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AVOIDANCE OF TRANSACTIONS IN INSOLVENCY:

A COMPARATIVE ANALYSIS OF PREFERENCE LAW IN GERMAN, ENGLISH AND LITHUANIAN LAW

Master Thesis

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1. Introduction

The distributions of the insolvent company assets among it's creditors arises over again every time there is major bankruptcy or serious economic recession[1]. Sometimes well-known equality of creditor principle cannot be ensured while distributing the assets of the debtor due to unfair acts of other creditors before the effective or relevant date of insolvency. For this reason, 'equality of creditors' could be reached or re-established by preference law, which will be analyzed in this master thesis. This thesis will concentrate on a comparative research in which the provisions of several different jurisdictions on the legal rules on preference law will be analyzed. Preference law within this master thesis shall refer to those legal transactions, by which *"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 proceeding, be better than the position that person would have been in if that thing had not been done"*[2]. As a key feature of this transaction 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[3]. These transactions traditionally occurs before the effective or relevant date of insolvency and as a result are set aside or otherwise be rendered ineffective in order to re-established the equality of creditors -*"foremost principle in the law of insolvency around the world"*[4] *and "the oldest and most frequently advanced goal of preference law"*[5]. First of all we should start this research by answering a simple question: why currently this topic is relevant?

To answer this question the words of ING analysts report regarding the world's business climate will be used: "*We believe that era of cheap access to resources is coming to an end*"[6]. Everyday news portals highlight the difficulties the world is facing in financial sector. "Euro zone crisis" and foreign debt issues are still hot topics of everyday news. We do remember that all these things are consequences of 2008/2009 global economic crisis that resulted in recession that cleared a path to corporate collapses. The European insolvency situation in the second year after the financial crisis was tense. The number of corporate collapses in the Western European

[1] J. S. Ziegel Preferences and Priorities in Insolvency Law: Is There a Solution? 39 St. Louis U. L.J. 793 1994-1995, p. 793

[2] R. J. de Weijs, J. R. V. Evert, R. Connell, and C. Bärenz, "Financing in Distress Against Security from an English, German and Dutch Perspective: A Walk in the Park or in a Mine Field?", 2011, Amsterdam Law School Research Paper No. 2011-45, p. 5

[3] Ibid., p. 5

[4] A. Keay, P. Walton, "The preferential debts regime in liquidation law: in the public interest?", 1999 C.f.i.L.R. p. 84-85.

[5] J. C. McCoid II, Bankruptcy, Preferences, and Efficiency: An Expression of Doubt, Virginia Law Review, Vol 67, No 2 (Mar., 1981), pp. 249-273, p. 260

[6] ING Equity research, Sector update, 01/04/201, p.1

States rose year-on-year by a margin of 0.3 percent – from 174,463 in 2010 to 174,917 in 2011, in the Eastern Europe rose by a margin of 6.1 percent – from 37,139 in 2010 to 39,423 in 2011[7]. It should be noted that corporate insolvencies in Lithuanian rose by 1.1 percent in 2011 compared with 2010, i.e. almost 4 times more that the Western Europe and approximately 5 times less than in the Eastern Europe. There are also some positive signs of changes in Lithuania as the number of companies in bankruptcy reduced by 7.6 percent within first 9 months of 2012 compared with the same period in 2011, however, the number of insolvencies has not reduced to pre-recession level[8].

In the light of the growing number of insolvencies within Europe and ongoing second face of financial crisis the assets of debtor may be disposed in countries other than the debtor became insolvent, thus, it is important to know how other jurisdictions (common law and continental) deal with the same pre-insolvency transaction matters. The author's choice to analyze selected legal systems is based on other reasons as well.

First of all, lack of harmonization of preferences rules in the EU framework. The Council of the European Union adopted the Regulation No.1346/2000 setting the common rules on insolvency proceedings[9], which resulted in preferences being governed by the different laws of Member States because Article 4 of the EU Regulation stipulates that preferences will be governed by *lex concursus.* In addition, Article 13 of the Regulation is interpreted in a way that with respect to the acts that are considered to be fraudulent, the *lex causae* derogates to the *lex concursus*. In other words, transaction friendly rule prevails. One of the goals of the European Union for this harmonization of Insolvency Law was to discourage the debtor from transferring the assets from one country to another in order to improve his legal position which is detrimental to the creditors' rights and position ('forum shopping')[10], however in reality it is on the contrary, it just helps to increased "forum shopping". In addition, during 2010, the Directorate General for Internal Policies issued a Note on the Harmonization of Insolvency Law at EU Level, setting the outlines of problems that might occur in the absence of common rules on the insolvency

[7] Insolvencies in Europe, A survey by the Creditreform Economic Research Unit 12/2011 https://www.uc.se/download/18.782617c713603ab70837ffd368/Europa_statistik_konkurser_2011.pdf (accessed: 10/11/2012, 16.34)

[8] Article *"Bankrotai: mažėja miestuose, daugėja regionuose", Matas Miknevičius*, UAB "Creditrefrorm Lietuva", Verslo Žinios, 09/10/2012 http://www.creditreform.lt/atsiskaitymas/?object=news&action=view&id=227&print=1 (accessed: 10/11/2012, 14.13)

[9] Council Regulation (EC) No 1346/2000. Official Journal of the European Communities L 160/1. Published on 30.6.2000. http://europa.eu/legislation_summaries/justice_freedom_security/judicial_cooperation_in_civil_matters/l33110_en.htm (accessed 9/9/2012, 14:35)

[10] Ibid.

proceedings among the EU member states[11], which again supports the idea that there is lack of harmonization in the insolvency law.

Furthermore, "European Parliament resolution issued on 15th of November 2011 with recommendations to the Commission on insolvency proceedings in the context of EU company law"[12] also included proposal to harmonize to some extend preference laws. However, all acts mentioned above do not harmonize preferences in an extensive way and brings the right for the countries to adopt their own laws. So, as long as situation involves lack of harmonization within the European Union countries, companies have the right/option to move their center of main interests and by doing this to indirectly choose legal rules, which will be applicable for their relations. From all that was mentioned above and keeping in mind the lack of harmonization of substantive insolvency law, including the lack of common preference rules let us analyze and compare various legal rules implemented by countries and to actually see the influence they bring to the outcome of the insolvency proceedings.

Consequently, the focus of this master thesis is concentrated on creditors' rights protection granted by preference law, which is one of the ways to ensure fair balance between creditors' interests and terms of cooperation amongst all the parties affected by unfair preferential acts[13]. The regulated cooperation of the creditors is needed in order to overcome the destructive asset grabbing[14].

The *aim* of this master thesis is to answer the thesis question: which legal system offers the most favorable regulation for creditors in the area of preference law, which protects their rights from voidable preferential transactions?

The *task* of the thesis is not to analyze all preference law provisions in Germany, England and Lithuania, however, to highlight core approaches in the preference law provisions in these jurisdictions and compare all these legal systems in order to answer the thesis question.

For the exhaustiveness of the analysis the author decided to include legal systems, which would represent both, common law and civil law approaches, thus, it was a ground for a decision to include German and English legal systems. The choice of Lithuanian legal system was

[11] DG For Internal Policies-Policy Department C: Citizens' Rights and Constitutional Affairs-Legal Affairs: *Harmonization of Insolvency Law at EU Level*, Brussels, 2010
[12] European Parliament resolution of 15 November 2011 with recommendations to the Commission on insolvency proceedings in the context of EU company law (2011/2006(INI)) http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P7-TA-2011-0484&language=EN&ring=A7-2011-0355 (accessed 12/9/2012, 17:35)
[13] R. J. Mokal, "*Corporate Insolvency Law",* 2005, Published to Oxford Scholarship Online, p 51 -71.
[14] R. J. De Weijs, "*Harmonisation of European Insolvency Law and the Need to Tackle Two Common Problems: Common Pool & Anticommons"* (October 19, 2011). Amsterdam Law School Research Paper No. 2011-44, p. 35

influenced by the good knowledge of this legal system of the author. In addition, the Lithuanian legal system has not been thoroughly analyzed in respect of preference law.

The following *methods* are used in the current research: analysis, comparative, abstraction, analogy, deduction and generalization. The combination of all of the methods mentioned above will enable the author to understand German, English and Lithuanian legal systems of preference law separately and to perform comparative analysis of all the systems together in order to answer the thesis question.

The object of the master thesis is the analysis of preference law regulation and the scope of creditors' rights protection in Germany, England and Lithuania. The preference law and related case law will be analyzed to the extent it is necessary to answer the thesis question.

In order to reach *the aim* of the master thesis the following structure of analysis is chosen. Firstly, general notion of preference law shall be presented. Secondly, the concept of preference laws in Germany, England and Lithuania will be introduced. Thirdly, the author will analyze the characteristics of parties participating in the transactions (debtors and creditors) and statute of limitations applicable to preferences (preferential transactions) in Germany, England and Lithuania. Finally, general comparative analysis of all the analyzed systems will be performed in order to answer the thesis question.

The hypothesis of the thesis is that German legal system is most likely to offer the best legal rules for creditors harmed by the preferential transaction. This hypothesis is based on opinion of the author that German law is more stable because it is based on statutory provisions and not precedents compared with English law. Lithuanian legal rules on preferences are still very young, thus, preferences laws are still not sufficiently analyzed and developed.

The purpose of this research is to prove or deny the master thesis hypothesis: that German legal system offers the best protection for creditors which were harmed by preferential act compared to English and Lithuanian legal rules on preferences.

2. General Notion of Preference Law

Avoidance of transaction in bankruptcy law is related with creditor's or bankruptcy administrator's rights to strike down pre-bankruptcy transactions, which: (a) the company (debtor) entered into insolvency proceedings, (b) "damage" was caused to creditors, (c) the company (debtor) was insolvent at the time before the date of the insolvency petition or – according to some statutes – before the date of the insolvency order (objective requirements)[15]. Furthermore, almost all European countries also establishes additional subjective requirement to prove that third party knew about the company's insolvency at the time of the transaction[16].

Legal doctrine recognizes 3 categories of pre-insolvency transactions, which occurs before the effective or relevant date of insolvency and as a result may be set aside or otherwise are rendered ineffective: (i) transactions defrauding the creditors, (ii) undervalue transactions and (iii) voidable preferences[17].

Transactions defrauding the creditors relate to insolvency law provisions that allow to challenge transactions concluded before the effective or relevant date of insolvency by debtor in fraudulent manner[18]. Undervalue transactions relate to the transaction by which the debtor disposes of an asset either without receiving value in return or without receiving adequate value[19]. Whether the transaction is fraudulent or mere undervalue transaction, depends on *"the knowledge of the debtor's dire financial situation and the concomitant subjective intention to prejudice creditor's by putting assets beyond their reach for the purpose of judicial execution"*[20], i.e. if there is intention to defraud – it is transactions defrauding the creditors, if not – undervalue transaction. In legal doctrine transactions defrauding the creditors and undervalue transactions are also called 'fraudulent conveyances'[21].

Third category is voidable preferences, which relate to insolvency law provisions that allow attacking transactions carried out by the debtor to give a "preference", i.e. favour one or

[15] R. Mangano, The Role of Fraudulent Transfer Rules in Corporate Insolvency, ECFR 2008, 193-212, p.196
[16] Ibid., p.197
[17] J. S. Slorach, J. G. Ellis, Business Law 2007-2008 Oxford University Press, 2007, p. 268-269
[18] R. Mangano, The Role of Fraudulent Transfer Rules in Corporate Insolvency, ECFR 2008, 193-212, p.195
[19] A. Boraine, Comparative Notes on the Operation of Some Avoidance Provisions in a Cross-Border Context (2009) 21 SA Merc LJ, p. 436
[20] Ibid., p. 436
[21] A. Boraine, Comparative Notes on the Operation of Some Avoidance Provisions in a Cross-Border Context (2009) 21 SA Merc LJ, p. 436

some creditors over all creditors[22]. Legal doctrine defines 'preference' as a benefit received by a creditor "<...> *either in the form of a pre-bankruptcy settlement of the debt or by improvement in his status as a creditor in that he is elevated from being an unsecured creditor to the rank of a secured creditor on the eve of bankruptcy, thus escaping the ordinary queue provided for payment in bankruptcy"*[23].

Preference law seeks to ensure that the assets are kept together and eventually sold in a structured procedure[24]. It prevents creditors from destroying the estate's value by selling it in pieces instead of all together. If the company which entered into insolvency has its assets all together it can be sold most likely for a much bigger price than selling it in parts or vice versa. If assets are kept together there are more possibilities for the administrator to decide how to sell them in most profitable way: sell all together, sell in parts or to reorganize the company in the way it could be sold more profitably. In addition, having insolvency procedure, as indicated by Creditors Bargain Theory[25], stops creditors from competing with each other over the debtor's assets. Insolvency laws brings legal security to the creditor by saving creditor's resources all together so creditor does not have to monitor his debtor in order to be able to join the fight over his assets on time.

In an international context of bankruptcy, the abovementioned transactions could be deceptive as well as rules that allow striking down these transactions because of different approaches in various countries. It means that it is important to understand the difference between these categories (fraudulent conveyances and preferences).

It should be noted that transactions defrauding the creditors and undervalue transactions can be also concluded and challenged prior to company's insolvency, however, preference law plays a role only after bankruptcy proceedings have been instituted and focuses on the period between the onset of insolvency and bankruptcy and its target is a transfer to one creditor during that period[26]. We see that preference law is different from the other category ('fraudulent conveyances') by the *period* when the voidable transaction was concluded and the *parties* entering into the transaction. Preference law is dealing with situations where preference is given to existing creditor (e.g. by settling pre-existing debt, discharging from liability to pay or

[22] R. Mangano, The Role of Fraudulent Transfer Rules in Corporate Insolvency, ECFR 2008, 193-212, p.195; R.J.De Weijs, J.R.V. Evert, R. Connell, and C. Bärenz, "*Financing in Distress Against Security from an English, German and Dutch Perspective: A Walk in the Park or in a Mine Field?"* (October 24, 2011), International Insolvency Law Review, Forthcoming; Amsterdam Law School Research Paper No. 2011, p. 45.
[23] Ibid., p. 436
[24] R. J. De Weijs, "*Harmonization of European Insolvency Law and the Need to Tackle Two Common Problems: Common Pool & Anticommons*" (October 19, 2011). Amsterdam Law School Research Paper No. 2011, p. 44.
[25] Ibid. p. 44
[26] J. C. McCoid II, Bankruptcy, Preferences, and Efficiency: An Expression of Doubt, Virginia Law Review, Vol 67, No 2 (Mar., 1981), pp. 249-273, p. 260

improving a particular creditor's position)[27], however, in fraudulent conveyances, the assets might be transferred as well to third parties (not only to existing creditors).

By fraudulent conveyances debtor seeks to dissipate the assets to the detriment of debtor's creditors by *"putting assets beyond their reach for the purpose of judicial execution",* however, in case of preference *"the debtor doing or suffering anything to be done at a time when he is insolvent which 'has the effect of putting [the person who benefits from the preference] into a position which, in the event of the [debtor's] bankruptcy, will be better than the position he would have been in if that thing had not been done"*[28]. It follows fraudulent conveyances and preferences seek *different consequences*.

Taking into account the purpose of avoidance of pre-bankruptcy transaction, the *goal of preference* law is to enhance the equal treatment of creditors by imposing rules on pre-bankruptcy behaviour so that behaviour will not make the principle of equality in bankruptcy distribution meaningless and to maximize the estate from which equal distribution is to be made[29] and fraudulent conveyances law - to strike down transactions, which diminish debtors assets available for execution in general or "hinder, delay or defraud creditors, or such dispositions made by an insolvent debtor for less than, or without, a fair consideration"[30].

Consequently, it should be emphasized that fraudulent conveyance law (transactions defrauding the creditors and undervalue transactions) and preference law (might) have the following differences: (i) periods when the voidable pre-bankruptcy transaction are made, (ii) parties concluding the transaction, (iii) consequences sought by the transactions, (iv) different goals. Finally, all of these categories intend to protect the right of creditors.

In this master thesis, the analysis will concentrate on preference law, which is one of the way to adjust the rights of creditors against other creditors that the creditor would not receive a greater share of debtor's assets than he would otherwise enjoy under rules of formal insolvency[31]. In order to analyze preference law, we also need to understand how it evolved in Common law and Civil Law.

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[27] A. Boraine, Comparative Notes on the Operation of Some Avoidance Provisions in a Cross-Border Context (2009) 21 SA Merc LJ, p. 441, R. Weisberg, Commercial Morality, the Merchant Character, and the History of the Voidable Preference', 1986, 39 Standford LR 3

[28] J. S. Slorach, J. G. Ellis, Business Law 2007-2008 Oxford University Press, 2007, p. 268-269

[29] J. C. McCoid II, Bankruptcy, Preferences, and Efficiency: An Expression of Doubt, Virginia Law Review, Vol 67, No 2 (Mar., 1981), pp. 249-273

[30] A. Boraine, Comparative Notes on the Operation of Some Avoidance Provisions in a Cross-Border Context (2009) 21 SA Merc LJ, p. 440-441

[31] R. Weisberg 'Commercial Morality, the Merchant Character and the History of the Voidable Preference (1986) Standford LR 3, p. 39

In common law, preference law stems from fraudulent conveyance law, which is related with debt collection procedures of property when creditors enforce their individual rights against debtors, however, these right becomes collective as soon as the formal insolvency procedures commences because assets have to be distributed equally among the creditors[32]. The settlement of an existing debt in common law countries was not regarded as illegal at first, however, major rules were formed by the case law and later incorporated in the statutory legislation governing insolvency [33].

In Civil law jurisdictions preference law initially develops from praetorian remedies of Roman law such as the *resitutio in integrum* and *interdictum fraudatorium, which* were initially available for creditor to recover property fraudulently transferred by the debtor. These remedies were reflected in well-known *actio Pauliana,* which developed from the codification of Justinian, and later were implemented in most of the civil law jurisdictions (including Germany and Lithuania)[34].

[32] A. Boraine, Comparative Notes on the Operation of Some Avoidance Provisions in a Cross-Border Context (2009) 21 SA Merc LJ, p. 436-440

[33] H. Rajak, Determining the Insolvent Estate A Comparative Analysis, Int. Insolv. Rev.,Vol.20:1-28 (2011), p. 5; A. Boraine, Comparative Notes on the Operation of Some Avoidance Provisions in a Cross-Border Context (2009) 21 SA Merc LJ, p. 442

[34] A. Boraine, Comparative Notes on the Operation of Some Avoidance Provisions in a Cross-Border Context (2009) 21 SA Merc LJ, p. 449

3. Preferences Law in German Legal System

Main act regulating insolvency law in German legal system is Insolvency Code which entered into force on 1 January 1999. The Insolvency Code has replaced the previous Bankruptcy and Settlement Code (Konkursordnung and Vergleichsordnung) of West Germany as well as the Act on Collective Enforcement (Gesamtvollstreckungsordnung) of East Germany and has created a uniform insolvency statute for Germany[35].

Legal rules of insolvency procedure in case of preferences are stipulated in Part Two, section three of the Insolvency Code. In the insolvency proceedings falling under German legal rules the Insolvency Code apply. The "Challenge Act"[36] which is used to avoid transactions outside the insolvency does not apply[37.] The Insolvency Code in the first place stipulates the general provision that transaction concluded prior to the opening of the insolvency proceedings can be contested by the insolvency administrator. It this situation Articles 130 till 146 of the Insolvency Code should be used. As for the scope of this master thesis the focus will be on provisions regulating preferences that are regulated by following Articles 130, 131 and 133 of Insolvency Code[38].

To start with, the provisions of the Articles 130 and 131 of Insolvency Code concentrate only on preferences. Article 133 of Insolvency Code is more general and deals with all the disadvantages of the creditors (including preferences).

Article 130 is attributed to congruent performance and Article 131 - to incongruent performances. As mentioned previously Article 133 is more general and covers both congruent and incongruent performances. In order to properly understand German legal system in case of preference in insolvency all three articles mentioned above are more thoroughly analyzed below.

[35] A. Trunk, 'Avoidance of transactions under the new German Insolvency code', in *International Insolvency Review*, 2000, p 221-229

[36] *Anfechtungsgesets – AnfG*

[37] W.W. McBride, *Principles of European Insolvency Law*, Deventer: Kluwer Legal Publishers, 2003

[38] R.J. de Weijs, J.R.V. Evert, R. Connell, and C. Bärenz, "*Financing in Distress Against Security from an English, German and Dutch Perspective: A Walk in the Park or in a Mine Field?"*, 2011, Amsterdam Law School Research Paper No. 2011 p. 3-5

3.1. Congruent Performances

Article 130 of Insolvency Code is applicable to the transactions of congruent performance. Congruent performance can be explained in the following way: transaction made by the debtor to secure or satisfy an insolvency creditor who was entitled to receive the security, payment or other consideration[39]. According to German legal rules stipulated in Article 130 congruent transactions can only be challenged if they were made within three months prior to the filing for the insolvency proceedings, or after it[40], and if the debtor was already insolvent or illiquid at that time and the creditor was aware of that or knew of the illiquidity[41]. The example for such a situation could be a transaction made in order to repay a matured debt.

The situation is as simple as this, the debtor had to pay his debt and he did pay it in an agreed way. To illustrate the situation, on the 1 January 2012 debtor borrowed 10 EUR and promised to pay back on the 1 January 2013, on agreed time the debtor paid 10 EUR to the creditor as agreed. According to the Article 130 this transaction may be reviewed by the office holder if it appeared within three months before the application for the insolvency proceedings and the debtor was unable at the time of the transaction, or due to the transaction, to pay all his debts and the creditor knew about it[42]. The author would like to bring extra attention that no interest is shown by the legislator to the debtor and to the subjective elements of his mind[43], all focus is on the creditors knowledge of debtor's illiquidity.

3.2. Incongruent Performances

Article 131 of the Insolvency Code, is applicable to the transactions of incongruent performance. The incongruent performance can be described following: the transaction was made by the debtor to secure or satisfy an insolvency creditor, who was not entitled to such payment or it was made not in that manner or at that time[44].

[39] P. R. Wood, "*Principles of International Insolvency",* 2nd edition, Sweet & Maxwell, 2007, p 207
[40] W.W. McBride, *Principles of European Insolvency Law*, Deventer: Kluwer Legal Publishers, 2003, p 174
[41]R.J. de Weijs, J.R.V. Evert, R. Connell, and C. Bärenz, "*Financing in Distress Against Security from an English, German and Dutch Perspective: A Walk in the Park or in a Mine Field?"*, 2011, Amsterdam Law School Research Paper No. 2011 p. 45
[42] Article 130 Insolvency Code
[43] R. J. de Weijs, "*Harmonisation of European Insolvency Law and the Need to Tackle Two Common Problems: Common Pool & Anticommons"*, 2011, Amsterdam Law School Research Paper No. 2011, p. 44
[44] P. R. Wood, "*Principles of International Insolvency",* 2nd edition, Sweet & Maxwell, 2007, p.43

The simplest example of such situation could be the payment of debt that was not yet mature at the time the payment was made. To illustrate the situation the author will give an example. As mentioned in previous example our debtor borrowed 10 EUR on 1 January 2012 and promised to pay it back on 1 January 2013. In the situation of incongruent performance the debtor pays 10 EUR to his creditor half year before the maturity date (agreed date), on 1 July 2012. This kind of action is understood as incongruent performance because the debt was paid before the agreed date. One more example of incongruent performance is when the debt is paid not in the right form. For example, our debtor instead of paying back 10 EUR in monetary value decides to give a book or provide service, worth 10 EUR, in favor of the creditor. This kind of action constitutes incongruent performance as well due to its performance in different form than agreed. Incongruent transactions may be reversed by the office holder if they happened one month prior to the application for the insolvency proceedings[45]. No further requirements apply here; most notable, no intent on either side needs to be proven by the office-holder[46], and this is in contrast to the congruent performances as mentioned in previous chapter. The transaction just has to be performed within one month period prior to the request to open insolvency proceedings. All incongruent actions falling in the time frame mentioned above will be reversed by the court.

If the transaction is performed earlier (within two or three months) prior to request to open insolvency proceedings the requirement for avoidance is focused on the situation of the debtors illiquidity. It is a matter of proof if at the time the transaction was performed the debtor was illiquid. If this can be proved Article 131 could be applied. This would again mean that the state of mind of the creditor is irrelevant just the same way if the transaction is performed one month prior to the application to open the insolvency procedure[47]. The conclusion from all that was mentioned is that in case of incongruent performance no intent on debtors or creditors sides has to be proven by the office-holder.

[45] § 131 (1)InsO
[46] R.J. de Weijs, J.R.V. Evert, R. Connell, and C. Bärenz, "*Financing in Distress Against Security from an English, German and Dutch Perspective: A Walk in the Park or in a Mine Field?"*, 2011, Amsterdam Law School Research Paper No. 2011, p. 45
[47] R.J. de Weijs, "*Towards an Objective European Rule on Transaction Avoidance in Insolvencies"*, 2011, Amsterdam Law School Research Paper No. 2011, p. 6

In addition to our previous conclusion, incongruent performances can be challenged if they are performed within two or three months prior to the filing for the insolvency proceedings 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[48]. In this wording of the Article 131 the author finds some subjective elements, which are explained by the legislator as "awareness". If the receiver of the preference is a person closely connected with the debtor, the burden of proof will be shifted so as to require the party to prove ignorance[49]. The situation mentioned should be understood in a way that such awareness will be presumed if a party to the transaction is relative of the debtor, or director, controlling shareholder or person with comparable positions in the company.

The conclusion of all that was mentioned in the light of Article 131 regulating incongruent performance is that incongruent performances give no significant relevance to the state of mind of the parties involved in the transaction. There is one exceptional situation - the requirement of "awareness". Thus the avoidance of preferences primarily relies on the objective criteria[50].

3.3. Congruent and Incongruent Performances

Article 133 of the Insolvency Code may be used to avoid the preferences as well as to recover concealed assets where is no preference, which happened before the three month period as stipulated in Articles 130 and 131 of Insolvency Code[51]. The aim of the German legislator to include this Article is to ensure that no transactions that could constitute as voidable preferences will go uncontested. Article 133 of Insolvency Code operates as a catch all provision[52]. This is done by providing the power for the reversibility of the transactions performed by the debtor within 10 years period to the filing for insolvency proceedings (or after the date of the petition) if the debtor intended ('*Vorsatz*') to harm or prefer its creditors and the counterparty was aware of the debtor's intent on the date of the transaction. Such awareness should be presumed if the other party knew of the debtor's imminent illiquidity, and that the transaction constituted a disadvantage for the creditors[53].

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[48] § 131 (1)InsO
[49] W.W. McBride, *Principles of European Insolvency Law*, Deventer; Kluwer Legal Publishers, 2003, p. 172
[50] R.J. de Weijs, J.R.V. Evert, R. Connell, and C. Bärenz, "*Financing in Distress Against Security from an English, German and Dutch Perspective: A Walk in the Park or in a Mine Field?"*, 2011, Amsterdam Law School Research Paper No. 2011-45, p.12-13
[51] Ibid, p. 22
[52] Ibid.
[53] R.J. de Weijs, J.R.V. Evert, R. Connell, and C. Bärenz, "*Financing in Distress Against Security from an English, German and Dutch Perspective: A Walk in the Park or in a Mine Field?"*, 2011, Amsterdam Law School Research Paper No. 2011-45

The main idea and difference from previous articles for avoidance of the preferences is that: in order to avoid a transaction as a preference it has to be proven that there were the intent to prejudice the creditors of the debtor and that counterparty was aware of it. 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 other creditors[54].

As mentioned previously the time period for such transaction that consists with intent to harm creditors is ten years. In comparison to three months stipulated in Articles 130 and 132 it is quite long time period. It might be argued that 10 years time period can cause legal uncertainty, but from author's point of view we have to consider this norm in the light of all what has been said previously. Compared to the Articles 130 and 131 of Insolvency Code the requirements for avoidance are set very high. Only in certain cases it will be possible to prove the intent to harm creditors. From author's point of view Article 133 of Insolvency Code ensures that there is possibilities for the office holder to challenge voidable transactions though it is hard to prove intend to harm. So contrary to what was said above the Article 133 brings legal certainty putting in place regulations that ensures that questionable transactions can be challenged within 10 years period.

Having the main knowledge of Articles 130, 131, 133 of German Insolvency Code regulating concurrent and incongruent performances the author will move to next topics to be analyzed. Further the focus of the master thesis will be on the time limits on voidable preferences and state of mind of the parties participating in transactions.

3.4. Statute of Limitations on Preferences

This part of the master thesis will introduce only time limits that apply for a transaction to be voidable under the German legal system. German legal system has double timing regulating voidable preferences:

- time limit during which transaction had to occur and
- time limit for taking action to avoid transaction that constitutes a preference.

See the description of time limits below: time period under which transactions had to occur in order to be avoided as a preference[55] - as introduced previously the Insolvency Code establishes a differentiated system of time limits starting from ten years before the insolvency petition and going down to acts committed after the petition:

[54] Article 133 Insolvency Code
[55] A. Trunk, Avoidance of transactions under the new German Insolvency code, in *International Insolvency Review*, 2000, p. 221-229

a. 10 years – Article 133 (1) of Insolvency Code when intentional harm to the creditors can be proved;

b. 2 years – Article 133 (2) of Insolvency Code when intentional harm to creditors is present in context with related persons that knew of the intent to harm the creditors;

c. 3 months - Article 130 (1) (1) of Insolvency Code, when a payment of due debts is made; Article 131 (1) (2) of Insolvency Code when a payment of undue debts is made and creditor is illiquid on the date of transaction; Article 131 (1) (3) of Insolvency Code when a payment of undue debts is made and the creditor was aware of a disadvantage to other creditors;

d. 1 month - Article 131 (1) of Insolvency Code when a payment of undue debts is made.

After the insolvency petition – Article 130 (1) (2) of Insolvency Code when a payment of due debt is made. Two years time limit that apply for taking action to avoid transaction that constitutes a preference[56] - the period of limitation starts with opening of the insolvency proceedings.

3.5. Characteristics of the Parties Participating in the Transactions

As shortly mentioned in the previous paragraphs, German legal rules on preferences have no general requirement of subjective intent[57] - desire to harm other creditors and mostly are objective. The division of the rules can be distinguished: those that give attention to intent and those that are completely objective:

- No intent to harm the creditor is required for the avoidance according to Article 131 (1, 2) of the Insolvency Code. The application of this article is completely free of any subjective intent. It only requires transactions of payments that are still undue to be made. If during this transaction there were any intent to harm creditors or give preference to other, German law does not take it into account.
- On the other hand, intent is required for the avoidance according to Article 133 of the Insolvency Code. The Article 133 requires proving intent to disadvantage other creditors as well as the fact that other party to the transaction knew about it.

[56] Article 146 Insolvency Code
[57] A. Trunk, Avoidance of transactions under the new German Insolvency code, in *International Insolvency Review*, 2000, p. 221-229

- "Elements" of intent are required for the avoidance stipulated in Articles 130 (1) and 131 (1)(3) of the Insolvency Code. In order for a transaction to be avoided it has to be shown that creditor was aware of debtor's illiquidity.

From all that was mentioned above, we can see that no interest is shown regarding the subjective elements of the debtor, only "awareness" has to be proved on the side of the creditor.

4. Preferences Law in English Legal System

Preference laws in England were first developed in response to misconduct on the part of debtors in attempting to determine, the manner in which their assets should be applied[58]. The legal rules regulating preferences under section 239 of the Insolvency Act 1986 are only applicable in the event of liquidation or administration of the company. In order for a transaction to be voidable as a preference in England law one of the following conditions should be met[59]:

- The debtor must be in administration or liquidation,
- The transaction has to happen during relevant time,
- The recipient of the preference has to be one of the insolvent's creditors,
- The transaction puts a recipient of the preference into a better position he or she would have been if the thing not been done,
- The debtor had a desire to prefer,
- At the time of, or as a result of, the giving of the preference, a company was unable to pay its debts within the meaning of the section 240 of the Insolvency Act 1986.

Out of the six conditions mentioned above that are needed for the transaction to be avoided, as for the scope of this master thesis the focus will be on time the transaction was performed and state of mind of the parties of the transaction. From the authors point of view the time and state if mind is the most important elements because it is very complicated in case of voidable transaction to determine if desire existed and if the transaction occurred during relevant time. Similar opinion was expressed by R. Parry: "In order to be a voidable as a preference, a transaction must have been entered into within the *relevant time* for the insolvency proceedings, most important, a transaction cannot be avoided as a preference *unless the debtor was "influenced…by a desire*" to bring about the improvement of position for the creditor. If these criteria are satisfied, the court may make such order as it thinks fit for restoring the position to what it would have been had the preference not been given[60].

[58] R. Weisberg, 'Commercial morality, the Merchant Character, and the History of the Voidable Preference', Vol. 39, *Stanford Law Review* No 1, 1986, p. 342
[59] A. Keay and P. Walton, *Insolvency Law. Corporate and Personal*, Bristol: Jordan publishing 2008, p 124
[60] R. Parry, J. Ayliffe QC, S. Shivi, *Transaction avoidance in insolvencies*, Oxford: Oxford university press, 2011, p. 254

Under English law, a preference can only be avoided if the debtor was 'influenced by a desire to prefer'[61]. This means that in order to challenge a transaction. The state of mind of the debtor should be taken into account in the first place.

English law concentrates on the debtor and his subjective decision to prefer, and no interest in creditor or his intentions is taken into account. Only debtor state of mind and his actions performed are taken into consideration by the court. It does not matter if the creditor was not aware or in good faith during the time of transaction. The defense of good faith is not open to the preferred creditor, a point made clear by section 241 (2)(b)[62]. In addition, there are no indications that English law distinguishes between congruent and incongruent performance[63]. However, besides the desire of the debtor to prefer and relevant time when the preferential act occurred, it also has to be proven that preferred creditor improved his conditions at the expense of other creditors. If the effect of the payment or transfer made or suffered by the company is to make a creditor better off on winding-up than he would otherwise have been, this can only be at the expense of other creditors[64]. It means that, in the situation when creditor provides consideration for the received payment, or in other words, creditor does not take out a penny more than he puts in, thus does not benefit at the expense of other creditors, transaction does not constitute a preference[65].

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[66].

In order to understand properly the England legal system on preferences the focus will be concentrated on the statute of limitation on voidable preferences and the state of mind of the parties involved in the transactions.

[61] R.J. de Weijs, "*Towards an Objective European Rule on Transaction Avoidance in Insolvencies"*, 2011, Amsterdam Law School Research Paper No. 2011-06.
[62] R. Goode, *Principles of corporate insolvency Law,* Sweet and Maxwell, 2005, p. 35
[63] R.J. de Weijs, J.R.V. Evert, R. Connell, and C. Bärenz, "*Financing in Distress Against Security from an English, German and Dutch Perspective: A Walk in the Park or in a Mine Field?"*, 2011, Amsterdam Law School Research Paper No. 2011-45
[64] R. Goode, *Principles of corporate insolvency Law,* Sweet and Maxwell, 2005, p. 307
[65] Ibid.
[66] R.J. de Weijs, J.R.V. Evert, R. Connell, and C. Bärenz, "*Financing in Distress Against Security from an English, German and Dutch Perspective: A Walk in the Park or in a Mine Field?"*, 2011, Amsterdam Law School Research Paper No. 2011-45

4.1. Statute of Limitations on Preferences

The current part of the master thesis will focus on the time limits on voidable transactions that are applicable under the UK legal system.

Section 239 of the Insolvency Act states that *"<...> company has at a relevant time (defined in next section) given a preference to any person <...>"*. Time limits relevant for the preference are defined in section 240 of the Insolvency Act. England legal rules on preference simply stipulate: preference can occur at any point in time, but the ones that are applicable for avoidance have to be within the limits of the statutory provisions[67].

So to start with, time limits in England differ depending of the relations of the parties, whether the person who has been preferred is a connected party to the debtor or not:

- General rule is that six months period before the onset of insolvency is applied for an action to be considered to constitute a preference[68].
- The term of six months is changed to two years if a connected person is involved[69]. Connected person, according to the section 249 of Insolvency Act, is director or shadow director of the company, or an associate of such person, or an associate[70] of the company.
- It has to be also taken into account that the period between making an administration application and the making of an administration order are not the same and are important as well as a time period between the filing with the court of a copy of notice of intention to appoint an administrator under paragraph 14 or 22 of Schedule B1 and the making of an appointment under that paragraph.[71] Transactions made during indicated two time periods are subject to avoidance as well.
- It should be noted that under the Limitation Act 1980, time limit for taking action to set aside transaction that constitutes a preference is 12 years period, however, to recover a sum of money – 6-year period[72].

It is important to understand the term onset of insolvency, which is used in section 240, as it might be unclear. This is bit misleading term, as it refers not to company's financial state in the balance sheet sense but to the implementation of formal insolvency procedures in relation to the

[67] R. Goode, *Principles of corporate insolvency Law,* Sweet and Maxwell, 2005, p. 204
[68] Insolvency Act 1986, s 240 (1) (b)
[69] Insolvency Act 1986, s 240 (1) (a)
[70] What is considered as an associate of a company is defined in section 435 of the Insolvency Act 1986.
[71] Insolvency Act 1986, s 240 (1) (c) (d)
[72] L. Sealy, D. Milan, Annotated Guide to the Insolvency Legislation, Sweet& Maxwell, 2012, p. 243, Re Priory Garage (Walthamstow) Ltd [2001] B.P.I.R. 144.

company[73]. Legislators in England provide us with five different definitions of the onset of the insolvency and the dates from which six months period is calculated. These five dates are stipulated below:

First, if insolvency proceedings are initiated by submitting administration application, six months period is calculated from the date on which application for administration is submitted[74].

Second, in case court received a copy or a notice of intention to appoint administrator for a company using paragraph 14 or 22 of Schedule B1, six month period will be calculated from the date on which the copy of notice is received by the court[75].

Third, if administrator of the company is appointed neither by submitting administration application nor by submitting a copy of a notice to appoint administrator to the court, then six month period is calculated from the actual date from which appointment takes effect[76].

Fourth, if company is in administration that is being converted into liquidation using Article 37 of EC regulation, or the appointment of administrator is no longer in effect, then six month period is calculated from the date on which company started being in administration[77]. It is very smart of a legislator to include this article, because unexpected obstacles could prolong the administration, and then if administration is converted into liquidation, considerable amount of time might pass, what can take some older transaction outside the scope of law if we calculated six months period from the beginning of the liquidation procedure[78].

Fifth, if company is going into liquidation at any other way, then six month period will be calculated from the beginning of winding up procedures[79].

From all that was mentioned above we can make a conclusion that actions of the administrator cannot be avoided on the grounds of preferences because his actions will not fall under the six months time period, thus legal rules for avoidance of preferences will not be applicable. In addition, referring to the questions of time limits of voidable preferences, it should be taken into account that under English law it is not allowed to bypass the law, by agreeing that a transaction has to be performed on the specific date in the future, and then argue during the proceedings that the transaction was agreed outside six month period, for this reason, rules for the avoidance of preferences is not applicable. This situation was mentioned by R. Parry, court

[73] R. Parry, J. Ayliffe QC, S. Shivi, *Transaction avoidance in insolvencies*, Oxford: Oxford University press, 2011, p. 232
[74] Insolvency Act 1986, s 240 (3) (a)
[75] Insolvency Act 1986, s 240 (3) (b)
[76] Insolvency Act 1986, s 240 (3) (c)
[77] Insolvency Act 1986, s 240 (3) (d)
[78] See R. Parry, J. Ayliffe QC, S. Shivi, *Transaction avoidance in insolvencies*, Oxford: Oxford University Press, 2011, p. 56
[79] Insolvency Act 1986, s 240 (3) (e)

will not accept such arguments and will keep that transaction happened not at the date of the agreement but when the actual transaction took place, and if it happened within six month period, rules for avoidance of preferences will be applicable[80].

To sum up, English law has a general term of six months of time limit of voidable preferences applies. The general term might be extended to two years if connected person is involved in the transaction. Both terms (six months and two years) should end up with the onset of insolvency. It should be noted that under the Limitation Act 1980, time limit for taking action to set aside transaction that constitutes a preference is 12 years period, however, to recover a sum of money – 6-year period[81].

4.2. Characteristics of the Parties Participating in the Transactions

For the administrator of the insolvency procedure to be able to avoid transaction as a preference he must prove that the debtor had a desire to prefer. Section 239 (5)[82] stipulates that "The court shall not make an order under this section in respect of a preference given to any person unless the company which gave the preference was influenced in deciding to give it by a desire <…>" which means to prefer one creditor over another. As we may understand that English law introduces a subjective criteria is likely that will be difficult to prove. Just a fact of preference is not sufficient for English legal system, it has to be proven that while giving the preference the company was influenced in decision making to give it by a desire to produce in relation to the preferred party the effect of putting him in a better position that he would have been in if the payment, transfer, etc. has not been made[83].

The leading case in English legal system regarding the desire to prefer is *McBacon*[84] case. In this case the company, which was suffering financial difficulties, granted to its bank a debenture to secure the pre-existing loan. After some time company was involved in liquidation procedure and the appointed liquidator applied to set aside a debenture on the basis that it was a preference. Judge J. Millet focused on the desire in section 239 (5) and indicated that the word was subjective:

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[80] R. Parry, J. Ayliffe QC, S. Shivi, *Transaction avoidance in insolvencies*, Oxford: Oxford University Press, 2011, p 115

[81] L. Sealy, D. Milan, Annotated Guide to the Insolvency Legislation, Sweet& Maxwell, 2012, p. 243, Re Priory Garage (Walthamstow) Ltd [2001] B.P.I.R. 144.

[82] Insolvency act 1986 s 239 (5)

[83] R. Goode, *Principles of corporate insolvency Law,* Sweet and Maxwell, 2005

[84] Re MC Bacon Ltd [1990] BCC 78

"*Desire has been substituted. That is a very different matter. Intention is objective, desire is subjective. A man can choose the lesser of two evils without desiring either <…> it is not, however, sufficient to establish a desire to make the payment or grant the security which it is sought to avoid. There must have been a desire to produce the effect mentioned in the subsection, that is to say, to improve the creditor's position in the event of an insolvent liquidation."*

The *McBacon* judgment is guidance on how to understand whether the actions performed by the debtor constitute a preference or not in English law. The most important element in order to establish a preference is to actually prove that the desire to improve the position of the creditor was an existing factor for making the transaction. It is important to notice, that such desire does not have to be the decisive factor, it is just enough that such desire existed. For instance, in this case, there was a preferential action performed, but not out of the desire to improve creditor's position, but from the desire to avoid insolvency and continue operations of the company.[85] The court in this case decided that it was neither (i) preference because the directors of the company did not want to improve the banks position, but simply wishes to continue trading, nor (ii) transaction at an undervalue because it did not deplete or diminish the value of the assets of the company[86].

Regarding the situation when connected person is involved in the preferences the legislator lets the office holder to choose a bit easier way to avoid preferences. If connected persons are involved in the transaction which office holder seeks to avoid, section 239 (6) can be involved. The section 239(6) if the Insolvency Act stipulates that a company which has given a preference to a person connected with the company (otherwise than by reason only of being its employee) at the time the preference was given is presumed, unless the contrary is shown, to have been influenced in deciding to give it by a desire to prefer[87].

After all that was said above, the decision made in *McBacon* case and the law regarding the connected persons, the reader could mistakenly think that it is quite easy to avoid a preference under the English law, however, in practice it is proved to be one of the most difficult and most demanding tasks for the office holder. To prove the subjective element, which is the desire to prefer, in real proceedings when debtors are not interested in reversal of their actions is extremely difficult[88]. Furthermore, already complicated conditions for the office holder to prove

[85] For more detailed information on McBacon case and the review of the wording used by judge J. Millet see A. Keay and P. Walton, Insolvency Law. Corporate and Personal, Bristol: Jordan publishing 2008 and R. Parry, J. Ayliffe QC, S. Shivi, Transaction avoidance in insolvencies, Oxford: Oxford University Press, 2011.
[86] Re MC Bacon Ltd [1990] BCC 78
[87] Insolvency Act 1986 s 239 (5)
[88]Usually in real life situations, persons will "play down" their intentions, particularly when directors of the insolvent company are the guarantors of the debt that has been already paid. See R. Parry, J. Ayliffe QC, S. Shivi, *Transaction avoidance in insolvencies*, Oxford: Oxford University Press, 2011, p 230

the desire of the debtor to prefer one creditor in disadvantage of the other are made even more complicated by other established case law that allows the defense of commercial pressure. As an example of such situation could be *Rooney v. Das* case.[89] The court did not established a preference because defendant stated that "The first second and third respondents all either in writing or verbally threatened legal proceedings against me which obviously caused me great concern. The motivation for paying the respondents was driven by a desire to avoid legal proceedings and stop the respondents from hassling me. This was the only reason for making the payment". From this judgment we can understand that in reality the defendant can easily state that he performed an action due to the commercial pressure and not out of the desire to prefer. This leads to the outcome that the office holder faces enormous complications and limitations to his ability to avoid preferences[90].

The case law of English courts, which allows the defense of commercial pressure, creates a more fundamental problem the office holder's inability to avoid a preference. The primary purpose of the insolvency proceedings in all countries is to prevent individual creditors from taking separate actions and to help to ensure that collective proceedings are performed instead. The decision to allow commercial pressure as a defense produces completely opposite effect and burdens office holder for avoidance of preferences[91].

To conclude, regarding the state of mind institute of the debtor, UK law takes a subjective approach to preferences, and requires providing proofs of the desire to prefer on a side of a debtor. In reality it is difficult or in many cases impossible to prove and that results in obstacles for the office holder to avoid the transaction and serve justice.

[89] See court decision in *Rooney v Das* [1999] BPIR 404, and for more detailed description of commercial pressure see A. Keay and P. Walton, *Insolvency Law. Corporate and Personal,* Bristol: Jordan Publishing, 2008, p. 132; R. Parry, J. Ayliffe QC, S. Shivi, *Transaction avoidance in insolvencies*, Oxford: Oxford University Press, 2011, p. 47

[90] See court decision in *Rooney v Das* [1999] BPIR 404, and for more detailed description of commercial pressure see A. Keay and P. Walton, *Insolvency Law. Corporate and Personal,* Bristol: Jordan Publishing, 2008; R. Parry, J. Ayliffe QC, S. Shivi, *Transaction avoidance in insolvencies*, Oxford: Oxford University Press, 2011.

[91] For the critique of retaining commercial pressure as a defense see R.J. Mokal, *Corporate Insolvency Law, Theory and Application*, Oxford: Oxford University Press, 2005.

5. Preferences Law in Lithuanian Legal System

In March 2001 Lithuanian Enterprise Bankruptcy[92] law (hereafter – EB) was introduced to regulate insolvencies of enterprises. After the commencement of formal insolvency proceedings, the administrator represent the debtors and examines transaction in which the debtor (company in bankruptcy) was involved prior to start of formal insolvency procedures in order to ensure that assets of debtor were disposed properly. For this purpose, the administrator has the right to contest the transactions concluded within 36 month before the debtor became insolvent[93].

The EB does not establish separate grounds for avoidance of transactions, thus, administrator, challenging the transactions concluded before the bankruptcy, has the right to challenge it according to all grounds set under Civil Code of Lithuania, including Actio Pauliana provisions indicated in Article 6.6 of Civil Code of the Republic of Lithuania (CC)[94]:

"A creditor shall have the right to challenge transactions made by a debtor, where the debtor was not bound to make them and where they violate the rights of the creditor, while the debtor knew or ought to have known that prejudice to the creditor would result from that transaction (Paulian Action). The creditor's rights shall be considered violated if by such transaction the debtor renders himself insolvent or by which, being insolvent, he grants ***preference*** *to another creditor, or the rights of the creditor are infringed in any other way."*[95]

According to Lithuanian law the right to contest the transactions made by the debtor is given to the creditor (after commencement of formal bankruptcy proceedings also to bankruptcy administrator). In this situation we have to analyse the Civil Code as a whole and keep in mind that administrator's duty is to protect the collective rights of the creditors.

[92] Enterprise Bankruptcy Law of Republic of Lithuania
for full text see http://www3.lrs.lt/pls/inter3/dokpaieska.showdoc_e?p_id=404353 (accessed 15:30 30/9/2012)
[93] Ibid., Article 11, section 3(8)
[94] The Supreme Court of Lithuania, 2003 10 08 BUAB "Aukštaitijos statyba" v. AB bankas "Hansa-bankas" No 3k-3-917/2003, 2009 09 30 „Utvilsta" v. UAB „Schindler-Liftas" No 3k-3-75/2011
[95] Civil Code of the Republic of Lithuania 6 (66) (1) (for full text see:
http://www3.lrs.lt/pls/inter3/dokpaieska.showdoc_e?p_id=404614&p_query=&p_tr2=2 accessed 15:55 30/9/2012)

The purpose of it is to protect creditor against unfair debtor actions, by which is reduced debtors solvency and at the same time oportunity to satisfy the claim of creditor[96].

The Supreme Court of Lithuania many times ruled that: "Differently from all the other grounds to avoid a transaction, Paulian Action, Art. 6 (66) of LR CC, is meant to restore the ability of debtor to repay all his debts, and return involved parties to the situation before the transaction" [97]. It is an important note to be made because the Civil Code itself does not say anything about other creditors. It was not created specifically for the events of insolvency for this reason Art. 6.(66) (4) states that the annulment of the transaction shall have legal effects only in respect of the creditor who brought the action upon the annulment of the transaction and only to the extent that it is necessary to remove the prejudice experienced by the creditor. That means that only a creditor that is a party to the transaction would be able to receive money from the avoided transaction to satisfy his claim. The Supreme Court states that Article 6.(66) is applicable as long as it does not challenge the Enterprise Bankruptcy law and has to be interpreted together with Enterprise Bankruptcy act Article 35, which states the order in which creditors will be paid in case of the insolvency[98]. Thus, the recovered assets or value are to be put into the common pool and distributed to all creditors[99].

There are grounds stipulated in Lithuanian law that should be met in order for transactions to be avoided. It is the duty of the party requesting the transaction to be void to prove that[100]:

1. Creditor has a real and valid claim;
2. Transaction that is being avoided has to violate rights and interests of the creditor;
3. Debtor did not have to make that transaction;
4. Debtor knew or ought to have known that prejudice to other creditors would result from that transaction;
5. Party to the voidable transaction was in bad faith[101];

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[96] The Supreme Court of Lithuania, 2010 11 30 *BAB „Alytaus tekstilė" v. AB „Rytų skirstomieji tinklai"* Nr. 3k-3-485/2010; 2011 09 27 Vilniaus apskrities valstybinė mokesčių inspekcija v. J. M., No 3K-3-362/2011, 2012 01 26 S. S. v. R. M. et all No 3K-3-25/2012

[97] The Supreme Court of Republic of Lithuania states this opinion in number of cases, where the purpose of action was to reverse the transaction in order to be able to perform a set-of. See cases *VĮ Valstybės turto fondas v. UAB „Cetarium", UAB „Ortofina,* 2006 01 11, Nr. 3K-3-17/2006; *UAB „Lietuva Statoil" v. BUAB „Virenita",*2010 02 20, Nr.2-133-280/2010

[98] The Supreme Court of Republic of Lithuania, 2005 11 14, *AB „Rameksta" v. V. J. K.*, Nr. 3K-3-573/2005

[99] D. Ambrasiene, S. Cirtautiene 'Specialus kreditoriaus interesu gynimo budai sutartiniuose santykiuose', *Jurisprudencija*. 2003, Nr. 37 (29). p. 54.

[100] Ambrasienė D., Baranauskas E., Bublienė D. *Civiline teise. Prievolių teisė: vadovėlis*. Vilnius: LTU Leidybos centras, 2004. P. 55-57

6. Transaction happened within the certain period of time;

7. Creditor's action is aimed to void a transaction of assets that are needed to guaranty the claim[102].

All the conditions listed above are equally important and all of them have to be proven in court in order to avoid a transaction, except condition number 7 which is relevant outside formal bankruptcy proceedings[103].

Notably, the Supreme Court of Lithuania established the following Actio Pauliana claim application rules: (i) the creditor has to have undisputable and valid claim, (ii) the contested claim has to breach the right of creditor, (iii) limitation period of one year to file claim is not expired, (iv) the debtor was not obliged to conclude contested transaction, (v) the debtor was unfair because he knew or had to know the breaching the righs of other creditors, (vi) third party concluding transaction with debtor was unfair, (vii) creditor's claim is directed to transferred property (or its value) by the contested transaction to the extent necessary to satisfy creditor's claim[104].

Unfairly prefered transaction can be avoided if all the abovementioned Action Pauliana grounds are proven. If at lease on of it is missing, there is no ground to invalidate such transaction[105].

From the abovementioned we see that Actio Pauliana is a right of creditor to contest debtor's transactions, which consist of three core elements (i) *not necessary to conclude* (Necessity), (ii) *breaching the rights of other creditor* (Breach of Creditor Rights) and (iii) *debtor knew or had to know about it* (Subjective Element). Further below the author shall analyze how these elements should be understood.

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[101] Civil Code of the Republic of Lithuania Article 6 (66) (2)
[102] Since article 6 (66) (4) of CC is not specifically meant for the insolvency situation
[103] The Supreme Court of Lithuania, 2001 01 21 AB "Turto Bankas" v. BAB "Rimeda", case No 3k-3-201/2001; The Supreme Court of Lithuania, 2007 10 12 Vilniaus miesto savivaldybė v. UAB "Baltijos parkingas",
[104] The Supreme Court of Lithuania, 2008 12 09 *BUAB „Multiimpex" v. UAB „Eneka",* No 3K-3-587/2008; The Supreme Court of Lithuania, 2009 07 31 *BUAB „Vinukas" v. UAB „LCL",* No 3K-3-339/2009; The Supreme Court of Lithuania, 2011 09 27 *Vilniaus apskrities valstybinė mokesčių inspekcija v. J. M.,* No 3K-3-362/2011
[105] The Supreme Court of Lithuania, 2011 10 18 *AB "Lietuvos draudimas" v. J.B.*, No 3k-3-392/2011, The Supreme Court of Lithuania, 2011 12 16 *UAB "Balmeto Medis" v. "Simega"*, bylos No 3k-3-511, 2012 01 26 S.S. v. R.M. et all, No 3k-3-25/2012; 2012 08 17 BUAB „LRG farmacija" v. UAB „Limedika" No 3k-3-393/2012

Necessity

Necessity it is a duty to perform an obligation, which may arise out of law, court ruling, debtor's one sided obligation, pre-contractual relationship, public tender and other imperative norms[106]. Such duty might also rise for example from public contracts[107]. Prof. V. Mikelėnas gives examples of such public agreements – a company that holds a monopoly in particular area (like supply of gas, electricity[108] or water) that is vital for the public, is not allowed to refuse to make a contract[109].

Furthermore, the duty to make a transaction can arise from the debtor's voluntary commitment (examples from case law of the Supreme Court include examples of loan agreements, pre-contractual obligations, and other factual situations like persons duty to take care of his parents or parents' duty to take care of their children)[110]. Also, it was highlighted by D. Augaitė[111] that cases in Lithuanian courts show that transactions which were detrimental to the creditors but were not made directly by the debtor, but by his creditors, can also be avoided. Example of that would be when a bank makes a transaction from company's account that company did not agreed to[112] or set-off[113].

Under recent case law of Lithuania, in a state of factual insolvency, the transfered electric transformer substation, did not constitute unfair preference, however, was considered as necessary transaction under all circumstances in order to ensure continuinity of electricity supply and further activity of the debtor[114]. It shows necessity could be proved the need to improve financial situation or avoid bankruptcy of debtor. In other cases, the reason were not strong enought to justify that transaction was necessary[115].

Furthermore, even though the debtor has the right to conclude transaction and make payment, however, it should not give preference to any of its creditors[116]. It shows that even the debtor is allowed to conclude transaction he should do it as much as possible balancing between

[106] The Supreme Court of Lithuania, 2000 04 05 V. B. v. G. B. et all No 3k-3-425/2000; *2006 01 11* VĮ Valstybės turto fondas v. UAB „Cetarium" et all *No 3K-3-17/2006*
[107] Commentary of Lithuanian Civil Code, "*Lietuvos Respublikos civilinio kodekso komentaras*". First edition. Vilnius: Justitia, 2002. P. 194-196.
[108] LR CC 6 (383)
[109] V. Mikelenas *" Sutarčiu teisė. Bendrieji sutarčių teisės klausimai: lyginamieji klausimai."* Vilnius. Justitia, 1996. P. 35
[110] The Supreme Court of Republic of Lithuania, 2000 04 05 "*V.Babarskis v. G. Boguševičius, E. Boguševicienė*", Nr. 3K-3-425/2002
[111] D. Augaitė, *'*Actio Pauliana*', Jurisprudencija*. 2004, Nr. 55 (47). P. 8.
[112] The Supreme Court of Republic of Lithuania, 2001 02 22, "*AB Panevėžio maistas v. AB Lietuvos žemes ūkio bankas"*, Nr. 3K-3-304/2001.
[113] The Supreme Court of Republic of Lithuania, 2009 07 31 UAB „ Vinukas" v. UAB "LCL" No 3K-3-339/2009
[114] The Supreme Court of Lithuania, 2010 11 30 d. BAB „Alytaus tekstilė" v. AB „Rytų skirstomieji tinklai", bylos No 3k-3-485/2010
[115] The Supreme Court of Lithuania, 2010 11 30 „Murena" v. UAB „Alseka Kaunas" No 3k-3-398/2012
[116] 2012 08 17 BUAB „LRG farmacija" v. UAB „Limedika" No 3k-3-393/2012

the interests of other creditors in equivalent position[117]. In addition, mere request of creditor to fulfill financial obligations which are due does not constitute an obligation for the debtor to pay under particular agreements[118].

Taking into account what was said, the duty to make a transaction might rise from the law, court decisions, pre-contractual obligations, debtor's voluntary commitments or factual circumstances, which are each time evaluated by the court. It should be noted that Lithuanian law does not use terms, congruent or incongruent performance, but in essence it tries to make such distinction. Furthermore, Actio Pauliana could be regarded as one of grounds limiting party autonomy in contract law, however, on the other hand as a remedy protecting the rights of creditors.

Breach of Creditor rights

Under Article 6.6. (Actio Pauliana) of Civil Code of the Republic of Lithuania established that the the rights of creditor can be breached when: (i) the debtor becomes insolvent, (ii) debtor being insolvent, gives preference to the other creditor or (iii) breaches the right of creditor in other way.

The application of Article 6.6 and the possibility for the creditors to exercise their right to challenge transactions very much depends on the term insolvency. For this purpose, it is important to understand what these terms mean.

The term of bankruptcy has different meaning in the analyzed countries. Usually it refers to an effective date or relevant date established in a statute or court ruling which indicated formal commencement of bankruptcy proceedings (including liquidation or formal business rescue procedures). This date is important for calculating the statute of limitation relevant for the purpose of avoidance of transactions. The term 'insolvency' has also other meaning, i.e not a formal commencement of bankruptcy proceeding as defined above (i.e. balance sheet insolvency), however, commercial insolvency – de facto insolvency (i.e. cash-flow insolvency)[119].

Under Lithuanian case law, the insolvency is defined as (i) *factual (de facto)* – not capability to perform financial obligations which are due and exist before constitution of formal

[117] The Supreme Court of Lithuania, 2012 05 02 BUAB „Bildunga" v. RUAB „Elektrotinklas" Nr. 3K-3-204/2012, 2012 08 17 BUAB „LRG farmacija" v. UAB „Limedika" No 3k-3-393/2012

[118] The Supreme Court of Lithuania 2004 12 07 *UAB "Birių krovinių terminalas" v. Laivų krovos AB "Klaipėdos* Smeltė" No 3k-7-541/2004, The Supreme Court of Lithuania, 2009 04 28 *AB "Liuto vaistinė" v. UAB "Optivita"* No 3k-3-105/2009, The Supreme Court of Lithuania, 2012 09 28 „Murena" v. UAB „Alseka Kaunas" No 3k-3-398/2012

[119] A. Boraine, Comparative Notes on the Operation of Some Avoidance Provisions in a Cross-Border Context (2009) 21 SA Merc LJ, p. 437-438

bankruptcy proceedings under BE and/or (ii) *qualified* – which could be described not only on capability to fulfill financial obligations, however, also some overdue liabilities and assets ratio in the balance sheet defined under BE[120].

The Supreme Court provided definition on factual insolvency: *"economic status, which is determined whether the company fulfills financial obligations and if it is economically capable to fulfill financial obligations"*. For the purpose of defining company's insolvency it is not necessary that there would be instituted bankruptcy proceedings because institution of bankruptcy proceedings, in case of factual insolvency, is a legal recognition of factual insolvency and execution of respective procedures[121]. It should be noted that the rights of creditors can be also breached by a transactions, which even did not cause insolvency of the creditor, however, reduced the value of assets in a way that it became not possible to satisfy the claims of creditor from the remaining debtor's assets[122].

In a state of insolvency, if not prohibited by law, the debtor has the right to conclude agreements and fulfill financial obligations, however, does not have right to grant preference to one of few creditors[123]. Furthermore, it is also not prohibited for debtor in a factual insolvency state to fulfill all financial obligations of one creditor under the agreement (concluded prior factual insolvency) which is due even if the debts of other creditors are also due, however, such decision could be justified by business practice. Under judicial practice of Lithuanian courts it is important that the rights of creditors in analogous situation would not be treated preferentially[124].

Subjective Element (The Debtor knew or had to know about it)

The transaction to preferred creditor can be challenged under Lithuanian Actio Pauliana rules once the debtor becomes de facto insolvent and gives preference to other creditor, however, there are also subject to other Actio Pauliana conditions[125]. One of the condition is that debtor should know about his financial situation.

The mere fact that the debtor fulfulled the financial obligation for more than one creditor in full or partly does not *ipso facto* mean that the rights of other creditors were not breached[126].

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[120] Article 2, part 8 of Enterprise Bankruptcy Law of Republic of Lithuania, 2001 03 20 No IX-216
[121] The Supreme Court of Lithuania, 2012 08 17 BUAB „LRG farmacija" v. UAB „Limedika" No 3k-3-393/2012
[122] The Supreme Court of Lithuania, 2006 01 11 VI Valstybės turto fonas v. UAB Cetarium, No 3k-3-17/2006; 2008 06 09 BAB "Artrio-2" v. UAB DnB Nord lizingas, No 3k-3-262/2008; 2010 02 01 AB "Rytų skirstomieji tinklai" v. BAB "Alytaus tekstilė", No 3k-3-15/2010; 2012 04 19 UAB "Vakarų laivų korporacija" v. UAB "Senega", No 3k-3-167/2012, 2012 09 28 UAB "Murena" v. UAB "Alseka Kaunas" No 3k-3-398/2012
[123] The Supreme Court of Lithuania, 2012 09 28 „Murena" v. UAB „Alseka Kaunas" No 3k-3-398/2012
[124] The Supreme Court of Lithuania, 2012 05 02 *BUAB "Bildunga" v. RUAB "Elektrotinklas"*, No 3k-3-204/2012, The Supreme Court of Lithuania, 2012 08 17 BUAB „LRG farmacija" v. UAB „Limedika" No 3k-3-393/2012
[125] The Supreme Court of Lithuania, 2012 09 28 „Murena" v. UAB „Alseka Kaunas".No 3k-3-398/2012
[126] Ibid.

Under Lithuanian case law the company while performing its contracutal obligations have to achieve proportionality between all creditors claims, i.e. to choose such means and extent of performance of financial obligations that at minimum would hinder payment to other creditors[127]. It means that the rights of other creditors should be taken into account otherwise it might happen that same rank creditors do not get part of the satisfaction for their claim while at the same time the other creditor (even of lower rank) received all the debt covered in full[128].

Under Lithuanian case law de facto insolvency is regarded as known to debtors and creditors at different time, i.e. for debtors is applicable objective criteria and for creditors - subjective. It means that the debtor should have known about the de facto insolvency at the same time when the company could not perform its obligations, however, for creditors the sitation is different, i.e. when the creditor started in fact not to perform its obligations to the creditor[129]. It means that the creditor can exercise his right to challenge transactions when he found out about the insolvent state of the debtor. This is relevant in calculating the time limit for striking down the preferential transactions.

After analysis of Lithuanian preference law regulation it appears that the right to challenge the transaction is granted by creditor and the administrator under Actio Pauliana provisions established in the Civil Code of the Republic of Lithuania, which have to be applied in line with BE and case law. Further, the author analyzes the time limits and the characteristics of the parties participating in the transactions.

5.1. Statute of Limitations on Preferences

Since Article 6 (66) of the Civil Code of the Republic of Lithuania as discussed previously is used to avoid preferences the author will discuss statute of limitations related to this article and time limits established in the Enterprise Bankruptcy Law.

First, Article 6 (66) (3) of the Civil Code states general rule that there is one year time limit to bring an action to the court[130]. It also stipulates that the beginning of the one year term starts to be calculated from the day on which the creditor (or in case of bankruptcy – bankruptcy administrator) learned or ought to have learned of the transaction which violates his rights. Lithuanian Supreme Court have ruled on this issue in it's case law[131]. The Court in it's ruling states that knowing ("learned") that the transaction violates the right of the creditors is the

[127] The Supreme Court of Lithuania, 2012 08 17 BUAB „LRG farmacija" v. UAB „Limedika" No 3k-3-393/2012, The Supreme Court of Lithuania 2008 07 03 Overview Regarding Application of Actio Pauliana, Indirect Claim, Retention Right and Prevention Claim
[128] The Supreme Court of Lithuania, 2012 09 28 „Murena" v. UAB „Alseka Kaunas" No 3k-3-398/2012
[129] Ibid.
[130] LR CC 6 (66) (3)
[131] The Supreme Court of Republic of Lithuania, Case Law review 2008, Nr. 28. (For full text see http://www.infolex.lt/lat_web_test/4_tpbiuleteniai/senos/nutartis.aspx?id=34067

question of the party knowing the fact and/or the " ought to have learned" – it is person's ability to find out the facts, so negligence will be treated as bad faith. The Court considers both objective and subjective criteria while investigating if the creditor or office holder knew about the transaction.

After recent improvement of the law, one year time period would be calculated from the courts decision to initiate insolvency proceedings[132], and it would be held that office holder knew about all the transactions from the day the insolvency procedures were open for the company. Such rules resulted in complicated situation for office holder. Its inability to protect the rights of the creditors because of one fact, the debtor usually does not cooperate and office holder is not able to receive any information regarding the transactions. In this case while getting all the information about the company one year period would pass. For this reason, new legal rules (new approach) were introduced and nowadays the beginning of one year period starts from the moment when the office holder receives the documents that indicates the creation of transactions that has to be avoided.[133] In addition, it has to be noted one thing, since we have to look to all the civil rules that are applicable, one year term, can be restored by the court, if it decides that it was missed because of the important reasons.[134]

Second important detail for the statute of limitations doctrine is set in Enterprises Bankruptcy Law Article 11 (3) (8), it stipulates that transactions which are checked by the office holder had to happen within three years period before the initiation of insolvency proceedings.

From all that was mentioned above, we can understand that there are double time limits that matter:

- Thee year time limit under which preference had to occur.
- One year time limit to start the proceedings for avoidance of preferences.

5.2. Characteristics of the Parties Participating in the Transactions

In the Lithuanian legal system in order to avoid a preferences falling under Article 6 (66) of the Civil Code, bad faith by debtor and third party involved in transaction has to be proven. All the requirements to prove bad faith of the debtor rise from Article 6 (66) (1) of the Civil Code. Taking into account the bad faith on the side of the creditor Article 6 (66) (2) states:

[132] The Supreme Court of Republic of Lithuania, 2008 04 01, *BUAB „Liūto vaistinė" v.UAB „Optivita"*, Nr. 3K-3-178/2008, kat. 35.6.1
[133] Enterprise Bankruptcy Law of Republic of Lithuania Art. 11 (3) (8)
[134] LR CC Art. 1 (132) (2)

"A bilateral transaction may be annulled on the ground established in Paragraph 1 of this Article only in the case when the third person concluding the transaction with the debtor concerned was in bad faith, i.e. he knew or ought to have known that the transaction violates the rights of the debtor's creditor. A gratuitous transaction may be annulled irrespectively of whether the third person is in good or bad faith."

Bad faith means that parties involved in transaction knew that the transaction will damage creditor's rights[135]. In order for a "bad faith" to be established the Courts in Lithuania have to use objective and subjective criteria as a basis of prove. Objective criterion for establishing bad faith is measured by the requirements of reasonableness and equity – thoughtful, careful and considerable behavior. The Commentary of the Civil Code stipulates that person acts in good faith if he acts like *bonus pater familias*[136] would act in a similar situation[137]. On the other hand, subjective criterion is referring to the sate of mind in that particular situation. The things that Court should consider are person's age, education, his abilities and experience. According to the Supreme Court of the Republic of Lithuania both, objective and subjective criteria have to be considered while establishing bad faith. It does not matter if the parties knew exactly which creditor and how will suffer from the transaction it is enough that there is possibility to damage any creditors rights[138].

Bad faith by the debtor and preferred creditor means that parties to the transaction knew or ought to have known that the transaction violates right of the debtor's creditors[139] and this knowledge have to be proven in order for a transactions to be void. According to the Civil Code of the Republic of Lithuania all persons are held in good faith unless proven otherwise. However, there are some exceptions to this general rule. Article 6 (67) makes it easier for the office holder by establishing presumption of bad faith of parties of the transaction – it lists situations in which parties to the transaction are automatically held in bad faith in relation to Article 6 (66)[140]. It is important to note that the list is finite and the article cannot be interpreted broadly.

[135] The Supreme Court of Republic of Lithuania, 2011 09 27, *Vilniaus apskrities valstybinė mokesčių inspekcija v. J. M. (J. M.), K. M., L. M. ir L. P.,* Nr. 3K-3-362/2011, kat. 35.6.1.
[136] Latin for "Father of the family"
[137] Commentary of Lithuanian Civil Code, "*Lietuvos Respublikos civilinio kodekso komentaras*". First edition. Vilnius: Justitia, 2002.. P. 77
[138] The Supreme Court of Republic of Lithuania, 2011 02 08, *A. Z. v. BUAB „Vakarų prekyba" administratoriui UAB „Kononenko ir ko", S. K. (S. K.) et al,* Nr. 3K-3-44/2011
[139] A. Norkunas, *'*Sažiningumo principo igyvendinimas*', Jurisprudencija,* 2003, Nr. 42 (34). P. 8-10.
[140] LR CC Art. 6 (67)

All "bad faith" presumptions could be divided into three categories. However, only two categories can be used to ease the avoidance of preference, as the third one is not applicable to preferences:

1. Parties of a transaction are related to the debtor – his spouse, children, parents or any other close relative or legal entity that is related to the debtor (legal person which is controlled by the debtor, or if the director or a member of the managing body of one of the parties to the transaction is a person who directly or indirectly, separately or jointly with his spouse, children, parents or close relatives hold by the right of ownership at least 50 percent of the issued shares (portion of shares owned by a shareholder, contributions, etc.) of the other legal person or of the issued shares (portion of shares owned by a shareholder, contributions, etc.) in both legal persons. So in case of preference the preferred creditor falls under the criterion mentioned above, bad faith will be presumed.
2. The value of the transaction which had to be performed by the debtor considerably exceeds the presentation presented by the other party to the transaction (disproportion of counter-obligations); As mentioned previously, this group is not relevant for the avoidance of preferences.
3. Transaction was made upon the debt that has not yet been matured[141]. If preference was made by paying of the debt, which is not yet matured, bad faith is presumed on both sides, the creditor and the debtor.

To sum up, state of mind (bad faith) is important criterion in Lithuanian legal system. Both, objective and subjective criteria are important and have to be proved for the court in order for a transaction to be void. Subjective and objective criteria are used to establish bad faith, which has to be proven on both sides: debtor and creditor.

[141] D. Ambrasienė, S. Cirtautienė, 'Specialūs kreditoriaus interesų gynimo būdai sutartiniuose santykiuose', *Jurisprudencija*. 2003. Nr. 37(29). P.51

6. Comparison of German, English and Lithuanian Legal Systems

In the current part of the master theses the author will provide comparative analysis of the three legal systems described above. The aim of this comparative analysis is to help the author to deny of prove the hypothesis of the master thesis, which states that: German legal system offers the best protection for the creditors which was harmed by preferential act of the debtor in the area of insolvency law compared to English and Lithuanian rules.

The focus of this comparative analysis is on below presented questions:

- Is there a difference between the sources of law?
- Does the legal system recognize the difference between congruent and incongruent performance?
- Is any attention given to the characteristics of the parties creating and receiving a preference?
- Do the statute of limitations for avoidance of preferences, differ in these legal systems and how does it influences creditors?

It seems appropriate to start with the simple fact that German and English legal systems have dedicated legal acts, which contain rules for avoidance of preferences. Insolvency Code in Germany and Insolvency Act in England. Both legal systems (German and English) have specific rules dedicated for the avoidance of preferences in the event of insolvency. On the other hand, there is Lithuanian legal system that adopted the Enterprise Bankruptcy law, which does not provide any specific legal rules for avoidance of preferences. For this reason common rules of the Civil Code of the Republic of Lithuania dedicated for the avoidance of transaction are used to avoid preferences in the event of the insolvency. Taking into account what was said, the author believes that legal systems of England and Germany should be preferred over the Lithuanian one because dedicated norms are more specific than common rules and it is easier for the Court to interpret.

The second point to be compared is whether the legal system distinguishes between congruent and incongruent performances. Author will use German legal system as a starting point. This choice is done because German legal system recognises and has a clear distinction between congruent and incongruent performances, which is captured in Article 130 and 131 of the German Insolvency Code respectively. A totally different approach is introduced in the English legal system. Article 239 of the Insolvency Act is used to avoid all preferences

regardless if they are congruent or incongruent. Going further on, we have Lithuanian legal system, which according to the analysis provided previously only allows for avoidance of incongruent performances. There could be few ideas on this issue, if these legal systems are considered from the theoretical side, taking into account the avoidance possibilities, German and English systems would be closer linked together as they both theoretically allow the avoidance of congruent and incongruent performances. However, if taking into account the avoidance possibilities in reality (case law) the author would place German system on one side while putting English and Lithuanian legal systems on the opposite. This decision of the author is based on the actual situation which could be described as follows: only German rules provide office holder with a real avoidance possibilities, while English legal rules make it extremely difficult to avoid congruent performances, which is in reality closer to Lithuanian legal system.

The third point is the question of the characteristics of the parties participating in the transaction. In this part three very different approaches are introduced by each legal system. First of all, we have English legal system, which stipulates the necessity of a debtor to have "desire to prefer". This approach places interest only on the side of the debtor. It basically means that in order to avoid a preference a debtor's state of mind has to be proven (his desire to prefer). On the other side we have German legal system with totally different approach. It puts all its attention on the side of the creditor and is much more objective. In German legal system only some situations requires proving "knowledge" on the side of the creditor.[142] Finally, we have Lithuanian legal system, which is different from both, German and English. It places interest on actions of creditor and debtor taking into account subjective and objective elements that have to be proved in every situation if preference is to be avoided. From all that was mentioned, we can make a conclusion that German rules would be preferential for the creditors which were damaged by preferential act as it is the most objective ones (does not require proves on the state of mind of debtor or creditor) in comparison to the English and Lithuanian laws.

The last issue to be compared is the statute of limitations set for the avoidance of preferences in insolvency. English legal system is straightforward and sets general term of six months, which might be extended to two years if connected person is involved. On the other

[142] If we compare subjective elements, it is much more difficult to prove 'intent' then 'knowledge'.
Also, in German legal system rules on preferences in art.130 and 131 of the Insolvency Code, regarding incongruent performance, require no subjective elements to be proven, regarding the congruent performance, subjective element "knowledge" on the side of the creditor has to be proven. Furthermore, art 133 requires to prove intent on the side of the debtor and knowledge on the side of the creditor, but this article is only used if transaction happened prior to the three month period and more importance is placed on art. 130 and 131 of Insolvency Code.

side, Lithuanian legal system has longer periods. There are: three year time limit under which preference had to occur before the insolvency and one year time limit in order to start the avoidance proceedings. Germany has more complicated statute of limitations system compared with English and Lithuanian. Similarly to Lithuanian legal system, it introduces double time periods: i. two years period for taking action to avoid preferences and ii. time period under which transactions had to occur in order to be avoided as a preference. The second one ranges from one month to ten years. To sum up, if we consider time periods, during which transaction has to occur, creditors in Germany have more possibilities to avoid preferences in the event of the insolvency.

7. Harmonization of Preferences Law

The author would like to mention some conclusions about preference rules in cross-border insolvency. European Union has adopted a Council Regulation (EC) No 1346/2000 of 29 May 2000[143], which constitutes a first endeavor to coordinate the measures to be taken regarding insolvent cross-border debtors. This regulation establishes uniform private international rules in relation to insolvency proceedings in respect to rules regarding allocation of jurisdiction, applicable law, recognition of foreign insolvency proceedings and co-ordination of concurrent proceeding, however, does not harmonize substantive laws of Member States.

Article 4 (2) (m) of this regulation states that *"the law of the State of the opening of proceedings shall determine <...> the rules relating to the voidness, voidability or unenforceability of legal acts detrimental to all the creditors".* It means that there are no common system of preference rules, which are analyzed in this thesis, established within EU Member States and preference law regulation remains subject to national legislation.

Furthermore, there is also global initiative such as The UNCITRAL Model Law on Cross-Border Insolvency[144] to assist United Nations Member States to equip their insolvency laws with a modern legal framework to more effectively address cross-border insolvency proceedings. It focuses on authorizing and encouraging cooperation and coordination between jurisdictions, rather than attempting the harmonization of substantive insolvency law.

The analysis of Germany, England, and Lithuania system of preference law shows significant differences (in particular regarding the statutes of limitation when the transactions can be challenged) and proves the need of harmonization in order to balance fragmented regulation of domestic preference law rules and ensure greater legal certainty for trade and investment, protection and maximization of the value of the debtor's assets over the EU and worldwide.

[143] Council regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32000R1346:EN:NOT (accessed 9/11/2012: 12:45)

[144] UNCITRAL Model Law on Cross-Border Insolvency: The Judicial Perspective, United Nations 2012 http://www.uncitral.org/pdf/english/texts/insolven/V1188129-Judicial_Perspective_ebook-E.pdf (accessed 9/11/2012: 10:50)

8. Conclusions

As mentioned previously, the purpose of this master thesis was to prove or deny the hypothesis that German legal system offers the best protection for the creditors which were harmed by the preferential act in the area of preference law compared to English and Lithuanian legal systems. Out of the analysis of all the systems separately and lately comparison of all of them together the author came to the following conclusions:

1. German and English legal systems have dedicated/ specific legal rules regulating the avoidance of preferences. On the other side, Lithuanian legal system uses common transaction avoidance rules for avoidance of preferences cases.

2. German legal system makes distinction between congruent and incongruent performances and allows avoidance of both. While other legal systems author do not make such distinction like English law or does not allow for avoidance of congruent performance like Lithuanian law. Thus, German law would be preferential for the creditors.

3. German law uses the most objective criterions in order to prove preferences. Thus it is preferential legal system regarding the avoidance of preferences in the event of the insolvency, if we compare it to Lithuanian and English legal systems.

4. German legal system provides longest time periods for avoidance of transactions. This ensure that more acts constituting voidable preference will be caught in comparison to Lithuanian and German legal systems.

5. The analysis of Germany, England, and Lithuania system of preference law shows significant differences (in particular regarding the statutes of limitation when the transactions can be challenged) and proves the need of harmonization in order to balance fragmented regulation of domestic preference law rules and ensure greater legal certainty for trade and investment, protection and maximization of the value of the debtor's assets over the EU and worldwide.

Therefore, the author would like to conclude the research stating that: the hypothesis that German legal system offers the best protection for creditors damaged by preferential transaction in the area of insolvency law compared to English and Lithuanian legal rule **has been proved**.

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10. Annotation in English and Lithuanian languages

Aleksonytė A. Avoidance of Transactions in Insolvency: a Comparative Analysis of Preference Law in German, English and Lithuanian law. Supervisor: Prof. dr. Rimvydas Norkus – Vilnius: Mykolo Romeris Universitety, Faculty of Law, 2012. – 50 p.

ANNOTATION

The aim of this master thesis is to answer the thesis question: which legal system offers the most favorable regulation for creditors in the area of preference law, which protects their rights from voidable preferential transactions? In order to answer this question the author analyzes: (i) general notion of preference law, (ii) preference law provisions in the Germany, England and Lithuania together with case law, (iii) the characteristics of parties participating in the transactions (debtors and creditors) and statute of limitation applicable to preferences (preferential transactions) in these jurisdictions. Finally, general comparative analysis of all the legal systems is performed.

Key words: avoidance of transactions, preference law, protection of creditor rights, Actio Pauliana

Aleksonytė A. Sandorių Ginčijimas Bankrote: Lyginamoji Pirmenybės Teisės Analizė Vokietijos, Anglijos ir Lietuvos Teisėje. Vadovas: Prof. dr. Rimvydas Norkus – Vilnius: Mykolo Romerio Universitetas, Teisės Fakultetas, 2012. – 50 p.

ANOTACIJA

Šio magistro baigiamojo darbo tikslas yra atsakyti į klausimą: kuri teisinė sistema suteikia palankiausią reguliavimą ginant kreditorių teises pirmenybės teisės reguliavime, kuris saugo kreditorius nuo ginčytinų pirmenybės suteikimo sandorių? Siekiant atsakyti į šį klausimą, autorė analizuoja: (i) pirmenybės teisės bendrą teisės koncepciją, (ii) pirmenybės teisės reguliavimą ir teismų praktiką Vokietijos, Anglijos ir Lietuvos teisėje, (iii) šalių, dalyvaujančių ginčytinuose susitarimuose, charakteristiką ir terminus taikytinus šiems susitarimams ginčyti analizuojamose jurisdikcijose. Pabaigoje, atliekama lyginamoji nagrinėjamų teisinių sistemų analizė.

Raktiniai žodžiai: sandorių ginčijimas, pirmenybės teisė, kreditorių teisių apsauga, Actio Pauliana

11. Summary in English and Lithuanian languages

Aleksonytė A. Avoidance of Transactions in Insolvency: a Comparative Analysis of Preference Law in German, English and Lithuanian law. Supervisor: Prof. dr. Rimvydas Norkus – Vilnius: Mykolo Romeris Universitety, Faculty of Law, 2012. – 50 p.

Summary

This thesis will concentrate on a comparative research in which the provisions of several different jurisdictions (English, German and Lithuanian) on the legal rules on preference law will be analyzed. Preference law within this master thesis shall refer to those legal transactions that occurred before the effective or relevant date of insolvency and as a result are set aside or otherwise be rendered ineffective. As a key feature of this transaction 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.

The aim of this master thesis is to answer the thesis question: which legal system offers the most favorable regulation for creditors in the area of preference law, which protects their rights from voidable preferential transactions?

The choice to do research on preferences laws is based on (i) the lack of harmonization of preferences rules in the EU framework, (ii) In the light of the growing number of insolvencies within Europe and ongoing second face of financial crisis the assets of debtor may be disposed in countries other than the debtor became insolvent, thus, it is important know other jurisdictions (common law and continental) deal with the same pre-insolvency transaction matters, (iii) this matter is not yet sufficiently analyzed in legal doctrine.

The purpose of this research is to prove or deny the hypothesis: that German legal system offers the best protection for creditors which were harmed by preferential transaction compared to English and Lithuanian legal rules.

The focus of this comparative analysis is on below presented questions:

- is there a difference between sources of law in the presented countries;
- does the legal system recognize the difference between congruent and incongruent performance;
- is any attention given to the characteristics of the parties creating and receiving a preference;
- do the statute of limitations for avoidance of preferences differ in these legal systems how it influences creditors;

Aleksonytė A. Sandorių ginčijimas bankrote: Lyginamoji Pirmenybės teisės analizė Vokietijos, Anglijos ir Lietuvos Teisėje. Vadovas: Prof. dr. Rimvydas Norkus – Vilnius: Mykolo Romerio Universitetas, Teisės Fakultetas, 2012. – 50 p.

Santrauka

Šiame magistro baigiamajame darbe bus analizuojamos pirmenybės teisės regulavimas keliose skirtingose jurisdikcijose (Vokietijoje, Anglijoje ir Lietuvoje). Pirmenybės teisė šiame magistro baigiamajame darbe turėtų būti suprantama kaip taisyklės numatančios kreditoriaus teisę ginčyti prieš bankrotą skolininko sudarytus sandorius, kurie pažeidė jo kaip kreditoriaus teises, kadangi skolininkas suteikė pirmenybę kitam kreditoriui. Pagrindinis skiriamasis šių sandorių bruožas yra tas, kad sandorio šalis, sudariusi šį susitarimą, yra skolininko kreditorius, kurio pozicija dėl sudaryto sandorio yra geresnė kitų kreditorių sąskaita.

Šio magistro darbo tikslas yra atsakyti klausimą: kuri teisinė sistema suteikia palankiausią reguliavimą ginant kreditorių teises pirmenybės teisės reguliavime, kuris saugo kreditorius nuo ginčytinų pirmenybės suteikimo sandorių?

Šio magistro baigiamojo darbo tyrimo atlikimą paskatino keletas priežasčių. Pirmiausia, pirmenybės teisės taisyklės nėra harmonizuotos Europos Sąjungos teisėje. Antra, didėjant bankroto procedūrų skaičiui Europoje ir tęsiantis financiniam nestabilumui skolininko turtas gali būti perleistas kitose valstybėse nei kurioje skolininkui buvo iškelta bankroto byla, todėl, yra svarbu žinoti kaip kitose jurisdikcijose (bendrosios teisės ir civilinės teisės) sprendžia tuos pačius iki bankroto sudarytų sandorių klausimus. Trečia, šis klausimas nėra pakankamai išanalizuotas teisinėje literatūroje.

Šio tyrimo tikslas yra įrodyti ar paneigti hipotezę kad: Vokietijos teisinė sistema suteikia palankiausią reguliavimą ginant kreditorių teises pirmenybės teisės reguliavime, kuris saugo kreditorius nuo ginčytinų pirmenybės suteikimo sandorių, lyginant su Anglijos ir Lietuvos reguliavimu.

Dėmesys šiame magistro baigiamajame darbe yra skiriamas šiems klausimams:

- Ar yra skirtumas nagrinėjamų valstybių teisiniame reguliavime;
- Ar teisinė sistema skiria sandorius kurie yra atlikti suėjus vykdymo terminui ir nesuėjus vykdymo terminui;
- Kokia apimtimi yra atsižvelgiama į sandorio šalies charakteristiką pasirinktose valstybėse;
- Kuri iš analizuojamų valstybių numato palankiausią senaties terminą ginčyti sandoriams sudarytiems pažeidžiant kreditorių pirmenybės eilę.