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Financing in distress against security from an English, German and Dutch perspective: a walk in the park or in a mine field?

Rules on transaction avoidance in insolvencies must find a balance between protecting creditors on the one hand and enabling struggling businesses to restructure their business on the other. This article compares the English, German and Dutch rules on transaction avoidance applied to the financing of distressed debtors against security. A distinction is made between cases in which the debtor provides security only for new credit and cases where the security right secures both old and new credit. Legislation should at least provide a safe haven under which lenders can take security for new money.

Introduction: Reorganisation and rescue of viable business

A company facing financial difficulties will first try to restructure its organisation and operation, before seriously considering entering insolvency proceedings. In order to restructure, the company will need money to pay for advisers, break up fees for business contracts such as leases and termination fees for excess personnel. At the same time, it will become increasingly difficult to raise new money. If a creditor is to provide new or additional money, it will normally only do so against security.

Even if there is a solid workable restructuring plan, there will be no guarantee of success. If the plan is implemented but is unsuccessful, a court appointed trustee or insolvency office-holder (office-holder) might argue that the restructuring attempt has only created additional losses to the detriment of the remaining creditors. The money is gone but a secured claim remains. Thus, if the rules on transaction avoidance make it too easy for an office-holder to invoke transaction avoidance against the security rights granted, banks (and other lenders) will naturally be less inclined to provide additional finance in times of distress. One of the major challenges in coming to a sound and workable framework of transaction avoidance is therefore the balancing of the interests of creditors with the interests of distressed debtors seeking to rescue their businesses.[1]

This article will provide a comparative analysis of the question to what extent a lender can extend credit against security to a company in distress, without having

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1 See also A. Walters, "Preferences", in: J. Armour and H. Bennet (eds), *Vulnerable Transactions in Corporate Insolvency*, Oregon: Hart Publishing 2003, p. 125. "*In recognizing that wider issues of policy – such as the need to promote the finality of transactions or to encourage the provision of credit to struggling but potentially viable businesses – might be in play, there is inevitably some undermining of the collective scheme.*"

to fear an office-holder invoking transaction avoidance if the company enters insolvency proceedings nonetheless. This question will be broken down into two:

First, the basic question is under what conditions an office-holder can invoke transaction avoidance against the granting of security rights for financing during financial distress. This question assumes there is a simple *quid pro quo* transaction and that the security rights only secure the new credit granted. The following hypothetical case will be taken as an example. Vinoculars Ltd[2] is facing financial problems and is on the brink of insolvency and on close inspection already over indebted. Bank Ltd is approached to provide a credit facility of €4 million for 18 months. Vinoculars Ltd grants Bank Ltd a first non-possessory security right over its inventory,[3] being wines from all over Europe, even England, with a total estimated market value of somewhere in the range of €4 million to €10 million.

In practice, banks that are willing to provide credit at a time of need, are often banks that have provided credit before. The new credit is therefore often additional credit. The second question is a complicated but a more realistic version of the first question. Under what circumstances can an office-holder invoke transaction avoidance as to the creation of a security right if the security right secures both old and new credit? Here the hypothetical case is altered. Vinoculars Ltd is again facing financial problems and is on the brink of balance sheet insolvency, but now Bank Ltd is approached to provide a credit facility of €4 million for 18 months, in addition to a previous, thus far unsecured, credit facility of €6 million. Vinoculars Ltd grants Bank Ltd a first non-possessory security right over its inventory valued at €10 million, securing both the old and the new credit facility.

The comparison of the legal rules is not a purely academic exercise. First of all, the double test[4] in the European Insolvency Regulation of *lex concursus* and *lex contractus* for transaction avoidance in cross border situations forces parties, practitioners and judges to familiarise themselves with other legal regimes as well. Secondly, national legislators are increasingly seeking to improve the possibilities of reorganisation and restructuring under their respective insolvency laws and therefore also review their avoidance provisions in that light. Thirdly, Insol Europe has presented a report[5] to the European Parliament analysing which insolvency laws are appropriate for harmonisation. One of the six selected topics is transaction avoidance.

Before turning to how the above questions are dealt with by English, German and Dutch law, a more theoretical analysis will be provided as to how these two cases fit into general transaction avoidance and how creditors are prejudiced.

Fitting distressed financing into basic transaction avoidance

2 We will not discuss cross border complications. So for the German analysis, the debtor will be Vinoculars GmbH and for the Dutch analysis, Vinoculars B. V.

3 In order to be able to make comparisons, we present a stylised case here. In the context of the English law analysis, it would be likely that the security includes floating charges over all the debtor's assets not specifically covered by any fixed charges.

4 See Article 4, 2(m) and Article 13 of Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings.

5 Insol Europe, *Harmonisation of Insolvency Law at EU level*, available at www.insol-europe.org/ .

Going back to the basics of transaction avoidance elucidates why the issue at hand causes some difficulties. A basic distinction into two categories can be made.

The first category concerns legal acts compromising the integrity of the estate of the debtor.[6] These are legal acts (whether separate or in combination with other acts) which are detrimental to the debtor itself and therefore detrimental to its creditors in subsequent insolvency proceedings. An example of such legal acts are transactions without consideration or at an undervalue.

The second category is constituted by preferences. The debtor does something, or allows something to be done, that has the effect of putting a person into a position that will, if the company enters insolvency proceedings, be better than the position that person would have been in if that thing had not been done. The main characteristic here is that the counterparty was already a creditor prior to the transaction and its position is improved by the transaction to the detriment of the remaining creditors.

Following this distinction, it is very difficult to bring the first case within the scope of transaction avoidance. Where Bank Ltd provides a new credit facility of €4 million and in return is granted a first non-possessory security right over the inventory, which only secures the new credit facility, the transaction does not easily fit into either category. Bank Ltd was not a creditor before and the transaction is therefore not a preference. If covered by transaction avoidance, the case should be considered under the first category of legal acts compromising the integrity of the estate of the debtor. But could one argue that the integrity of the estate has been compromised by the granting of new credit against securities?

The question falls within the more general problem of legal acts concluded on arm's length conditions that are not directly detrimental to the debtor or the creditors, but may be so in a more indeterminate way. This is one of the most difficult questions in relation to transaction avoidance. A more general example can be taken to clarify the point. Take the sale of assets against market value after which the proceeds are dissipated. The proceeds can be applied in making a dividend payment or they may have been used in any other way. One could judge the joint creditors having been prejudiced by the transaction, because without the sale and the subsequent dissipation of the proceeds, the assets would have been available for distribution among the creditors. In order to construct this prejudice, two acts have to be taken together: first the sale and second the application of the proceeds. Are or should such transactions be within the scope of transaction avoidance at all? Under German law, both the explanatory notes to the legislation and settled case law make it clear that such transactions are within the scope of transaction avoidance.[7] As a broad generalisation, English law is reluctant to bring arm's length transactions within the scope of transaction

6 The words 'integrity of the estate' are derived from Uncitral, *Legislative Guide on Insolvency Law*, 2005, p. 152, but are not defined.

7 M. Balz and H. G. Landfermann, *Die Neuen Insolvenzgesetze*, Düsseldorf: IDW-Verlag 1995, p. 229. The explanatory notes state (translated): "*The transfer of real property against fair market value can be subject to avoidance on the basis of intentional prejudice (§ 133 InsO), if the counterparty knew of the intention of the debtor to put the proceeds beyond the reach of creditors.*" Original: "*So kann die Veräußerung eines Grundstücks auch dann wegen vorsätzlicher Benachteiligung (§133 InsO) anfechtbar sein, wenn sie zwar zu einem angemessenen Preis er-*

avoidance.[8] As will be seen,[9] the idea of linking the destination of credit to the enforceability of the right securing that credit is, however, not completely foreign to English law.

Whether Bank Ltd can be confronted by a successful action for transaction avoidance in the first hypothetical case, where Bank Ltd has been granted a security right only securing new credit provided, much will depend on the extent to which the law allows for different legal acts to be taken together. This question will in turn depend on whether the law sees a *responsibility* for banks to inform themselves of the application of the funds provided and, in case of a restructuring plan, of the robustness and likelihood of success of the plan.

Insofar as the security right also seeks to cover old liabilities, the case fits much more easily into transaction avoidance. Clearly there is a preference as far as securing the old credit is concerned. The previous unsecured credit is upgraded to secured status. In analysing the motives of the parties, there is room for suspicion. Did the bank truly wish to participate in a restructuring attempt, or did the bank only provide additional credit in order to conduce the debtor to grant security rights for the old credit as well?

We will now turn to the way English, German and Dutch law deal with the two questions.[10]

English law

General framework: Transaction Avoidance in Insolvencies

English law on transaction avoidance has never been developed into a coherent whole.[11] There are several provisions in the Insolvency Act 1986 (IA) dealing with different kinds of transactions. The main provisions (absent fraudulent intent) are those on transactions at an undervalue (Section 238 IA) and preferences (Section 239 IA).[12]

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folgt, wenn der Schuldner aber die dem anderen Teil bekannte Absicht hat, das Geld dem Zugriff der Gläubiger zu entziehen."; see also BGH, NZI 2005, 692, 693.

8 In protecting the integrity of the estate, in addition to the objective rule in Section 238 of the Insolvency Act 1986 (**IA**), English law has a more general rule in Section 423 IA. The quintessential criterion here is the intent of the debtor to harm its creditors. However, it is similar to Section 238 IA in that it is limited to transactions at an undervalue. Parry, Ayliffe and Shivji, *Transaction Avoidance in Insolvencies* (2nd edition, Oxford University Press, 2011) p. 19 recognises that in doing so, some transactions entered into to defraud creditors fall outside the scope of Section 423 IA. The role of directors will fall to be considered in the context of sections 239 IA (preferences) and 214 IA (wrongful trading) and their other statutory and common law duties.

9 See § 3 b of this Article.

10 It must be noted that the transaction avoidance mechanisms of these jurisdictions are subject to regulations implemented by each country implementing the European Parliament and Council Directive 2002/47/EC on financial collateral arrangements (within which we assume the above hypothetical case will not fall).

11 Roy Goode, *Principles of Corporate Insolvency Law* (4th edition, Sweet & Maxwell, 2011) p. 524.

12 In addition, common law provides other avenues for challenge such as under the anti-deprivation rule or where there is a lack of commercial benefit. Certain fixed charges and all floating charges are void against a liquidator, administrator or creditor if prescribed particulars of the charge are not registered at the Companies Registry within 21 days of their date of creation (in the case of English companies, Section 860 *et seq* Companies Act 2006).

Section 238 IA provides for avoiding legal acts made or entered into without consideration or at an undervalue, if the transaction took place within two years prior to the 'onset of insolvency' and if the company was already insolvent or became insolvent as a result of the transaction. There are no further subjective criteria on either side, such as intent or knowledge. Section 238(5) IA, however, provides a defence if the debtor (not the creditor) acted in good faith for the purpose of continuing its business and there were at that time reasonable grounds for believing the transaction would benefit the debtor. The sanction will usually be limited to either the counterparty revesting title to the insolvent company or paying the difference; in other words disgorging the benefit obtained from the transaction.[13]

Section 239 IA provides for the avoidance of preferences. Under English law, the avoidance of preferences depends on the state of mind of the debtor. A preference can only be avoided if the debtor was influenced by a 'desire to prefer' (a subjective test). Additional requirements are that the preference was created within six months[14] prior to the 'onset of insolvency'[15] and that the debtor was already insolvent at that time or became insolvent as a result of it. The element of desire to prefer is more difficult to establish outside related ("connected") parties, such as a payment made to or for the benefit of a director of the company.[16] The scope of Section 239 IA is very broad and seeks to cover all manners and ways in which a debtor can improve the position of a single creditor.[17]

There is, however, a further specific provision which is of interest here, namely a special provision dealing with floating charges (Section 245 IA). Floating charges are to be distinguished from fixed charges. Floating charges are a form of non-possessory security right.[18] In essence, floating charges enable a corporate debtor

13 See Section 241 IA. There is also a potential risk here for lenders that have provided finance to a buyer of an asset acquired at an undervalue and who have taken security over that asset.

14 Extended to two years in case of connected parties.

15 This term is used in the Insolvency Act 1986 to refer to when a relevant insolvency process is deemed to have commenced, rather than a time which a debtor is deemed to have become insolvent, or 'unable to pay its debts'.

16 Keay and Walton, Insolvency Law (Bristol: Jordans 2008) pp. 559-560. "Absent the situations where the respondent is a connected person or an associate of the insolvent who is labouring under the burden of a presumption that the insolvent had a desire to give a preference to the respondent, office-holders will often have difficulty in adducing any or sufficient evidence to impugn the transaction."

17 Section 239(4) IA provides the following: "(4) For the purposes of this Section and Section 241, a company gives a preference to a person if – (a) that person is one of the company's creditors or a surety or guarantor for any of the company's debts or other liabilities, and (b) the company does anything or suffers anything to be done which (in either case) has the effect of putting that person into a position which, in the event of the company going into insolvent liquidation, will be better than the position he would have been in if that thing had not been done."

18 As to the nature of a floating charge see Romer LJ, Re Yorkshire Woolcombers Ltd [1903] 2 CH 284: "I certainly do not intend to attempt to give an exact definition of the term "floating charge," nor am I prepared to say that there will not be a floating charge within the meaning of the Act, which does not contain all the three characteristics that I am about to mention, but I certainly think that if a charge has the three characteristics that I am about to mention it is a floating charge. (1.) If it is a charge on a class of assets of a company present and future; (2.) if that class is one which, in the ordinary course of the business of the company, would be changing from time to time; and (3.) if you find that by the charge it is contemplated that, until some future step is taken by or on behalf of those interested in the charge, the company

to continue to use the encumbered assets as part of its business until the occurrence of certain insolvency events or when the secured creditor enforces the security, at which point the floating charge converts into a fixed charge.[19] Floating charges extend to property of the debtor acquired after their creation, potentially at the expense of unpaid creditors, hence their having special treatment under Section 245 IA.

Section 245 IA provides that a floating charge created in the 12 months[20] prior to the 'onset of insolvency' is not valid *unless* and *to the extent* that it secures certain specified forms of new value.[21] Where the security taker is not connected with the debtor, the debtor must already have been insolvent or become insolvent as a result of the transaction.[22] [23]

With this framework in mind, we can now turn to how English law deals with the issue of security for new credit granted as part of a restructuring attempt and the issue of a single security right securing both old and new credit.

New securities for new credit

The answer to the first question (hypothetical case) appears to be relatively simple. Fixed charges created to secure fresh credit are usually not even consid-

may carry on its business in the ordinary way as far as concerns the particular class of assets I am dealing with." Bailey and Groves, Corporate Insolvency (3rd edition, LexisNexis Butterworths 2007), p. 977: "Of the three characteristics the greatest of the three is the third."

19 The charge holder will not, however, enjoy the full benefits of priority conferred under English law on fixed charge holders because the charge was "created" as a floating charge (see Section 251 IA for a definition of "floating charge"). It is also important to note that some charges may purport to create, and be characterised as, fixed charges, but in substance take effect as floating charges see e. g. *National Westminster Bank Plc v Spectrum Plus Ltd (in creditors' voluntary liquidation)* [2005] UKHL 41. Such charges are also vulnerable to avoidance under Section 245 IA.

20 Extended to two years in case of connected parties.

21 Section 245 IA: (1) This Section applies as does Section 238, but applies to Scotland as well as to England and Wales. (2) Subject as follows, a floating charge on the company's undertaking or property created at a relevant time is invalid except to the extent of the aggregate of – (a) the value of so much of the consideration for the creation of the charge as consists of money paid, or goods or services supplied, to the company at the same time as, or after, the creation of the charge, (b) the value of so much of that consideration as consists of the discharge or reduction, at the same time as, or after, the creation of the charge, of any debt of the company, and (c) the amount of such interest (if any) as is payable on the amount falling within paragraph (a) or (b) in pursuance of any agreement under which the money was so paid, the goods or services were so supplied or the debt was so discharged or reduced.(3) (. . .) (6) (. . .).

22 However, where a floating charge holder whose security has already been enforced by e. g. an administrative receiver (where permitted), has received payments as a result, the payments cannot subsequently be challenged under Section 245: see *Mace Builders (Glasgow) Ltd v Lunn* [1986] Ch 459; (1986) 2 BCC 99 532. Nourse LJ also held that the clear effect of the predecessor Section was to render the charge invalid only from the commencement of the winding up!

23 Despite their vulnerability to transaction avoidance, floating charges are a popular and common form of security in the UK. This is not only because of the priority afforded to lenders on enforcement, but also because if they meet certain qualifying criteria, they afford the lenders a significant amount of control over the timing and initiation of any insolvency process. In addition, in many cases it will be difficult under English law for a lender to obtain a fixed charge (the most senior ranking form of security). In practice, lenders will often consider that these benefits, added to the prospect that the floating charge will have 'hardened' by the time any insolvency proceedings are initiated, make it worthwhile taking floating charge security even if at the time of its creation, the security is vulnerable to challenge under Section 245 IA.

ered as possibly running afoul of transaction avoidance; they do not qualify as a preference under Section 239 IA[24] and they are also outside the scope of Section 238 IA.[25] If, as is likely, a floating charge has been granted for one of the specified forms of new value, it is valid. Where credit is provided to a company in distress for reorganisation purposes, there is no legal requirement, unlike under German and Dutch law (see below), for the bank to make an in depth analysis of the reorganisation plans and whether they are, in view of the bank, likely to succeed.[26] There are, however, a number of threats still lurking, especially as to floating charges.

The first threat is that the bank advances the 'new money' before taking the security, for example by allowing the borrower, before negotiations are completed, to exceed its facility limit perhaps to meet a critical deadline such as to pay a wage bill or a key supplier on the last Friday of the month. In that case, a court is likely to rule that no new value has been provided, since the credit facility has already been provided prior to the creation of the floating charge.[27]

Secondly, it is noteworthy that English law does not completely turn a blind eye to the destination of the proceeds. A floating charge, even if made for new value, is vulnerable to avoidance unless it was meant to benefit the company or to be at its disposal. For example, a floating charge granted by members of a group of companies to a bank making a loan to *another* member of the group may be held to be invalid except to the extent of the value received by the security provider.

A floating charge is also vulnerable if new money has been provided (in consideration for the security) but the money is only used to refinance an old unsecured debt.[28] Such a naked mechanism for converting an old unsecured debt into a secured debt would be likely to be invalid. But not everything is black and white: for example, there is an old and well established line of authority under English law[29] that allows unsecured debt to be converted to secured debt (in an insolvency context) where repayments of old debt are made by the debtor and new advances are made by the creditor. This can be illustrated by an example of

24 The reason is that as far as the new credit is concerned the bank is not a creditor yet and can therefore not be held to have been placed into a better position as a creditor compared to that which it would have been if the transaction had not been conducted.

25 In *Re MC Bacon* [1990] B. C. C. 78 securities for new credit were held to be outside the scope of transactions at an undervalue altogether.

26 This is of course not to say that banks will not typically make such an assessment for sound credit risk purposes. However, there are also other lenders that have to navigate through the same rules but without necessarily having the resources to make such an assessment.

27 See Slade J. in Re Shoe Lace Ltd [1993] BCC 609 CA 620: "In a case where no presently existing charge has been created by any agreement or company resolution preceding the execution of the formal debenture, then, in my judgement, no moneys paid before the execution of the debenture will qualify for the exemption under the subSection unless the interval between payment and execution is so short that it can be regarded as minimal and payment and execution can be regarded as contemporaneous." The suggestion is made at 619 that the maximum lapse of time would be 'a coffee break'. Note, however, that where moneys are paid pursuant to a binding agreement between the lender and the company that the company will enter into a floating charge security, the requirement of contemporaneity will be satisfied even if the security is not itself entered into for a long time afterwards.

28 Parry, Ayliffe and Shivji, *Transaction Avoidance in Insolvencies* (2nd edition, Oxford University Press, 2011) pp. 444-454.

29 The rule in *Clayton's case* (1816) 1 Mer 52 which provides that in the context of a 'running account', such as an overdraft or revolving credit facility, sums that are repaid by the debtor are applied first in discharge of the earliest debt.

a company that on 1 September has an unsecured debt to its bank of €100K under an overdraft facility and it gives the bank a floating charge as security. On 1 September that is new security for old debt, but suppose it pays €10K per day into the account and withdraws €10K per day. On 10 September, it still owes the bank €100K but that would be new money for the purpose of the security given on 1 September.

Another example of where a challenge is likely to be successful is where new money was only provided with the aim of paying a specific creditor. Where the company is no more than a conduit through which the money flows, the charge will not be valid.[30] In such cases, English courts will always look at the substance rather than the form of the transaction.

However, if the money is really advanced to the debtor and the financing is obviously intended to provide future benefit to the debtor, there should be little concern as to the enforceability of a floating charge.

In the above case study, where Bank Ltd provides Vinoculars Ltd with a credit facility of €4 million in order for it to be able to restructure its business and organisation and the restructuring attempt is fruitless, Bank Ltd will be able to rely on its security right. An office-holder seeking to invoke transaction avoidance under the Insolvency Act 1986 as to the creation of the security right is unlikely to be successful.

New securities for both new and old credit

As to the second case, English law is also clear. In the case study, Bank Ltd provided Vinoculars Ltd credit of €4 million in addition to a previous unsecured credit facility of €6 million, and Bank Ltd was simultaneously granted a *floating charge* securing both the new credit of €4 million and the old credit of €6 million. Assuming Bank Ltd is not a connected person and it can be shown that Vinoculars Ltd was already insolvent at the time the floating charge was created, or became insolvent in consequence, and it enters into administration or liquidation within 12 months afterwards, under Section 245 IA, the floating charge will not be valid except to the extent of the 'new advance'. The floating charge will be valid *to the extent* it secures the new credit facility.[31] As to the old credit facility, this is likely to be held invalid unless and save to the extent that it has been replaced by new monies because e. g. the old €6 million facility is available as an overdraft.[32]

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30 See Simonds J in Re Destone Fabrics Ltd, [1941] Ch 319: "It is also quite clear, I think, that, so far as he was concerned, the transaction was a mere subterfuge, and, to use the words of an authority to which I shall refer, that the company was a mere conduit pipe through which a sum was paid, part of which was paid out afterwards to him." See on the issue also H. Bennett, Late Floating Charges (in J. Armour en H. Bennet (eds), Vulnerable Transactions in Corporate Insolvency, Oregon: Hart Publishing 2003) p. 201: "If the company is employed as a mere conduit pipe through which purported loan money is passed in return for the creation of additional security, there is no genuine benefit to the company and the loan will not count as money paid to the company." See further on the issue Bailey and Groves, Corporate Insolvency (3rd edition, LexisNexis Butterworths 2007) p. 981 and Roy Goode, Principles of Corporate Insolvency Law (4th Edition, Sweet & Maxwell, 2011) p. 604.

31 Bailey and Groves, Corporate Insolvency (3rd edition, LexisNexis Butterworths 2007) p. 981: "Where there is a charge which secures both an existing debt and additional money provided at the time of the creation of the charge, it will be valid in respect of the additional money."

32 See footnote 29.

It is important to note that there is no 'all or nothing approach' under English law. There is no element of punishment in the sense that the bank also loses the right to invoke its floating charge for the new credit facility because it tried to bring the old credit under the floating charge as well.

If Bank Ltd had recognised the problem at the time of providing credit and wanted to better secure its position, it should have sought to be granted a *fixed charge* for the old credit facility as well. In the context of Vinoculars Ltd, this may have been problematic as in practice its assets will mostly consist of inventory and receivables. If, however, there were assets which could be encumbered by a fixed charge, Section 245 IA would not apply, since it only applies to floating charges. The creation of the fixed charge would then be tested against the criteria of Section 239 IA. As has been indicated above in the context of Section 239 IA, the required 'desire to prefer' on the debtor's side is seldom held to have been met outside connected parties but this cannot be ruled out.[33] Section 238 IA is not likely to provide assistance either as English case law holds that the mere creation of security over a company's assets does not deplete or diminish them[34] and so is not vulnerable under this section.

Conclusion as to English law

Although the statutory provisions of English law regarding transaction avoidance in an insolvency context are well defined, case law provides considerable further insight into their interpretation. There are many cases where it is very clear that transactions are an abuse of creditors' rights on insolvency and these will be struck down. Other cases are not so clear-cut and, particularly in the context of financing a distressed debtor in the zone of insolvency, the key is to ensure that it is clear that the debtor receives real benefit from the consideration given by the lender.

Where a lender finances a distressed debtor against security interests in the form of a floating or a fixed charge, and actually provides new money, there is relatively little risk of an office-holder successfully avoiding the securities granted.

However, if the lender also tries to bring old credit under the new security rights, a floating charge will only be upheld *to the extent* new credit has actually been provided.

This is where banks are in a possibly stronger position than other lenders due to their ability to provide rolling credit facilities which swap old money for new money, reducing the risk to any security.

33 See for example, *Barnes (the liquidator of Mistral Finance Ltd) v Premium Credit Ltd* [2001] BCC 27, where the borrower failed to register a registrable security within the prescribed period (thereby rendering the security void against a liquidator – see footnote 12). The parties sought to rectify the mistake by entering into a new agreement pursuant to which a new charge was created (and registered). A short time later the borrower went into insolvent liquidation. The court found that the requirements of Section 239 IA were satisfied in relation to the security, which was therefore held to be void under that section.

34 *Re MC Bacon Ltd* [1990] B. C. C. 78.

German law

Applicable framework

German law on transaction avoidance[35] has been worked into a coherent, rather complex framework in the German Insolvency Act; the *Insolvenzordnung* (InsO). Whereas English law has one basic provision dealing with preferences, German law differs in that there are several. A distinction is made as to congruent performance (*kongruente Deckung*) in Section 130 InsO, incongruent performance (*inkongruente Deckung*) in Section 131 InsO, transactions constituting a direct disadvantage to the creditors in Section 132 InsO, wilful disadvantage in Section 133 InsO and gratuitous benefits in Section 134 InsO.[36]

According to German preference law, a performance is qualified as congruent if the creditor has an entitlement to a concrete transaction of the debtor. Most straightforward is the payment of a sum of money on the due date. A performance is qualified as incongruent if there is a difference between the transaction due under the content of the obligation and the transaction actually made, e. g. if the creditor receives from the debtor a security for or a payment in respect of an amount which he is not or not yet due to receive according to the original agreement between the parties. A clear example of the latter is the case when the debtor is illiquid and resorts to paying a creditor not with money but instead pays him by transferring a certain tangible asset, for example paying the ICT consultants by transferring a painting hanging in the board room (so called, 'in lieu of' payments).

The specific German rules on voidable transactions are, especially from an English perspective, extremely detailed and nuanced. In short, congruent performances can be challenged if performed within three months prior to the filing for insolvency proceedings if the debtor was already insolvent or illiquid at that time and the creditor was aware of that.[37] In contrast, incongruent performances are much easier to reverse. Especially compared to English law, transactions carried out in a way or at a time other than stipulated by contract or law are subject to ample avoidance possibilities. All incongruent performances within one month prior to the filing for insolvency procedures can be avoided. No further requirements apply here; most notable, no intent on either side needs to be proven by the office-holder. The mere fact that a transaction was made within one month prior to the filing for insolvency suffices for the transaction to be subject to reversal – regardless of whether it can be proven that the company was illiquid at the time. If the incongruent performance took place two or three months prior the filing for insolvency, all incongruent performances can be challenged if the debtor was already illiquid at that time. Again, no intent on either side needs to

35 The German Insolvency Act also contains other provisions which technically are not avoidance provisions but do have the same effect: see sections 88, 110 II and 114 III InsO. These provisions will not be included in the discussion here.

36 It is assumed that the lender is not also a shareholder. Under German law, loans provided by shareholders (with an exception for shareholders holding less than 10%, who are also not involved in the management of the company) are treated as capital and therefore subordinated. Security rights granted to secure shareholder loans also cannot be invoked in case of insolvency (sections 39 and 135 InsO).

37 In case of related parties, this knowledge is presumed with a possibility of proof to the contrary.

be proved by the office-holder. Incongruent performances can be challenged if they are performed within two or three months prior to the filing if the creditor knew that the performance would be to the disadvantage of the remaining creditors or had knowledge of circumstances which would lead to that conclusion.

The office-holder may also challenge any transaction which directly prejudices the interests of the creditors of the company under the terms of Section 132 InsO. According to Section 132 InsO a legal transaction on the part of the debtor constituting a direct disadvantage to creditors may be challenged by the office-holder, if carried out during the three month period prior to the filing for insolvency, if the debtor was illiquid on the date such transaction and if the debtor party had knowledge of the illiquidity on this date. According to Section 132 InsO, a legal transaction must constitute a direct disadvantage to other creditors. This means that it is not sufficient if the disadvantage arises only after other circumstances ensue later. Apart from that, the conditions of Section 132 InsO are largely identical to those of Section 130 InsO.

Gratuitous benefits or gifts granted by the debtor may be challenged by an office-holder pursuant to Section 134 InsO. A gratuitous benefit occurs when the recipient of the benefit is not entitled to receive any payment, collateral or other consideration from the debtor but receives something, or if the debtor is giving away assets of the company without valuable consideration.[38] A gratuitous benefit is voidable if granted four years prior to the filing for insolvency. No further requirements need to be proved by the office-holder. In this context it has to be considered that the Federal Court of Justice assumes that a claim is of no value if the debtor is on the brink of insolvency.[39] This can have dramatic effects when groups of companies are involved. A transaction may be voidable under Section 134 InsO if the creditor receives collateral from a group company securing a worthless claim against another group company. Intra-group collaterals are therefore often subject to avoidance actions.

Outside the aforementioned periods, transactions can be avoided on the basis of Section 133 InsO. Section 133 InsO thereby operates as a catch all provision, while sections 130 and 131 InsO provide specific, rather strict, rules on the avoidability of preferences, in particular in the three month period prior to the filing for insolvency. Section 133 InsO provides the framework for the reversibility of performances of the debtor within a 10 year period prior to the filing for insolvency proceedings (or after the date of the petition) if the debtor intended ('*Vorsatz*') to prejudice its creditors and the counterparty was aware of the debtor's intent on the date of the transaction. Such awareness shall be presumed if the other party knew of the debtor's imminent illiquidity, and that the transaction constituted a disadvantage for the creditors. An intention of a debtor to disadvantage its creditors in the aforementioned sense does not require a wilful intent of the debtor. It is sufficient if the debtor recognises that a satisfaction of a creditor or the granting of a security to a creditor is likely to cause disadvantages to the other creditors, e. g. that the other creditors cannot be paid out of the remaining assets of the company, and accepts this as a consequence of its acts.

38 cf. BGH WM 1964, 590.
39 cf. BGH NZI 2009, 891.

This is why Section 133 InsO also covers all acts which are "only" in a more indeterminate way detrimental to the debtor.[40]

In order to protect parties which provide new value, Section 142 InsO stipulates that new value transactions can in principle only be reversed on the basis of Section 133 InsO (*Bargeschäft*). Despite the wording of Section 142 InsO, incongruent performances can still be avoided pursuant to Section 131 InsO and Section 134 InsO even if new value is provided by the creditor.[41]

Section 142 InsO is only applicable if the performance of the creditor is more or less equal to the performance of the debtor. A security for a loan is considered to be equal if the realistic value of the security is not substantially higher than the loan.[42] The performance of the debtor and the consideration of the creditor must happen within a short timeframe, where two weeks could be regarded as a safe haven. The timeframe applies both ways, so both if the credit was granted slightly sooner than the creation of the security right as well as slightly later. Therefore, and apparently different from English law,[43] a security right will be treated as for new value under Section 142 InsO, also if the money was transferred for example one week before the security right was granted.

With this framework in mind, we can now turn to how German law deals with the issues at hand.

New securities for new credit

If a bank provides new credit to a debtor against security, the first question which arises is whether Section 142 InsO applies. If the new credit is paid out in a direct temporal and factual connection to the granting of the security and if the new credit matches the security, sections 130, 131 and 132 InsO do not apply. In this case the test as to whether the security rights can be challenged is to be found in Section 133 InsO, requiring that the transaction has been executed within 10 years prior to the filing for insolvency, and that the debtor intended to prejudice its creditors and the counterparty knew of that.

It would seem like the test of the debtor intentionally harming creditors will rarely be met in case of a restructuring attempt which failed. In general, the intent of Section 133 InsO includes *dolus eventualis*, meaning that although the transaction is not aimed at prejudicing the consequences but the likely consequences are accepted nevertheless, there is intent. The interpretation of the courts in failed restructuring cases (*gescheiterte Sanierungversuche*), also give rise to concerns for banks, especially since all parties involved will realise that *if* the restructuring attempt fails that the attempt itself will usually result in the creditors being harmed, especially if financed by secured loans. Therefore, the issue of transaction avoidance will be on the agenda any time a bank needs to consider whether to provide credit to facilitate a restructuring attempt by a debtor in distress.

40 See the comparison made with English law above in § 2.
41 cf. BGH ZIP 2007, 924.
42 cf. BGH WM 1998, 248.
43 See above under footnote 27.

From case law, several requirements follow. First of all, there must be a reorganisation plan, the goal of which must have been the saving of the company. If such a plan exists, there is an indication that the debtor has no intention to prejudice its creditors. It is not required that the plan succeeds. It is however required that the restructuring plan seemed, on the basis of specific identified grounds, to be executable and to provide a solution. A positive outcome under the restructuring plan has to be rather likely from an ex-ante perspective. Typically, such a restructuring plan will be approved by an auditor.[44]

In the case of Bank GmbH providing a loan to Vinocular GmbH for a restructuring attempt, Bank GmbH will request a restructuring plan meeting the standards set out. In that case, and if the requirements of Section 142 InsO are met, Bank GmbH will usually be able to rely on security rights granted in this respect. However, Bank GmbH should also consider the question of over-collateralisation.[45]

New securities for both new and old credit

In case the bank is granted a security right for both old and new credit, the validity of the security right is tested against different provisions. Section 142 InsO is not applicable.

If the restructuring attempt fails within three months, the creation of the security right for the old credit will usually be qualified as an incongruent performance (Section 131 InsO) or as a transaction constituting a direct disadvantage to the creditors (Section 132 InsO). This is why such a transaction is regularly the subject of avoidance actions.[46] The reasoning why, under German law, the granting of security rights is to be considered under Section 131 InsO as an incongruent performance deserves some further attention, because it takes a different approach compared to the Dutch approach. Usually securities are granted following a request by the bank invoking general bank conditions. The question then arises if such a subsequent granting of a security interest should be dealt with under Section 130 InsO, as a congruent performance, or under Section 131 InsO as an incongruent performance. The reasoning applied is that, notwithstanding the obligation arising out of the general bank condition to provide additional credit, this obligation is too indeterminate to qualify as a congruent performance. Therefore the additional security is to be considered under Section 131 InsO. This line of reasoning is also followed if the debtor only possesses a single asset.[47]

44 There is another reason for such plan. Without such a plan, there is not only the risk for avoidance actions for the banks, but also the possibility of lenders' liability towards other creditors (!).

45 There are different types of over-collateralisation under German law. In the majority of the cases the debtor will have a claim against the bank to release a corresponding part of the collateral. However, there is case law under which the whole collateral can be regarded as void.

46 Even if there is a contractual clause providing for the obligation to grant security rights to the bank at first request, a subsequent creation of security rights is usually treated as an incongruent performance.

47 cf. BGH, ZIP 1995, SECTION 1078 *et seq*., 1082. See also Henckel, *Anfechtung im Insolvenzrecht*, Berlin: De Gruyter Recht 2008, p. 254.

Probably more interesting is the question whether the security for the new credit is valid or not. Two questions need to be answered. First, whether the creation of new security rights is to be upheld. Here the test is of course the same as set out under b above. Therefore, again an executable plan aimed at saving the debtor is required. This will, however, not be sufficient if the security right created secures not only the new but also the old credit. German law allows for a distinction as to validity of a single security right valid in part for new credit and possibly invalid in part for old credit. This partial approach will, however, only be adopted if the parties differentiated clearly in the agreement as to the security right securing old and new credit. In such cases the outcome *can* be that the security right is subject to transaction avoidance to the *extent* it secures old credit and qualifies as an incongruent performance. To the extent the security right secures new credit, and its creation passes the test of Section 133 InsO, the security right will be upheld.[48] However, if the parties make no such clear distinction – as in most cases – there is a high risk that an office-holder may set aside the security right in full.[49]

Although German law is, like English law, not necessarily punitive as to the bank securing new and old credit by a single security right, there are significant risks in this respect.

Conclusion as to German law

German law provides complex provisions allowing an office-holder to avoid transactions which grant security for or satisfy existing claims in times of distress.

According to German law, it is possible to grant securities for new credit, without running afoul of transaction avoidance too easily. The security interests will be upheld if there is a reorganisation plan, the goal of which must be the saving of the company. It is not required that the plan succeeds. It is however required that the restructuring plan seemed, on the basis of specific identified grounds, to be executable and provided a solution, which makes a successful restructuring rather likely to succeed. Last but not least, the bank should meet the requirements of Section 142 InsO, meaning that there should be a contemporaneous exchange of equal value.

Under German law, there are significant avoidance risks if a debtor grants security rights for old credit, especially if the application for the opening of an insolvency procedure follows shortly thereafter. The risks are exacerbated for banks if they received a security right for both old and new credit. If the parties grant a security for old and new credit, an office-holder may challenge the security in full if it is not clear which debt the security right seeks to secure.

Dutch law

Applicable framework

At first sight, Dutch law is pretty straightforward when it comes to transaction avoidance in insolvencies (better known by its old Roman name of the '*actio*

48 cf. BGH ZIP 1993, 271, 274.
49 Braun/Riggert, InsO, § 142 marginal note 3; cf. BGH ZIP 1993, 271, 274.

Pauliana'). There are only two basic provisions in the Dutch Insolvency Act (*Faillissementswet*, Fw) which together cover all possible transactions prejudicing creditors in a subsequent insolvency procedure.[50] A transaction is either voluntary and covered by Section 42 Fw, or obligatory and covered by Section 47 Fw.

In short, an obligatory legal act is an act performed by the debtor in a way and manner and at a time the debtor was under the legal obligation to do so. Economic necessity to perform a legal act does not make an otherwise voluntary legal act an obligatory one. Voluntary legal acts are all legal acts performed by the debtor, which are not obligatory. Voluntary legal acts encompass both voluntary preferences[51] such as payments of undue debts and 'in lieu of' payments (sale followed by set-off to pay an existing debt) as well as voluntary transactions compromising the integrity of the estate such as transactions at an undervalue and gifts.

The criteria in Section 42 Fw for the avoidance of voluntary legal acts requires the office-holder to prove that the legal act i) was a 'voluntary act', ii) resulted in prejudice to the creditors,[52] iii) the debtor knew or should have known that the creditors would be prejudiced and iv) if the legal act was against value received, the counterparty also knew or should have known that other creditors of the debtor would be prejudiced.[53] The subjective criteria (iii and iv) are notoriously difficult to prove for the office-holder, the reason being that Section 43 Fw shifts the burden of proof to the defendant in certain cases. Of special concern for banks is the shifting of the burden of proof as to the subjective criteria in cases of a voluntary payment or of a voluntary granting of a security right for a debt not yet due in the year prior to the opening of the insolvency procedure. In particular, this presumption makes it difficult for banks demanding new security for old credit. Banks' general terms and conditions therefore contain a provision containing the *obligation* to provide security at the bank's first demand. If security rights are created on the basis of this provision, this creation no longer qualifies as a voluntary legal act but as an obligatory one. In such cases the creation should be considered under Section 47 Fw.

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50 In Dutch law these provisions are only applicable to the liquidation procedure ('*faillissement*') and the insolvency of individuals ('*Wet Schuldsanering Natuurlijke Personen*'). These provisions are not applicable to the suspension of payment procedure ('*surséance van betaling*').

51 As far as preferences are concerned, the distinction between voluntary legal acts and obligatory legal acts is in essence quite similar to the German distinction between congruent and incongruent performances. The application in specific cases is sometimes rather different, most notably as to the qualification of security rights granted following a request by the bank on the basis of banks' general conditions and payments made under pressure of the creditor.

52 To determine whether a transaction was detrimental to the creditors, a comparison must be made between the actual situation and the hypothetical situation in which the transaction would not have taken place. HR 23 December 1949, *NJ* 1950, 262 (*Boendermaker/Schopman q. q.*), HR 19 October 2001, *NJ* 2001, 654 (*Diepstraten/Gilhuis q. q.*) and HR 22 September 1995, *NJ* 1996, 706 (*Ravast/Ontvanger*).

53 In case of a detrimental legal act not against value received, only three conditions have to be met. As to the subjective elements, it is only required that the debtor acted with the knowledge that creditors would be prejudiced and there are no further requirements as to the knowledge or intent of the counterparty. Although there is debate in Dutch literature as to whether the granting of a security right should be viewed as an act against value received or not, here the point of view is taken that it is. In that sense we follow the reasoning under English law as expressed in *Re MC Bacon* [1990] BCC 78.

Section 47 Fw provides that an obligatory legal act can be avoided in only two limited cases. The first is that the counterparty at the time of the transaction knew of the pending application to open the insolvency procedure. The second alternative ground for the avoidance of obligatory legal acts is that the debtor and his counterparty colluded to favour this creditor over other creditors (collusion criterion). Case law of the Dutch Supreme Court shows that the collusion criterion focuses on the actual intent of parties and has to be interpreted restrictively.[54]

In the last decade, three judgments of the Dutch Supreme Court have tried to provide guidelines on how to deal with the abovementioned criteria in restructuring situations.[55]

New securities for new credit

If a bank provides new credit to a debtor in distress against new security, the first question is whether these acts qualify as voluntary and have to be considered under the rather broad scope of Section 42 Fw or qualify as obligatory and have to be considered under Section 47 Fw. It is generally accepted that the debtor has no obligation to refinance its debt. Therefore, the provision of new credit against new security has to pass the tests provided by Section 42 Fw.[56]

Two questions deserve further inspection, namely whether creditors are harmed by the creation of the new security right(s) in return for the new credit and secondly, under what circumstances parties can be said to have acted with the required knowledge that their acts would be detrimental to the creditors.

The question whether creditors are prejudiced in a case such as Vinoculars B. V., where Bank B. V. provides new credit to Vinoculars B. V. against a security right as part of a restructuring attempt and the attempt fails nonetheless, has received much attention in literature.[57] Banks understandably argued that there is no detriment, because of the contemporaneous exchange of value: new credit against new security. In 2005, the Supreme Court ended all debate by ruling categorically that, in case of a failed restructuring, the prior provision of new credit against new security will be detrimental to creditors, even if the new credit has been provided and used by the debtor to pay existing creditors. The reason-

54 HR 20 November 1998, *NJ* 1999, 611 (*Verkerk/Tiethoff q. q.*) and HR 24 March 1995, *NJ* 1995, 628 (*Gispen q. q./IFN*).

55 HR 16 June 2000, *NJ* 2000, 578 (*Van Dooren q. q.*/ABN AMRO I), HR 8 July 2005, *NJ* 2005, 457, (*Van Dooren q. q.*/ABN AMRO II) and HR 22 December 2009, *NJ* 2010, 273 (*Van Dooren q. q.*/ABN AMRO III).

56 We assume here that the provision of new credit and the creation of new security take place simultaneously. If there is a delay in the creation of the security right, the actual creation at a later date will qualify as an obligatory legal act and will be tested against the criteria of Section 47 Fw. In case these criteria are not met, the office-holder can still try to reach back to the moment at which the debtor assumed the obligation to create the security rights and invoke the *actio Pauliana* against this assumption being a voluntary legal act.

57 ABN AMRO/Van Dooren – (nog) geen happy end, I. Spinath, in: INSOLAD Jaarboek 2010 ('De insolvente vennootschap'; J. T. Jol & R. H. W. A. Verhoeven, 'Noodkrediet in Nood', *Bancaire Zekerheid, Liber Amicorum mr. J. H. S. G. K. Timmermans*, Deventer: Kluwer 2010, p. 230-231; H. De Coninck-Smolders and C.J. Jager, 'HR 22 December 2009, (*Van Dooren q. q.*/ABN AMRO III)', *TvI* 2010/17 and R. M. Wibier, 'Faillissementspauliana in de rechtspraak van de Hoge Raad' *TOP* 2010, p. 225-232.

ing is that the remaining creditors are now faced with a secured creditor and would have received more if no additional credit facility had been provided.

The fact that creditors are prejudiced is however not enough to reverse the creation of the security rights. It also has to be examined whether the debtor and the bank knew or should have known that the provision of new credit against new security would prejudice the creditors. Banks were hoping, and more or less expecting, that their interests against a too broad application of the *actio Pauliana* would be protected by a strict interpretation of the subjective criteria. In 2009, banks were disappointed in these hopes by the Supreme Court in its controversial ruling on how these subjective criteria need to be applied in case of a failed restructuring attempt.

In understanding the test formulated by the Supreme Court, one has to realise the following; creditors will only be prejudiced in the case of an insolvency scenario; only if the debtor is lacking sufficient funds to pay all creditors in full can creditors be prejudiced. Therefore, in order to have knowledge that creditors will be prejudiced by a legal act, parties will also need to have some knowledge of the impending insolvency of the debtor. The Supreme Court provided the following as a general rule. Parties will act with the required knowledge of their act being prejudicial to creditors if '*at the time the act is performed the opening of the insolvency procedure and a deficit in the insolvency procedure were foreseeable with a reasonable amount of probability for both the debtor and its counterparty.*'[58]

The test formulated as such and by itself, does not provide much guidance. One can, however, ask a more fundamental question as to restructuring cases. Is the restructuring attempt outside the scope as soon as there is a sincere attempt, although parties realise that the attempt might fail? Or can parties only embark upon the attempt if the chances of success clearly outweigh the chances of failure? This was exactly the question posed to the Supreme Court. The bank argued that the reasonable amount of probability that an insolvency procedure will be opened against the debtor can only be assumed if the bank could reasonably no longer assume that continuation of the business was possible. The Supreme Court did not only *not* follow the interpretation put forth by the bank, but even explicitly rejected it. The Supreme Court held that such an interpretation could not be reconciled with the general rule it had just formulated, namely that the opening of the procedure and a deficit in the insolvency procedure must have been foreseeable with a reasonable amount of probability. So, while the bank argued that as long as there was a reasonable chance of the reorganisation being successful, the legal acts would be outside the scope of transaction avoidance, the Supreme Court took a more pessimistic approach. The Supreme Court was only willing to look at the chances of failure. We believe that a close reading of the judgment of the Supreme Court leaves no room for any conclusion other than that, even if the bank could *reasonably* assume that continuation of the business was *possible*, if at the same time, the opening of insolvency procedure could still have been foreseeable with a reasonable amount of probability. Although the wording used by the Supreme Court leaves ample room for discus-

58 Under 3.7 and 3.8 in HR 22 December 2009, *NJ* 2010, 273 (*Van Dooren q.q.*/ABN AMRO III).

sion, we understand the judgment as requiring that the restructuring is likely to succeed.

In the same judgment, the Supreme Court ruled that banks cannot defend themselves by arguing that they simply did not know about the insolvency risk. Banks financing debtors in distress are under an obligation to make an assessment of the financial data in order to establish whether or not an insolvency procedure was foreseeable with a reasonable amount of probability. This is an additional obligation for the bank and is regarded as an extension of the duty of care of banks.[59]

The Supreme Court's judgment has met both support and fierce criticism. The proponents of the Supreme Court's ruling believe that the rule provides clear guidance for banks and applaud the ruling apparently for that reason.[60] At the same time the proponents think that the banks have enough knowledge and analytical skills to see whether a rescue plan is realistic and whether an insolvency procedure is foreseeable or not. The critics argue that the rule makes the decision for banks more complex and will lead to less restructuring cases and does not sufficiently take into account the need for possibilities to restructure struggling but potentially viable businesses.[61]

In the case of Vinoculars B. V., it is clear that Bank B. V. cannot simply assume that its security rights will hold as long as it provides new value. Bank B. V. will have to make sure there is a sound reorganisation plan. It will, however, not be sufficient in order for Bank B. V. to be safe, that the rescue of the debtor is deemed *possible*. The Supreme Court demands a higher likelihood of success. There is no leading case law yet positively indicating what chances of success are required. This makes distressed finance for Bank B. V. a risky affair.

New securities for both new and old credit

Dutch banks will almost always include in their credit arrangements the obligation to provide additional security rights on the bank's first demand. A subsequent creation of a security right following such demand will have to be considered under the criteria of Section 47 Fw [62]. Office-holders rarely succeed in challenging such a creation of security rights. This interplay of general bank conditions and Section 47 Fw gives banks a very strong position. Even if, only

59 In the Netherlands banks have to follow certain steps before terminating a facility agreement once the debtor is in default (see Hof Arnhem 18 February 2003, *JOR* 2003, 267). This might lead to a catch 22 position for banks. On the one hand the bank may find obstacles in terminating facility agreements instantly and on the other hand banks might be faced with an office-holder who might nullify the additional arrangements made in the twilight of an insolvency procedure. See on this matter: R. I. V. F. Bertrams, '*Aanpassing van de kredietovereenkomst, pauliana en art. 20 Algemene Bankvoorwaarden*', *TvI*, 24, p.127; M. C. J. A. Schröder-van Waes, '*Krediet(relatie) opzeggen of voortzetten ?*', *MvV* 2009/9 and case note Spinath *JOR* 2006/89.

60 ibier; B. Vermeu,'Wetenschap en de Pauliana na HR ABN AMRO/Van Dooren q. q. III' TvI, 2011/9.

61 De Weijs, Jol & Verhoeven, De Coninck-Smolders & Jager, Spinath, Van Schilfgaarde (case note *NJ* 2010/273) and Faber (case note *JOR* 2011/19).

62 Usually the debtor will be motivated to do so because its director and/or shareholder provided a guarantee. There are no rules in Dutch law treating the payment to the bank in such cases as a preference to the guarantor. See on the issue, R. J. De Weijs, '*Financieren met garanties door aandeelhouders: vergeten problematiek*', *FIP* 2010/6.

days prior to the filing of the request for the opening of insolvency proceedings, the bank has granted new security interests, these are usually upheld. This practice, and the strong position of banks related thereto, is subject to criticism.

Problems, however, present themselves, if banks do not invoke the general bank conditions but receive a single security right covering both old and new credit. In such a case, the creation of the security interest will be considered under Section 42 Fw. If the old credit has *not* been terminated and the credit has not been declared due and payable, an additional problem presents itself. In such a case, the burden of proof will be shifted onto the bank by the working of Section 43 Fw because the security right is in part created to secure a debt not yet due. Because of the mixing of old and new credit, the bank finds itself in the position where its knowledge of prejudice to creditors is presumed.[63] It can try to deliver proof to the contrary, but this is very much an uphill battle.

A way out of this, for the bank, might be to have the debtor create a first and second security right in the same asset; a first security right created following a demand on the general bank conditions and qualifying as an obligatory legal act and a second security right securing the new credit.[64] The benefit is first of all that the bank can benefit from the broad possibilities to demand securities for old credit on the basis of the general bank conditions. Another benefit for the bank is that it will not be at a disadvantage by the working of the shifting of the burden of proof in its discussions with the office-holder as to the validity of the security right securing the new credit.

In the case of Vinoculars B. V., Bank B. V. should avoid mixing old and new credit. Doing so will be at its peril and will risk the entirety of its security right.

Conclusion as to Dutch law

Dutch law on transaction avoidance makes a sharp distinction between obligatory and voluntary legal acts. Obligatory legal acts are notoriously difficult for office-holders to attack.

If a bank demands security for old credit and invokes general bank conditions, the subsequent creation of a security right will qualify as an obligatory legal act and will only be subject to avoidance if the office-holder can either demonstrate that the counterparty already knew of a pending application to open insolvency procedures or if the bank and debtor colluded.

If the bank, however, extends new credit to a distressed debtor and receives security in return, these acts will be qualified as voluntary legal acts. The security rights will be subject to transaction avoidance if both the debtor and the bank knew or should have known that the acts would be detrimental to the remaining creditors. The Supreme Court has explicitly ruled that in case of a failed restructuring attempt, the granting of a security right against the provision of new credit will be detrimental to the remaining creditors. The office-holder will, however, also have to prove that both debtor and bank knew or should have known that

63 In literature, the position has been taken that the court might rule that the shift of burden of proof would only apply to part of the security right (see Faber in his case note *JOR* 2011/19). This can however not be regarded as accepted law.

64 See on this Spinath, p. 143-144 and De Weijs, diss, p. 265-274.

the extension of credit against security rights would be detrimental to creditors. The test to be applied is whether, at the time the act was performed, the opening of the insolvency procedure and a deficit in the insolvency procedure were foreseeable with a reasonable amount of probability for both debtor and counterparty.

If the bank fails to make a clear distinction between security rights securing the old credit and new credit, it not only loses the ability to cash in on its strong position and ample possibilities to demand security for old credit, it also risks a shift in the burden of proof and is likely to face the uphill battle of having to prove that it did not know nor should have known that the transaction would prejudice the creditors.

Comparison and conclusion

The avoidance provisions of the respective countries are quite different in their basic structure and approach. Most notable are the differences as to the use of subjective and objective criteria[65] and if subjective criteria are used, whose subjectivity is deemed important: the debtor's or its counterparty?

As far as preference law is concerned, the focus of English law in Section 239 IA is exclusively on the state of mind of the *debtor*. The debtor must have been influenced by 'a desire to prefer'. The subjective elements on the *creditor's* side don't play any role here. German preference law contained in sections 130 and 131 InsO on the other hand, makes no references whatsoever to subjective elements on the debtor's side and generally takes a more objective approach.[66] As far as sections 130 and 131 InsO do require subjective requirements to have been met,[67] they focus on the subjective elements of the *creditor*, and not of the debtor.[68] Dutch law tends to require subjective criteria to have been met on both the creditor's and the debtor's side.[69]

The subjective English approach and the generally more objective German approach as to preferences is not followed through in their respective approaches to legal acts at an undervalue and other legal acts compromising the integrity of the estate. Under English law, transactions at an undervalue and transactions not

65 Subjective criteria are concerned with the state of mind of the parties involved, such as intent and knowledge of something.

66 It provides for ample opportunities for challenging the so called incongruent performances. These are subject to transaction avoidance without any further requirements if the preference has been created in the month prior to the filing for insolvency proceedings or after such request, and in the two – and three month-period prior to the request if the debtor was already illiquid.

67 Section 133 InsO can also be applied to preferences created prior to the three month period. In that case, intent of the debtor is required, with knowledge of the counterparty thereof.

68 Incongruent performances are also subject to transaction avoidance if performed within two or three months prior to the request, if the *creditor* knew that the performance would be to the disadvantage of the remaining creditors (Section 131 InsO). Congruent performance can be challenged if performed within three months prior to the filing of the request if the debtor was already insolvent or illiquid at that time and the *creditor* was aware of that (Section 130 InsO).

69 Voluntary legal acts against value received can be challenged if both the *creditor* and the *debtor* knew or should have known that the act would be detrimental to the creditors (Section 42 Fw). Obligatory legal acts can be challenged on the ground that *debtor* and *creditor* intended to prefer that creditor over the other creditors, or in case the *creditor* knew of a pending request for insolvency proceedings (Section 47 Fw).

against value received are, as against the counterparty, subject to reversal on the basis of Section 238 IA, without the office-holder having to prove any subjective element on either side.[70] Under German law, transactions at an undervalue or otherwise compromising the integrity of the estate can only be challenged under Section 133 InsO[71] if the *debtor* acted with the intent to prejudice its creditors and the *counterparty* knew thereof. Dutch law again tends to require subjective criteria to have been met on both the creditor's and the debtor's side.[72] So, whereas English *preference* law is highly subjective with a sole focus on the debtor's intent, and German *preference* law is highly objective, English law as to transactions at an undervalue is highly objective, whereas the German approach[73] to transactions at an undervalue is more subjective.[74]

In comparing how these different legal regimes approach to the granting of security rights to banks by debtors in distress, it is almost impossible to identify one regime as being overall permissive and another as being overall more scrutinous and strict.

As far as the avoidance risk as to security rights for old credit is concerned, Dutch law seems to place itself at the bank-friendly end of the spectrum. Here, as long as general bank conditions are invoked, the bank can usually rely on the securities granted. Then, creation of security rights will qualify as an obligatory act and can only be attacked by an office-holder if parties actually 'colluded' or if the bank already knew of a pending application. German law is rather suspicious of the creation of security rights on the eve of the declaration of insolvency. German law usually treats these as being incongruent performances, which are subject to ample avoidance possibilities, especially if created within the three - months prior to the filing for the opening of an insolvency procedure. It is difficult to pinpoint the English position, the reason being that one first needs to make a distinction as to the type of security right which has been created. Floating charges are to be considered under Section 245 IA and fixed charges may qualify as a preference and fall to be considered under Section 239 IA. Floating charges are voidable if created within one year prior to the onset of insolvency if the debtor was already insolvent and to the extent no new value was provided. Fixed charges are, on the other hand, more difficult to avoid, even if created close to the onset of insolvency.

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70 Section 238-5 provides for a good faith defence on the side of the *debtor* and under Section 241(2) bona fide third parties are protected.

71 Acts not against value received can be challenged on the basis of Section 134 InsO on purely objective grounds. It suffices that there has been an act not against value received in the four years prior to the opening request.

72 Voluntary legal acts against value received can be challenged if both the *creditor* and the *debtor* knew or should have known that the act would be detrimental to the creditors (Section 42 Fw). In case the voluntary act is not against value received, it is only required that the debtor acted with the required knowledge.

73 Whether and to what extent this different theoretical approach leads to different outcomes is difficult to say. The German provision (Section 133 InsO) first of all contains rebuttable presumptions as to the fulfilment of these subjective criteria. In addition thereto, case law provides for significant alleviations of the burden of proof, where objective elements will often indicate the fulfilment of subjective criteria.

74 See for a further analysis and explanation of these differences, R. J. de Weijs, 'Towards an objective European rule on transaction avoidance in insolvencies' in *International Insolvency Review* 2011, forthcoming.

The central question in this article is, however, not a comparison of late creation of security interests for previously extended credit, but the extent to which banks can safely provide new or at least additional credit against new securities. As a high level remark, it is interesting to note that the relative position that the different legal regimes take towards late security rights for previously extended credit is not mirrored by their treatment of new security for new credit.

Here, English law seems to be the most lenient. Fixed charges created to secure fresh credit are usually not even considered as possibly running afoul of transaction avoidance; they do not qualify as a preference under Section 239 IA[75] and they are also outside the scope of Section 238 IA.[76] As far as concerns a floating charge that has been created when new value has actually been extended, the floating charge will usually also be upheld. This is however not to say that one should not be extremely careful. There are always risks related to distressed finance. A powerful reminder of that is, for example, that a bank should not be too forthcoming in making the new credit available, for example in order to facilitate the payment of salaries. If the bank provides credit first and arranges for a floating charge later on, there is the very real risk that the floating charge will not be enforceable.

German law is more suspicious of bank financing restructuring attempts against security rights than English law. German case law has developed a conceptual framework within Section 133 InsO for dealing with failed rescue attempts. The security rights will be upheld if there is a reorganisation plan aimed at saving the company and the requirements of Section 142 InsO are met. It is not a requirement that the plan succeeds. It is however required that the restructuring plan seemed, on the basis of specific identified grounds, to be executable and to provide a solution which makes a successful restructuring rather likely to succeed.

While Dutch law seems to be the most permissive as to simply securing old credit, it proves to be rather suspicious and strict as to banks granting new credit against security. The test is whether, at the time the act is performed, the opening of the insolvency procedure and a deficit in the debtor's estate were foreseeable with a reasonable amount of probability for both the debtor and its counterparty. The Supreme Court refused to change this perspective in the case of distressed finance. It held that is not sufficient that the parties to the restructuring could reasonably believe that the continuation of the business would be possible. Although it is difficult to compare the Dutch approach to the German approach *in abstracto*, at least there is a difference in focus and perspective. The Dutch Supreme Court focuses on the negative and the risks of failure, whereas the German Supreme Court focuses on the positive and the chances of success. Also, from established German case law, a workable practice has emerged invoking the assistance of auditors.

75 The reason is that as far as the new credit is concerned the bank is not a creditor yet and can therefore not be held to have been placed into a better position as a creditor compared to that which it would have been if the transaction had not been conducted.

76 In *Re MC Bacon* [1990] B. C. C. 78 securities for new credit were held to be outside the scope of transactions at an undervalue altogether.

All said, as regards security rights securing new credit, English law is the most tolerant. German and Dutch law place secured distress finance under considerably more scrutiny. This different approach can be explained by a completely different focus and a different understanding of what transaction avoidance law is. English law on transaction avoidance focuses on an unjust benefit gained by the counterparty of the debtor at the expense of the joint creditors.[77] German and Dutch law have as their starting point not the benefit of the counterparty, but the prejudice of the joint creditors. In the case of the extension of new credit against securities as part of a failed restructuring attempt, there is often little benefit and considerable risk for the bank, as recognised by the more lenient English approach. At the same time, the remaining joint creditors can be said to have been prejudiced, even if the extended credit has been paid to pay some creditors. This explains in part the stricter German and Dutch approach.

The most intriguing outcome of comparing the three systems is the relative position of the different grounds for transaction avoidance within a single jurisdiction; in other words, the relative risk of transaction avoidance a bank faces as to security rights created to secure new credit compared to security rights created to secure old credit. If structured properly, both German and English law on the whole take a more lenient view as to the granting of security interests for new credit, than the late creation of security interests for previously extended credit. Dutch law takes a different approach. Dutch law ended up with a system which is more lenient to a bank simply reeling in additional security interests for old credit on the basis of general bank conditions, as compared to where the same bank under the same circumstances provides new credit against new securities.[78] One might question whether this is the wrong approach if one wants to increase the possibilities for distressed debtors restructuring their business.

In all three legal systems there are risks, albeit that they are rather different depending on whether the issue at hand is the late creation of a security interest or whether the issue is the providing of fresh credit against a new security interest. In practice, these two issues often present themselves simultaneously. The question then is whether the law applies an 'all or nothing' approach so that if the creation of the security right can at least in part be attacked on the basis of transaction avoidance, whether the bank is denied the security in full. English law is very explicit in the possibility that a floating charge can be invalid in part and invoked in part at the same time. A late floating charge is only valid *to the extent* new credit has been provided. German law allows for a partial invalidity if it is clearly documented that a security right secures in part old and in part new credit and the security right can be upheld under security 133 InsO. If this is, however, not clearly documented, as is often the case, banks risk losing the entirety of a security right securing both old and new credit. Dutch law is not

77 Roy Goode, Principles of Corporate Insolvency Law (4th edition Sweet & Maxwell, 2011) p. 522: "All but two of the grounds of avoidance known to insolvency law involve the unjust enrichment of a particular party at the expense of the general body of creditors. Once this crucial point is grasped, much of the legislative structure falls into place." The two exceptions Goode refers to are grounds of avoidance which under German and Dutch law are not typically regarded as part of transaction avoidance law, but part of the fixation principle. Goode: "The two exceptions are failure to register a registrable charge and the making of a post-petition disposition of the company's property without the authorisation of the court."

78 See § 5 a.

clear on the subject, but banks failing to distinguish properly between obligatory and voluntary legal acts and new and old credit risk losing a security right securing both.

In the process of continuing harmonisation of European Insolvency Law, one of the most important and most difficult issues will be rules on transaction avoidance. At present the rules are very different, but have in common that they have become highly detailed and technical. It is therefore easy to lose sight of the underlying policy issues. In evaluating the different rules, one first needs to realise that the underlying conflict of interests is not just that between the unsecured creditors and a secured bank. There is a larger interest at stake, namely the need to be able to finance restructuring attempts. The rules on transaction avoidance should acknowledge that there will be many uncertainties in any restructuring attempt. Where all parties realise that events may also take a turn for the worse, banks should not be too easily punished for providing new credit in times of crisis if the attempts fails. If a bank is, however, simply reeling in security rights for previous extended credit, this should be treated with more scrutiny compared to the case in which a bank actually provides additional credit against new securities. In practice banks often do both; demanding security for new and old credit. Rules which provide full avoidability of a security right, because part of the security right runs afoul of transaction avoidance law, will dissuade banks from participating in restructuring attempts. Therefore, legislation should provide at least for a safe haven under which lenders can take security for new money.