small to Medium Size UK Companies*, 9 REV. FIN. 65 (2005) (reporting that insolvency liquidations subtract twenty to forty percent 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, which usually have more simple capital structures, non-bankruptcy procedures might be more efficient. *See* Edward R. Morrison, *Bankruptcy's Rarity: An Essay on Small Business Bankruptcy in the United States*, 5 EUR. COMPANY & FIN. L. REV. 172 (2008); Edward R. Morrison, *Bargaining Around Bankruptcy: Small Business Workouts and State Law*, 38 J. LEGAL STUD. 255 (2009); Stuart C. Gilson et al., *Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default*, 27 J. FIN. ECON. 315 (1990). However, see Karin S. Thorburn, *Bankruptcy Auctions: Costs, Debt*

A second set of solutions may consist of the imposition of *fiduciary duties* toward creditors, or even their duty to file for bankruptcy. 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 interests of the creditors by *discouraging* value-destroying transactions in the zone of insolvency. Ex post, avoidance actions may *reverse* value-destroying transactions that coordinated and informed creditors would have unlikely approved. Therefore, the use of avoidance powers may be a powerful tool to protect creditors.

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 to solve those problems that may arise *among* creditors. For these problems, most insolvency jurisdictions provide a mechanism to avoid transactions favoring one creditor over others. In jurisdictions with a multiple set of avoiding powers (e.g., Australia, United Kingdom, United States), 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 just for the fact of being harmful for *individual* creditors. Therefore, while systems with multiple avoidance actions usually provide different actions to reverse transactions potentially harmful for the *creditors as a whole* (undervalue transactions or fraudulent conveyances) or *individual creditors* (preference law), jurisdictions with a single system of avoidance actions usually allow to reverse both transactions through the same action—sometimes subject to different requirements, though.

The use of *preference law*, as we will name those mechanisms consisting of avoiding transactions that may favor one creditor over others, may also reduce opportunistic behaviors. Some authors argue that preference law does not help maximize the value of the firm.[28] Namely, they argue

Recovery, and Firm Survival, 58 J. FIN. ECON. 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 & Leora F. Klapper, *Bankruptcy Around the World: Explanations of Its Relative Use*, 7 AM. LAW & ECON. REV. 253 (2005).

28. *See* GOODE, *supra* note 1, at 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 of preference law is to reverse or prevent unjust enrichment, see Andrew Keay, *The Recovery of Voidable Preferences: Aspects of Restoration*, *in* RESTITUTION AND INSOLVENCY 237, 251 (Francis Rose ed., 2000), and Peter Birks & Charles Mitchell, *Unjust Enrichment*, *in* 2 ENGLISH PRIVATE LAW 525, 590 (Peter Birks ed., 2000).

that preference law is not concerned with the "size" of the pie but just with its distribution. Other authors, however, have proposed a different hypothesis, arguing that preference law may reduce, at an early stage, the common pool problem that bankruptcy law seeks to solve.[29] Some scholars, nonetheless, disagree with this argument, and they state that, even though preference law may maximize the value of the firm, the way to do so is not by solving a common pool problem.[30] Indeed, according to this proposal, preference law, as it is currently designed in many jurisdictions, does not deter grabs in the vicinity of insolvency. In fact, creditors will be better off by grabbing assets: If the company is not finally put into bankruptcy, or the transaction is not finally avoided, the debtor's counterparty will preserve the preference. And if the transaction were eventually avoided, the counterparty would not be worse off.[31] 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 on the preferred creditor.[32] However, several reasons may explain why this solution has not been adopted in many jurisdictions.[33] In the case of "adjusting creditors,"[34] this solution may lead to an ex ante increase in the cost of debt, even in those cases where the likelihood of bankruptcy is very low.[35] Alternatively, it may lead to an underinvestment problem, since many creditors may be reluctant to provide finance to many debtors, even if they are economically viable and

29. *See* JACKSON, *supra* note 5.

30. Arguing that U.S. preference law fails to fulfil this goal, see Adler, *supra* note 5. With a similar view in the context of U.K. preference law, see Adrian Walters, *Preferences*, *in* VULNERABLE TRANSACTIONS IN CORPORATE INSOLVENCY, *supra* note 1, at 123, 136–38.

31. 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 claim of the debtor's counterparty claim will be classified as an administrative expense. *See* Insolvency Act art. 73.3 (B.O.E. 2003, 13813) (Spain). 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 in the context of transactions at an undervalue, the debtor's estate may increase.

32. For example, by subordinating its claim or by making the preferred creditor to bear the debtor's attorney fees for the avoidance procedure.

33. The subordination is applied in some jurisdictions when it is proved that the debtor´s counterparty acted in *bad faith*. For example, see the Spanish Insolvency Act, art. 73.3 (B.O.E. 2003, 13813).

34. For an analysis of the concept of "adjusting" and "non-adjusting" creditors, see Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 882 (1996).

35. *See* Adler, *supra* note 5, at 590–98.

they want to pursue socially valuable projects. In the case of non-adjusting creditors, the explanation may be a bit simpler: these creditors, by definition, do not have the ability to negotiate the terms of their contracts. Therefore, they will ignore that the debtor is facing financial trouble. Thus, they can be involved in an unlawful 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 the desirability of preference law, various bankruptcy scholars have provided other reasons. Firstly, it has been argued that preference law helps preserve the pari passu principle in the vicinity of the insolvency.[36] 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 for the creditors, since the use of avoidance powers implies litigation costs, but a preference does not always generate an increase of 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."

In my opinion, the most desirable solution should depend on the specific features of a corporate and bankruptcy jurisdiction. In countries where 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.[37] Thus, the ex ante function of preference law would be credibly fulfilled. Moreover, from an ex post perspective, preference law would also be used in a more efficient way. Nevertheless, in jurisdictions where the trustee has a poor level of expertise, or the bankruptcy procedure is managed by the debtor in posses-

36. *See generally* Charles Seligson, *Preferences Under the Bankruptcy Act*, 15 VAND. L. REV. 115 (1961); John C. McCoid, II, *Bankruptcy, Preferences, and Efficiency: An Expression of Doubt*, 67 VA. L. REV. 249 (1981); GOODE, *supra* note 1, at 569–71. For a critical examination of the pari passu principle, see Rizwaan Jameel Mokal, *Priority as Pathology: The Pari Passu Myth*, 60 CAMBRIDGE L.J. 581 (2001). For a more recent criticism of the principle of equality in bankruptcy, see David A. Skeel, Jr., *The Empty Idea of "Equality of Creditors*,*"* 166 U. PA. L. REV. 699 (2018).

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

sion, several reasons may justify the *imposition*, and not just the ability, to avoid preferences, even if this solution might be inefficient.[38] Indeed, in countries in which the trustee is not a qualified actor, the trustee will not be in a good position to distinguish "efficient" or "inefficient" avoidance actions. Likewise, in 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 may encourage the debtor to favor some creditors (normally related parties or repeat players) over others, since it will be known that: (i) if the company does not finally enter into bankruptcy, the debtor's counterparty will preserve the preference; and (ii) if the company eventually ends up in bankruptcy, it will be in the debtor in possession's hands to avoid (or not) the preference. Therefore, in these latter jurisdictions, it would seem desirable to avoid *any* preference given in the vicinity of insolvency.

A second explanation given to justify the desirability of avoidance actions is not based on "fairness" reasons but on efficiency grounds. Namely, it has been argued that preference law 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, it may have incentives to gamble the firm.[39] For this reason, the existence of *fraudulent conveyance law* may discourage (ex ante) or reverse (ex post) some 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 put in place (e.g., disqualifications or liability for wrongful trading), the debtor still has incentives to bet the firm. The situation could change, however, if the debtor's counterparty is used as a gatekeeper. In these situations, multiple market participants would be monitoring debtors, and they would only be incentivized to enter into

38. This solution should be imposed, unless the creditors decide otherwise. Sometimes, the creditors may prefer to give up part of their recoveries, provided that nobody else is "unfairly" getting more than them. This hypothesis may be supported by behavioral theories such as the *ultimatum game*. *See infra* notes 83–84.

39. Challenging this "overinvestment hypothesis," see Erik Gilje, *Do Firms Engage in Risk-Shifting? Empirical Evidence*, 29 REV. FIN. STUD. 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 J. FIN. ECON. 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. *See* Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537, 540 (2004).

transactions with a debtor provided that the transaction is fair and the debtor is financially sound. Otherwise, the debtor's counterparty may be exposed to a future avoidance action, and therefore, from an ex ante perspective, may be discouraged to enter into transactions with debtors in distress.

In a similar way, it may occur—and here is where *preference law*, instead of fraudulent conveyance law, may fulfil a reasonable economic goal—that the debtor in financial trouble does not want to pursue any new investment project. Let´s suppose that the debtor just wants to remain in business. In these cases, it may ask for cash from either a new or a preexisting lender. 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 preexisting creditors are *out* of the money, it might be rational for them to provide funds—no matter their use—provided that the lender receives a security interest not only for the new money but also for *part* of the preexisting debt. Thus, an overinvestment project may be created or at least exacerbated by preexisting lenders. Therefore, the use of preference law may help maximize the value of the firm by preventing these value-destroying behaviors.[40]

Finally, other arguments have been pointed out to justify the efficiency of preference law. Namely, it has been argued that the existence of preference law encourages creditors to oversee the debtor's activities. And this monitoring function could be valuable for society as a whole. 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) creditors for those resources spent in monitoring the debtor's activities. In this context, the existence of preference law may serve this goal.[41] 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 creditors invest time and resources in monitoring the debtor's activities, 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

40. *See* Adler, *supra* note 5; Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 462 (1992); Alan Schwartz, *A Normative Theory of Business Bankruptcy*, 91 VA. L. REV. 1199, 1203, 1229–31 (2005).

41. This argument was developed by Triantis & Daniels, *supra* note 2, at 1094–95.

departure from the general scheme of liquidation in bankruptcy. Therefore, there would be unlawful preferences that should be avoided in bankruptcy.

3.2.3. 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 twentieth century. Since this contribution, and especially after the 1970s, legal and finance scholars started to focus their attention on how to minimize those conflicts of interests existing between *managers and shareholders*.[42] However, this misalignment of incentives between managers and shareholders has not been generally assumed by bankruptcy law scholars.[43] Perhaps for simplicity, it is generally assumed that managers and shareholders have similar interests, since the shareholders have the ability to appoint, pay, and remove the directors.[44] Likewise, bankruptcy scholars have not traditionally taken into account the primary agency problems existing in jurisdictions with controlling shareholders, that is, those agency costs existing between majority and minority shareholders.[45]

Corporate law scholars teach us that, unlike it is generally assumed by bankruptcy scholars, 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 be exacerbated when a company faces financial trouble, especially if the company is not economically viable and therefore the likelihood of ending up in liquidation is higher.

Indeed, in jurisdictions with *dispersed* ownership structures, managers may have (even more) incentives to favor themselves at the expense of the shareholders.[46] They could do so by siphoning assets out of the company, or just by assuming a suboptimal level of risk as a way to preserve their jobs and private benefits of control.[47] Moreover, they may have incentives

42. For a seminal explanation, see Jensen & Meckling, *supra* note 16, at 313.

43. In fact, in previous sections of this paper, we also assumed this fact. Namely, it was assumed when we analyzed the conflict of interests of shareholders/managers vis-à-vis creditors.

44. MOKAL, *supra* note 9.

45. *See* Simeon Djankov et al., *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430, 436 (2008); Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1114 (1998). However, proposing that controlling shareholders should be allowed to pursue their "idiosyncratic vision," see Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560, 564 (2016).

46. This is a consequence of the higher agency costs between managers and shareholders existing in these jurisdictions.

47. *See* Eckbo & Thorburn, *supra* note 39.

to favor some creditors over others, just because they are friends or because they can become future employers for them. 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 *heighted* misalignment of incentives between majority and minority shareholders arising in the zone of insolvency.

4. Constraining the Harmful Effects of Avoiding Powers

It has been argued that avoidance provisions may generate several benefits for insolvent firms and more generally society as a whole. Nevertheless, the existence of these actions is not costless. Ex post, avoidance procedures may generate litigation costs. Ex ante, the possibility of avoiding perfectly valid transactions may generate legal uncertainty, so it may discourage investments. Therefore, a very "lax" regime of avoidance actions (that is, a system in which it is too easy to avoid a transaction) may be harmful for the promotion of economic growth. Ex post, however, these systems may be more powerful to maximize the bankruptcy estate and to credibly fulfil the economic goals of avoidance actions (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, a regime in which it is so hard to avoid a transaction) may be desirable ex ante. However, it may also generate some costs. Namely, it may reduce the pie available for distribution and it may also make avoidance actions a less credible mechanism against third parties. So, while this latter effect can be valuable for legal certainty, it may also harm the power of avoidance provisions to prevent opportunistic behaviors in the zone of insolvency.

4.1. Minimizing the Risk of Legal Uncertainty

The retrospective avoidance of 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 actions. 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 legislation 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 trustee or debtor in possession—acting in the interest of the creditors—could be discouraged or even impeded from exercising the action. Nevertheless, as it will be analyzed below, while most of the aforementioned solutions can efficiently reduce legal uncertainty, some of them may also generate adverse effects that insolvency legislators should take into account.

4.1.1. The Use of Twilight Periods

4.1.1.1. The Concept and Rationale of "Twilight Periods"[48]

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 requirement just helps 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* twi-

48. This paper will use the term "twilight period," "suspect period" or "look-back period" as synonyms. Avoidance period, however, will be used in a different way. This latter concept will be used for those periods in which no financial condition is needed to avoid a transaction.

light period may serve several functions.[49] 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 system may encourage third parties to oversee the debtor's financial situation, and therefore to create positive externalities in society. Nevertheless, the costs of this solution, in our opinion, may exceed its benefits.

First, not all markets participants have the ability or, in the case of involuntary creditors, even the chance to monitor the debtor's financial situation. Second, if the only criterion to avoid a transaction is the debtor's insolvency, and therefore those debtors in insolvency will be factually excluded from entering into transactions with other market participants, debtors may be incentivized to reduce the risk of insolvency. And if so, companies may bear a suboptimal level of risk (or to borrow less money), so this solution could harm innovation and growth. Finally, the possibility of avoiding *any* transaction entered into by a debtor in financial trouble, no matter when it took place, may be harmful for legal uncertainty. Therefore, it could lead parties to be reluctant to enter into transactions with many market participants, even when they were financially sound. 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. In other words, this policy choice may be helpful to maximize the pie available for distribution, but it could be harmful for legal certainty. 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.[50] 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

49. Spain used to have this *unlimited* twilight period prior to the Insolvency Act (B.O.E. 2003, 13813).

50. 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, *supra* note 1.

generally depends on several factors such as 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 than the period to avoid a *transaction at an undervalue*.[51] This distinction is probably explained by the fact that when a debtor is starting to face financial trouble, it may have more incentives to accept any condition required by its 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 likely borne by the debtor. Moreover, in the case of gifts, or transactions with no consideration at all for the debtor, a longer twilight period seems to be 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, the debtor would not likely give something without receiving any consideration). However, when the debtor's financial situation is getting worse, and there are no chances to turn around the company, the debtor may have more incentives to give *preferences*, as a way to preserve its relationships with friends, future suppliers, or future financiers. Therefore, the likelihood of giving preferences will be higher nearer the commencement of the bankruptcy procedure.

Likewise, and perhaps with a clearer rationale, many insolvency jurisdictions establish different twilight periods according to the type of the debtor's counterparty.[52] Namely, some jurisdictions extend the twilight period in cases of *related parties*, as they are supposed to have superior information. By contrast, non-related parties are usually subject to shorter twilight periods. However, even though most insolvency jurisdictions "punish" related parties, the way to do so differs across jurisdictions. While some jurisdictions, such as the United States, extends the twilight period for the avoidance of preferences given to 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

51. In the United States, the twilight period for preferences is either ninety days (non-related parties) or one year (related parties). The period for avoiding fraudulent conveyances is always two years. In the United Kingdom, the twilight period for transactions at an undervalue is also two years while the lookback period for preferences can be six months (related parties) or two years (non-related parties).

52. See, in this sense, the LEGISLATIVE GUIDE ON INSOLVENCY LAW, *supra* note 1.

debtor's state of insolvency[53] or by establishing a list of transactions that, in every case, will be voidable.[54]

4.1.2. Unavoidable Transactions

Sometimes, the possibility of avoiding any transaction entered into within the twilight period can harm the debtor's financial situation, since many suppliers may be reluctant to keep providing goods and services to a financially distressed firm. Therefore, avoidance actions could generate an underinvestment problem. For this reason, most jurisdictions protect transactions entered into in the *ordinary course of business* from the exercise of avoiding powers, provided that these commercial transactions are conducted in good faith and according to ordinary business terms. Secondly, some *financial contracts* may also be 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 financial derivatives or margin or settlement payments made by or to a financial institution.

Finally, a jurisdiction may also decide to require some *subjective conditions* as a way to enhance legal certainty. For example, in the United Kingdom, the avoidance of preferences given to non-related parties requires to prove the debtor's "desire" to prefer the counterparty. Therefore, by making it harder (ex post) to avoid a transaction, this requirement may serve as a tool to enhance legal certainty, since parties will be incentivized (ex ante) to enter into transactions without bearing the risk of being subject to a future avoidance action. In other jurisdictions, some subjective conditions may also be required from the debtor's counterparty. For instance, the *lack of knowledge* of either the debtor's financial situation or the harm to other creditors may serve as a defense for the debtor's counterparty.[55]

53. This is the case of United Kingdom for transactions at an undervalue.

54. This is the case of France or Spain, where the office-holder has a set of 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.

55. The lack of knowledge of the debtor's financial situation as a defense to the debtor's counterparty seems to be available under German law. In the Netherlands, the defense may consist of the lack of knowledge about the damage to other creditors. *See* JAY LAWRENCE WESTBROOK ET AL., A GLOBAL VIEW OF BUSINESS INSOLVENCY SYSTEMS 109–10 (2010).

Therefore, these subjective requirements can also be seen as a mechanism to enhance legal certainty.[56]

4.1.3. Protection of Good Faith Parties

Most insolvency jurisdictions provide protection to certain third parties (different than the debtor's counterparty) who received property or value in good faith from the debtor's counterparty.[57] By doing so, bona fide third parties may be encouraged ex ante to enter into transactions without any (or a very low) risk of avoidance. Therefore, it may enhance legal certainty. Ex post, these parties would 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 the debtor's affairs. Therefore, the risk of opportunism is higher in these situations. However, since not all related parties usually have this superior information, 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. 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 the hands of someone else. In other situations, the value of the assets received by a debtor can be lower than the amount that the debtor gave. Moreover, 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 liquidity problems of a debtor in the financial distress. Likewise, from the counterparty's perspective, the fact that a bona fide transaction can be reversed at

56. In some jurisdictions, such as the United Kingdom, the United States, and Spain, while the knowledge of the debtor's financial affairs does not generally affect the avoidability of the transaction, it could have various consequences for either the avoidance procedure (e.g., length of the twilight period or proof of the debtor's financial situation), or the debtor's counterparty (e.g., subordination of its claim).

57. For a U.K. perspective, see Armour, *supra* note 3, at 79. For a U.S. approach, see BARRY E. ADLER ET AL., BANKRUPTCY: CASES, PROBLEMS, AND MATERIALS 341–52 (4th ed. 2007).

some point in the future can reduce its incentives to enter into commercial transactions ex ante.

For these reasons, some insolvency jurisdictions 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 no "value" to be returned. In these situations, an available remedy may be to discharge the company's obligation to guarantee the debt. In either case, it would seem desirable for an insolvency jurisdiction to provide a set of alternative remedies to the actual avoidance of the transaction.

4.1.5. Temporal Limitations Within the Procedure for the Exercise of Avoiding Powers

Finally, another way to reduce legal uncertainty in the context of avoiding powers may be given not only by limiting the time in which a transaction can be challenged but *also* the period in which the action can be exercised within the procedure.[58] 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.

4.1.6. The Financial Situation of the Debtor at the Moment of Entering into the Transaction

The primary role of an avoidance action is to protect the creditors when they become the residual claimants 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 liabilities, and therefore a company is *balance-sheet insolvent*. In these situations, the shareholders have lost everything, and thereby the company

58. In the United States, for example, avoidance actions cannot be exercised after the later of: (i) "2 years after the entry of the order for relief"; or (ii) "1 year after the appointment or election of the first trustee." 11 U.S.C. § 546(a)(1) (2012). In Colombia, the trustee is not allowed to exercise the action after six months upon the approval of the list of claims. L. 1116/2006, art. 75, diciembre 27, 2006, Diario Oficial [D.O.] (Colom.). 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.

is entirely funded by the creditors. Nevertheless, the concept of the balance-sheet test embraces several issues.

First, a balance-sheet is formed by assets, liabilities, and equity. 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, and accounting principles may provide different approaches to value assets and liabilities.[59] The problem becomes more complex when a company has assets and liabilities in various countries, and therefore it may be subject to different accounting rules. For example, in some jurisdictions with more conservative accounting rules, a *contingency* may be registered as a liability on the balance-sheet, while the same concept could be just explained in the notes to the financial statements in other jurisdictions. Likewise, some assets can (or even have to) be registered on a historical basis, while other jurisdictions (or even the same ones[60]) may impose a yearly valuation of the assets in order to make sure that the accounting value of the asset reflects its market value.

More critically, the company's assets can be valued either on a *going-concern* or a *break-up* basis.[61] The proper valuation will normally depend on the stage of the company (going-concern or liquidation), or, at least, on its viability. In general, companies *outside* of bankruptcy are usually valued on a going-concern basis, unless it is shown that the company has no viability at all. In these latter circumstances (i.e., when the company is not economically viable), the valuation on a break-up basis not also seems more appropriate from a financial perspective, but it will also be more valuable for the creditors, since it will provide an accurate valuation of how much value the creditors will be able to get in a hypothetical liquidation.

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) the viability of the company.[62] For instance, if a company seeks to reach a *reorganization* plan, the company should be valued both as a going concern and on a break-up basis. The reorganization plan

59. GOODE, *supra* note 1, at 138–47.

60. The International Financial Reporting Standards (IFRS) allows this possibility for land and intangible assets.

61. GOODE, *supra* note 1, at 142–47.

62. For an excellent analysis of valuation of distressed companies, see Michael Crystal QC & Rizwaan Jameel Mokal, *The Valuation of Distressed Companies: A Conceptual Framework* (pts. 1 & 2), 3 INT'L CORP. RESCUE 63, 123 (2006).

should only be achieved if the value of the company as a going concern is higher than the value of the company's assets in a piecemeal liquidation.[63] Likewise, if a company files for liquidation (or it ends up in liquidation), the company's assets should be valued on a break-up basis.[64] This valuation will act as a "reserve price." Therefore, if a third party offers a higher price for the assets, they should be sold to the highest bidder. If nobody shows of, the assets will be sold on a break-up basis, and the proceeds will be used to pay the creditors according to the scheme of distribution.

If a preference or transaction at an undervalue took place when the value of the company's assets was, or after the transactions became, 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 its 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*.[65] 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.[66] In the United States, the relevant test seems to be the balance-sheet test.[67] Nevertheless, along with this "insolvency test," the U.S. Bankruptcy Code also allows the possibility of avoiding transfers (and assuming constructive fraud) when the debtor is left with "an unreasonably small capital" or was incurring debts that it knew it would not be able to repay in due time.[68] Other jurisdictions, such as Australia, seem to favor a *cash-flow* (or com-

63. This rule basically implies to respect the "best interest of creditor" test. Even though many jurisdictions do not have this test, this rule seems desirable to promote the efficient allocation of the debtor's assets.

64. This valuation should be made on a market (rather than an accounting) basis. Moreover, it should include the costs of liquidation. *See* Andrew R. Keay, *The Insolvency Factor in the Avoidance of Antecedent Transactions in Corporate Liquidations*, 21 MONASH U. L. REV. 305, 308 (1995).

65. In well-functioning debt markets, cash-flow insolvency should occur *after* a company is balance-sheet insolvent. In other words, if debt markets work well, companies with an equity cushion or unencumbered assets (by definition, balance-sheet solvent) should be able to borrow money, even if they are cash-flow insolvent. Nevertheless, these markets conditions not always take place (especially in some jurisdictions). For this reason, it would be possible to find companies balance-sheet solvent but cash-flow insolvent.

66. *Compare* Insolvency Act 1986, c. 45, § 240(2) (Gr. Brit.), *with id.* § 123. For an analysis of the concept of corporate insolvency in the United Kingdom, see GOODE, *supra* note 1, at 109–47. In the case law, see *BNY Corporate Trustee Services Ltd v Eurosail*, [2013] UKSC 28 (appeal taken from Eng.), resolved by the U.K. Supreme Court in 2013. In this decision, the U.K. Supreme Court reversed a decision of the Court of Appeal holding that the balance-sheet insolvency test is satisfied when a company has reached "the point of no return." *Id.* [46].

67. *See* 11 U.S.C. § 101(32)(A) (2012). For municipalities, however, the relevant test is the *cash-flow* insolvency test. *See id.* § 101(32)(C).

68. *Id.* § 548(a)(1)(B)(ii)(II).

mercial) *insolvency test*, generally defined as the debtor's inability to pay its debts as they become due.[69] Finally, there are jurisdictions, including the United Kingdom, where the relevant test can be satisfied *regardless* of the debtor's financial situation just by proving some *external facts* such as an unsatisfied, undisputable debt.[70]

All of these relevant tests can justify somehow the existence of avoidance actions. However, while the balance-sheet test offers the most vigorous explanation (since it is the only situation in which the creditors *factually* become 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. 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 solution 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 advantages of the debtor's financial situation. Therefore, it might make sense to use a cash-flow insolvency test to protect both the debtor and its creditors. Second, when a debtor is cash-flow insolvent, and therefore is unable to meet its payments, the creditors can enforce their claims. This situation will imply that the creditors will be able to seize and sell the assets. In these situations, value can be destroyed when a company has going-concern value. Hence, the use of a cash-flow insolvency test may be socially desirable.

Likewise, the use of some *external facts* to satisfy the financial requirement for the exercise of avoiding powers can also fulfill several economic goals. First, creditors do 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 not expired yet. In the worst scenario, the debtor required to report financial statements might be voluntarily postponing this disclosure because it may fear the reaction of the market. Regardless of the

69. Keay, *supra* note 64, at 307–08.

70. This test is used in most jurisdictions to allow creditors to file for bankruptcy—that is, in involuntary petitions.

reason, markets participants will not be able to know the real financial situation of the debtor. They will just be able to know what they observe (e.g., unpaid debts, mortgage foreclosures, etc.). And based on these observations, they will be able *infer* the debtor's financial conditions. Thus, the use of external facts may help protect creditors.

Second, external facts can also act as positive externalities. 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 hand, once the debtor is defaulting in payments (not because it wants *but* because it is *unable* to pay its debts as they become due), the existence and consequences of these external facts will encourage managers to take corrective actions (e.g., promoting an out-of-court restructuring or filing for bankruptcy).

4.2. Minimizing Litigation Costs

4.2.1 Introduction

The *existence* of an effective system of avoidance actions is not costless. The possibility of avoiding perfectly valid transactions may create legal uncertainty. Moreover, once the system is in place, the *use* of avoiding powers can also generate litigation costs. In fact, under some circumstances, the existence of *litigation costs* can make the creditors worse off when using avoiding powers.[71] Therefore, for a transaction avoidance system to be efficient, insolvency legislators should minimize these costs.

There are several ways in which insolvency jurisdictions may minimize litigation costs. The most common way across jurisdictions is the use of *presumptions*. According to these presumptions, some elements potentially required to exercise the avoidance action will be met, or a list of specified transactions will be deemed harmful, unless otherwise is shown. Likewise, some jurisdictions also require *subjective requirements* to avoid some transactions. For example, in the United Kingdom, the avoidance of preferences to non-related parties requires proof that the debtor had the "desire," and not just the "intention," to prefer the creditor.[72] If the desire is

71. The most common example can be given by the avoidance of pre-petition payments. The money given to the preferred creditor is recovered, but the debt also returns to the company's estate. However, since the avoidance procedure implies litigation costs, the company's net assets may be reduced in the amount of the litigation costs.

72. Insolvency Act 1986, c. 45, § 239(5) (Gr. Brit.). In *MC Bacon*, Lord Millet 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*." [1990] BCLC (Ch.) 324 at 340 (Eng.) (emphasis added).

not proved, the transaction cannot be avoided. At first glance, it may be argued that this subjective requirement increases litigation costs, since it will be hard to prove this requirement. However, as long as this requirement makes it very difficult (if not impossible) in practice to avoid a preference given to non-related parties under U.K. insolvency law, this subjective requirement actually reduces litigation costs due to the fact that not many actions will be exercised to avoid preferences. Finally, and perhaps more importantly, one of the most significant costs of the avoidance procedure is the attorney's legal fees. Therefore, when designing a system of avoidance actions, insolvency jurisdictions should also take into account 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, these transactions will always be avoidable. In other cases, however, the transaction is only deemed harmful *unless* otherwise shown. These transactions are usually identified with some *transactions* that generally take place in the vicinity of insolvency (e.g., transactions with no consideration, transactions with related parties, security interest given to secure an antecedent debt, etc.).

Therefore, when the legislation provides a set of *avoidable transactions*, it will be easier (and less costly) for the trustee to identify and challenge these transactions. Nevertheless, it is not always possible to define all type of avoidable transactions. Thus, even in systems with specified avoidable transactions, the legislator still provides a general definition of avoidable transaction. For example, in Italy or Spain, despite the fact that the legislator provides a set of avoidable transactions, there is also a general provision stating that any *harmful transaction* for either the creditors (Italy) or the company's assets (Spain) will be avoidable. Thus, these systems may get the benefits of a system of a defined set of avoidable transactions (i.e., lower investigation costs), but reducing the risk associated with 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 justifies 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 based on such a specified and theoretically concrete moment in which the company becomes insolvent, since it is when the creditors formally 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 further *litigation costs*. Therefore, since these costs may be ultimately borne by the creditors,[73] 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.[74] 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.[75]

Other jurisdictions, however, go beyond this presumption and establish a fixed period of time in which it is *always* possible to challenge a transaction *regardless of* the debtor's financial situation. In these jurisdictions, then, the period in which a transaction can be challenged should no longer be considered as a "twilight period" but as an "avoidance period."[76] The rationale for choosing this type of avoidance periods seems very straightforward: to delete those *investigation and litigation costs* associated

73. 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, the trustee gets one percent of the net assets recovered for the estate.

74. This is the case of the U.S. Bankruptcy Code for both types of avoidance actions (that is, preferences and fraudulent conveyances).

75. This solution is adopted in the United Kingdom for the avoidance of transactions at an undervalue entered into with a related party.

76. For this reason, Spain does not technically have a "twilight period" but an "avoidance period."

with determining whether or not the debtor was insolvent at the moment of entering into the transaction.[77]

However, despite these benefits, the adoption of this solution may raise several problems. First, unless the twilight period is very short,[78] it can seriously harm legal uncertainty. Second, it could increase moral hazard, since some *solvent* debtor foreseeing financial trouble may have incentives to make risky investment decisions, or even to underinvest in gathering and analyzing information, taking into account that: (i) if the transaction goes well, it can be more profitable for the company; and (ii) if the transaction goes bad, and the company becomes insolvent, they can always avoid the transaction. Third, this solution also faces a final problem. It should be reminded that the avoidance of completely valid transactions only seems to be justified when a company is, or as the result of the transaction becomes, insolvent.[79] If a company is solvent, insolvency law should not interfere in the company's affairs. Therefore, the avoidance of valid transactions does not seem to be justified in solvent firms.

In our opinion, the most desirable solution should come from a combination of the aforementioned systems. For example, the legislator may impose a very short "avoidance period" (e.g., up to three or six months) in which the financial requirements should not be proved. Beyond this period (perhaps up to two years), any transactions potentially challenged should require the trustee to prove, among other aspects, the debtor's state of insolvency. Thus, the system will be able to reduce litigation costs but not at the expense of weakening the economic justification of avoidance provisions.

4.2.2.3. Bad Faith

Acting in good or bad faith may have several consequences for the debtor's counterparty in avoidance procedures—and, more generally, in bankruptcy. Sometimes, it may imply a longer twilight period. In other

77. 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 requirements such as "an unreasonably small capital." *See* 11 U.S.C. § 548 (a)(1)(B)(ii)(II) (2012).

78. This is not the case of Spain, where the "avoidance period" is always two years, no matter the type of transaction (preference or fraudulent conveyances) or the type of counterparty (related or non-related party).

79. In many 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. For instance, the United Kingdom and the United States follow this approach.

situations, it could affect to the right held by the third party to preserve or, if so, return the property. In some jurisdictions, the claim held by the debtor's counterparty may also be subordinated after the transaction is avoided.[80] Therefore, it seems relevant to determine the concept of good and bad faith, at least, for the purposes of avoiding provisions. These concepts, however, are very controversial. In many jurisdictions, the concept of *bad faith* is usually referred to those market participants who knew what was going on. That is, in the context of avoidance actions, they *knew*, among other aspects, about: (i) whether the transaction was made 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; or (iv) especially for third parties different from the debtor's counterparty, whether the property acquired comes from any of the aforementioned situations.[81] Therefore, the concept of bad faith implies knowledge and intention of acting in a particular way.

Nevertheless, it is costly 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, a related party does not always have that information. In other circumstances, the third party may have the information but might not use it for a bad purpose. Hence, it would seem desirable to allow the counterparty to prove its good faith, for example, by proving that it did not have the information, or, if so, by showing that it acted according to an independent judgment made in good faith. By contrast, the concept of *good faith* is not usually defined. Most jurisdictions presume the fact that people act in good faith unless otherwise is shown. 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. This requirement makes it virtu-

80. This is the solution, for example, in Spain. *See* Insolvency Act art. 73.3 (B.O.E. 2003, 13813) (Spain).

81. In the United States, for example, see *In re Manhattan Investment Fund Ltd.*, 310 B.R. 500, 509 (Bankr. S.D.N.Y. 2002). In this case, the court held that, for a sophisticated lender, failing to act diligently in a timely manner is bad faith.

ally impossible to avoid a preference given to a non-related party. Therefore, rather than increasing litigation costs, we believe that this requirement actually reduces litigation costs, since the avoidance of preferences has become almost impossible in the United Kingdom.

In fact, it could be argued that the intention of the U.K. legislators was precisely that: the de facto abolition of preference law for non-related parties.[82] Therefore, in practice, U.K. insolvency law would only allow the avoidance of preferences given to related parties.[83] This solution, at first glance, may seem "odd." However, some scholars have supported this solution based on efficiency grounds. Namely, some scholars have argued that, unlike transactions at an undervalue, the avoidance of preferences does not create any clear gain for the company's *net* assets. Moreover, the avoidance of preferences generates litigation costs. Therefore, the avoidance of preferences may reduce the pie available for distribution.[84] In these situations, therefore, the use of preference law could make the creditors *as a whole* worse off. Hence, it would make sense the U.K. approach.

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,[85] people *may* care about fairness.[86] Therefore, some creditors may

82. I am grateful to John Armour for suggesting this hypothesis in his corporate insolvency course at Oxford.

83. Indeed, under U.K. law, preferences given to non-related parties are virtually *unavoidabl*e. For an analysis of the requirement to avoid preferences under U.K. insolvency law, see Walters, *supra* note 30, at 159–70, and MOKAL, *supra* note 9, at 316–38. For related parties, however, it will be enough to prove that: (i) the transaction puts a creditor in a better position and; (ii) the preference was given in the twilight period in which the debtor was, or as a result of the transaction became, insolvent. *See generally* Walters, *supra* note 30.

84. *See* Schwartz, *supra* note 40, at 1229–38. 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 counterparty's attorney fees.

85. 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 to fifty percent of the sum of money to allocate. *See* Werner Güth et al., *An Experimental Analysis of Ultimatum Bargaining*, 3 J. ECON. BEHAV. & ORG. 367, 371–72, 375 (1982). For an excellent explanation of the ultimate game, see Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1489–93 (1998).

86. 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. Otherwise, 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

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, relies on how to design the *default rule* that, in our opinion, should govern a preference law that takes into account these considerations. 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 trustee 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 preference. In order to make its judgment, the trustee should consider, among other aspects, the overall effect of the avoidance actions over the creditors' returns, the conditions in which the preference was given, and the identity of the preferred creditor. For example, if a preference is given to a professional lender, or even to a repeat player, it makes more sense to avoid the preferences—since these parties may have the knowledge of the debtor's financial situations, or the debtor may have perverse incentives to prefer these creditors. By contrast, if a preference is given to a non-qualified outsider (i.e., a person who is not a related party either), it would make more sense to preserve the preference, especially if the avoidance procedure may make the creditors as a whole worse off.

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.[87] In this context, the rule

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 their counterparties happy (suppliers, costumers, etc.). Therefore, it might be both rational and efficient for the Proposer to offer a similar allocation of the sum of money.

87. As pointed out in Arturo Bris et al.:

> 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

governing attorney's fees in avoiding powers vary across jurisdictions. Moreover, they can also depend on the procedural rules existing in a particular jurisdiction.[88] 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 counterparty's legal fees to the loser—especially if it acted reckless or in bad faith. Therefore, since bankruptcy law does 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 trustee 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 might make sense not to exercise the action. Nevertheless, since the risk of opportunism to give preferences may be higher in jurisdictions with a debtor in possession (as it happens in the United States), we believe that, *unless* the creditors say otherwise, any preference should be avoided, even if it makes the creditors as a whole worse off. Otherwise, the system could create perverse incentives in the vicinity of insolvency, and preference law would not effectively fulfill its economic goals either. By contrast, in jurisdictions with an independent, qualified trustee managing the company in distress, this decision should be made by the trustee based on some of the *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

> 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).

Arturo Bris et al., *Who Should Pay for Bankruptcy Costs?*, 34 J. LEGAL STUD. 295, 296 n.1 (2005). 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* Schwartz, *supra* note 40.

88. For an overview of the systems, see GIUSEPPE CHIOVENDA, LA CONDENA EN COSTAS 210 (Juan de la Puente trans., 1928), and Steven Shavell, *Suit, Settlement, and Trial: A Theoretical Analysis under Alternative Methods for the Allocation of Legal Costs*, 11 J. LEGAL STUD. 55 (1982).

faith, or the preference was given to a related party, the preference should be avoided.

From a policy perspective, in systems with a debtor-in-possession regime, or with a non-qualified, independent trustee, 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 trustees, the legislator could confer the power to decide whether or not to avoid the transaction to the trustee. Under this regime, the trustee should decide based on several indicia, such as the identity of the debtor's counterparty or the conditions in which the preference was given.

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 trustee should make a double effort in deciding whether or not to exercise the action.[89] Firstly, it should assess the likelihood of winning or losing the avoidance procedure. And only when the trustee decides that there is a high probability of success, the trustee will decide whether or not to exercise the avoidance action, based, among other aspects, on the overall effect of this action on the creditors as a whole.

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, or in systems in which the debtor knows that the trustee may have incentives to exercise the avoidance action.[90] 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 debtor's liability at the moment of exercising the avoidance procedure. If the

89. For this reason, sometimes it could be efficient to assign the action to a qualified third party specialized in avoidance actions willing to bear all the litigation costs in return for a percentage of the net gains generated by the action.

90. These incentives come from the fact that, apart from getting their fees based on the debtor's assets, trustees in some jurisdictions also get a percentage of the recoveries in any avoidance action.

value of the assets is greater than the value of liabilities, the bankruptcy estate would be sufficient to pay all the creditors (in these circumstances, the debtor would be in bankruptcy just because it is facing liquidity problems), and the use of avoiding powers would also be in the exclusive interests of the shareholders.

As mentioned 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 condition at the moment of *exercising* the avoidance procedure.[91] The reason, we believe, is that they seem to assume that debtor is *balance-sheet insolvent*. Therefore, the debtor does not have enough assets to pay all its debts. 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* than the value of its liabilities, but, nevertheless, the debtor is just facing liquidity problems.[92] 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, from an ex ante perspective, the avoidance of these transactions can create *moral hazard*, since the debtor may have incentives to make inefficient decisions knowing that: (i) if 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. Likewise,

91. In Colombia, for example, the debtor's balance-sheet *insolvency* is a formal requirement to exercise an avoidance action. *See* L. 1116/2006, art. 74, diciembre 27, 2006, Diario Oficial [D.O.] (Colom.). In Spain, it used to be a requirement under the old bankruptcy regime. *See* 2 JOSÉ RAMÍREZ, LA QUIEBRA, DERECHO CONCURSAL ESPAÑOL (2d ed. 1998) (Spain). For an analysis of the new article 71 of the Spanish Insolvency Act, (B.O.E. 2003, 13813), 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 paper) such as the *actio pauliana* existing in article 1111 of the Spanish Civil Code, C.C., B.O.E n. 206, July 24, 1889.

92. 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, COLEGIO DE REGISTRADORES DE LA PROPIEDAD, BIENES MUEBLES Y MERCANTILES DE ESPAÑA, ESTADÍSTICA CONCURSAL 2011 ANUARIO: EL CONCURSO DE ACREEDORES EN CIFRAS 17–18 (2012) (Spain). 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. Nevertheless, it should be noted that, under Spanish accounting rules, "positive net assets" (or positive equity) does not mean that the company has unencumbered assets. Therefore, a company may be "balance-sheet solvent" and, nevertheless, all its assets may be given as collateral.

from an ex post perspective, the avoidance of these transactions can also create *unjust enrichment* for the shareholders at the expense of the debtor's counterparty.[93] 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, as the valuation of an asset may be subjective, and it may change 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. Thus, the legislator will make sure that the company's assets will be sufficient to pay all in case of a hypothetical liquidation.[94]

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 in this paper. However, there are still some residual costs that can depend on the specific circumstances of the case. Therefore, the trustee should also 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—even as an administrative expense, as it happens in Spain.[95] Therefore, even though this transaction can increase the bankruptcy estate, it could be harmful for the maximization of the value of a *viable firm* facing liquidity problems.

The trustee should assess all of these residual costs. Although these costs may vary from case to case, they may include the 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 the creditors' recoveries, or the perverse incentives that an improper use of avoid-

93. For a comparative analysis of the concept and requirements of unjust enrichment, see UNDERSTANDING UNJUST ENRICHMENT (Jason W. Neyers et al. eds., 2004).

94. For instance, it would seem reasonable that the avoidance action will not be exercised if the value of company's assets is twenty percent greater than the value of the company's liabilities.

95. 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 as an *administrative expense*. *See* Insolvency Act art. 73.3 (B.O.E. 2003, 13813) (Spain). Therefore, the return of this money may make the debtor—and therefore the creditors as a whole—worse off.

ing powers may generate (especially from the perspective of the debtor). For this reason, the role and the expertise of the person in charge of deciding whether or not to exercise the action will be crucial, in order to make sure that the action will be socially desirable.

5. CONCLUSION

This paper provides a comprehensive analysis of claw-back actions 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 with avoidance actions. 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 make sure that the existence of avoidance powers does not do more harm than good.