

Clawback Provisions in French Insolvency Law

Paul J. Omar
of Gray's Inn, Barrister

by

Anker Sørensen, Avocat
Price Waterhouse Tax & Legal Paris

Introduction

By definition and from experience, there are rarely enough assets in insolvency to meet the expectations of all creditors that debts owed them will be met in full. For that reason, insolvency law offers the insolvency practitioner, and hence by extension the creditors, the opportunity to swell the assets of the insolvent company by clawing back assets and funds which have been transferred out of the insolvent's estate. The provisions have the effect of restoring the *pari passu* principle in order to prevent creditors jumping the queue or third parties from benefiting from transactions with the insolvent designed to offer them preferential treatment. As often these provisions are only available in the context of insolvency proceedings, there may be an incentive for creditors, knowing of the likelihood of assets having been transferred, to initiate insolvency proceedings and require the insolvency practitioner to invoke the claw-back provisions.

Nevertheless, because there is a legal requirement for certainty in business transactions and because the conduct of business would be irreparably damaged if there were no limitation on the possibility of opening all transactions to scrutiny, claw-back provisions are generally limited in time. This has the effect of protecting transactions of a certain antiquity, which may have no relationship whatsoever with the subsequent insolvency of the debtor. The period within which transactions are open to review by a court is traditionally known as the 'relation-back period'.¹

The Relation-Back Period: A Definition

The law on insolvency in France,² in contrast with that applicable in other jurisdictions, does not provide for an automatic or fixed relation-back period applicable to all insolvency proceedings.³ It is up to interested parties to request that a court fix a relation-back period for the purposes of bringing an action for avoidance of certain transactions entered into by the insolvent debtor during that period. Indeed, there could be, for the purposes of some insolvency

¹In French law: 'Période suspecte'.

²All references to articles of a law ('L. Art.') or decree ('D. Art.') which follow will be to Law no. 85-98 of 25 January and Decree no. 85-1388 of 27 December 1985. An overview of insolvency law in France may be found in Sorensen & Omar, *Corporate Rescue Procedures in France* (1st edition) (Kluwer, 1996).

³English law, in s423, Insolvency Act 1986, allows any transaction made with the intention of defeating creditors to be attacked regardless of when the transaction occurred. Other transactions, falling within the scope of ss238-239, Insolvency Act 1986, require the transaction to occur within 'a relevant time', which varies from 2 to 5 years. Preferences to non-connected persons are vulnerable to attack only if occurring within 6 months of the insolvency.

proceedings, no relation-back period at all when no request and no consequent court order granting it have been made.⁴ The only provision in the law relates to maximum periods. Where a relation-back period is set, the general rule is that it may be fixed at up to 18 months before the date of the opening judgment. This period may be exceptionally extended up to 24 months in instances of gifts or free transfers of assets unsupported by consideration. The fact that the relation-back period is so discretionary, and may not even be pronounced in some proceedings, means that its importance can easily be overlooked. This may lead to acts that unsuspecting creditors may have entered into during this period later being sacrificed in the interests of other creditors by being declared void.

Cessation of Payments: A Definition

Central to insolvency proceedings is the concept of cessation of payments. This is defined as the impossibility for a business to meet due debts with available assets.⁵ This is a legal rather than an accounting concept so that it cannot be determined by a purely mathematical approach.⁶ In practice, a court will consider matters on a case by case basis, taking into account the special circumstances of each case. In general, the fact that debts which were certain, quantifiable and payable were not paid may be sufficient evidence that a debtor was in a state of having ceased to make payments.⁷ Concrete examples include cases where there was a failure to pay employees and where there were considerable outstanding tax liabilities.⁸ The Supreme Court has, in a recent case, somewhat changed the philosophy behind the definition.⁹ In this instance, the court considered that the creditor's failure to demand payment of a debt, which was already due, until a later date meant that the later date alone had to be used in calculating the moment at which cessation of payments occurred.¹⁰

Cessation of Payments: The Terminus Ex Quo

The debtor must petition for the opening of insolvency proceedings within a period of fifteen days which follows the date of cessation of payments. Although the impression may be that it is the debtor who determines this date, it is ultimately up to the court to determine the date of cessation of payments. On a provisional basis, this is fixed at the date of the opening judgment. If later petitioned, however, the court, has the power to later find that the cessation of payments in fact occurred at any time up to 18 months before the date of the opening judgment and antedate the relation-back period from this point.¹¹ This

⁴From experience, this is not a purely hypothetical situation.

⁵L. Art. 3.

⁶Soinne, *Traité des Procédures Collectives* (2nd edition) (Litec, Paris 1995) p.232.

⁷Cassation Commerciale, 27 June 1989, Bull. Civ. IV No. 952.

⁸CA Amiens, 28 April 1988, Juris-Data no. 047676; CA Grenoble, 26 November 1986, RPC 1988-1, p.37.

⁹Cassation Commerciale, 28 April 1998 (Appeal no. S95-21.969).

¹⁰This is on the principle that the creditor is free to waive or postpone payment at his discretion.

¹¹L. Art. 9. A different regime applies to the finding of liability for directors.

also has the effect of penalising debtors where the filing is deemed to have taken place after the period for filing has expired.

There are two main reasons why the court has that power. First, it is obviously difficult for a court hearing a petition to determine with the information available, which may be quite rudimentary, the exact date on which a business was unable to meet its debts. This is normally ascertained on an examination of the accounts of the business or when creditors of the business lodge their proofs of debt.¹² Furthermore, the manoeuvre also permits certain acts which took place during this period to be rendered void or voidable. This avoids transactions which may have a fraudulent element or which were designed to dissipate assets in event of an impending insolvency. Rendering these actions void is ultimately for the benefit of the insolvent business or its creditors as the repayments may be used to continue business or ensure a higher dividend to creditors.

The law provides that only certain parties may petition the court to backdate the date of cessation of payments. These include the administrator or liquidator, as the case may be, the creditors' representative and the public prosecutor. The court may also proceed of its own motion to backdate the relevant date. Petitions must be filed within 15 days of certain specified events, which include the filing of the Economic and Social Report by the administrator before the end of the observation period,¹³ the filing of a restructuring plan under the simplified procedure by the debtor where no judicial administrator has been appointed,¹⁴ and in case of liquidation, the filing with court of the list of the admitted or rejected proofs of debt by the supervising judge, which in practice is usually done within 12 to 18 months after the opening of proceedings. For several months after the opening judgment, creditors may well be unaware of the ultimate cessation of payments date which may be set retrospectively. The court's decision to backdate the cessation of payments takes effect immediately.¹⁵ Even if this decision is appealed within the strict time limit imposed, the appeal will have no bearing on any actions for avoidance which may be taken subsequent to an extended relation-back period being fixed.¹⁶

Actions for Avoidance

In contrast to the period for appealing the fixing of an extended relation-back period, the law does not specifically impose a time limit for beginning proceedings for avoidance. Those parties who are entitled by law to bring an action include the administrator, the creditors' representative, the liquidator or the

¹²Soinne, *op. cit.* at p.249.

¹³L. Art. 18 requires the administrator to file a social and economic report with the court, which must include a complete financial picture of the business, a diagnosis of its viability and recommendations for a rescue plan or liquidation.

¹⁴The simplified procedure occurs where the debtor company in question employs less than 50 people and has a yearly turnover of less than FF 20 million.

¹⁵D. Art. 155.

¹⁶Cassation commerciale, 3 January 1989, Bull. Civ. IV No.6.

rescue plan supervisor, who may bring an action while they are in office. This means that, strictly speaking, an action for avoidance may be brought at any time during the currency of insolvency proceedings.¹⁷ This includes the period of a rescue plan, which in some cases may last for up to 10 years from the date of the opening judgment.¹⁸

Void or Voidable Transactions

The law provides that certain acts performed by the debtor after the date of cessation of payments will be deemed void or voidable.¹⁹ Acts caught under Article 107 are subject to strict liability and thus void, whilst those caught under Article 108 are subject to discretionary liability and thus voidable. The law states explicitly that the aim of such an action is to restore the assets of the debtor. It is clear that the courts have, in many cases, been guided by that overriding goal in stretching the scope of the operation of the law in order to render certain acts void. Good faith on the part of third parties entering into transactions with the debtor is irrelevant for acts subject to strict liability under Article 107. The fact that a contracting party was not aware of the debtor being in a state of cessation of payments, which may be raised as a defence in other instances, is thus irrelevant.²⁰ The interests of the business and of its creditors taken as a whole are deemed to take precedence over those of third parties caught by these provisions.²¹

Strict Liability or Void Transactions

Free Transfer or Gifts of Property

The law provides that all transfers made without consideration, whether of real or other property, are void.²² The rationale for this provision is that a debtor should not be disposing of its assets at a time when it has, or the court later decides it has, ceased to be able to meet payments which are due. Although the interdiction on transfers offends against the principle of freedom to dispose of personal assets, in an insolvent situation such gifts are obviously detrimental to the position of creditors and to the constitution of the debtor's assets. It is important to note that in connexion with gifts or free transfers, a court may

¹⁷Monserie, *Les Contrats dans le Redressement et la Liquidation Judiciaire des Entreprises* (Litec, Paris 1994) p.432.

¹⁸L. Art. 65. Rescue plans for agricultural businesses may last for up to 15 years.

¹⁹L. Arts. 107-108. Contrast this with the approach of English law which has both rules for the avoidance of dispositions of property between presentation of the petition and granting of the order as well as during the relation-back period.

²⁰CA Bordeaux, 28 April 1989, RPC 1989-2, p. 223, no. 8; CA Pau, 7 September 1989, RPC 1990-4, p. 388, No. 7.

²¹Le Cannu et al., *Entreprises en Difficulté* (GLN-Joly Editions, Paris 1995) p.278.

²²L. Art. 107 al. 1. This may be compared with the effect of s423, Insolvency Act which applies to transactions entered into at any time with the intention of defeating creditors as well as that of ss238-239, Insolvency Act 1986, which limits claw-back to claims occurring within a certain defined period.

declare void acts within the relation-back period as well as those occurring up to 6 months prior to the date of cessation of payments.

Courts have taken an expansive view of the definition of property and have held that shares, bonds and debts are property for the purposes of the law on insolvency.²³ Examples of transfers of property by the debtor which have been held void include a waiver of debts,²⁴ the payment of life insurance premiums considered excessive given the financial capacity of the party to be insured,²⁵ the granting of security by the debtor unsupported by consideration,²⁶ as well as a unilateral promise to sell certain assets where consideration was patently inadequate.²⁷ Courts have also considered that, in cases where consideration is provided but which is adjudged totally inadequate, such transfers will also be declared void as the consequences of maintaining the transfers would lead to the unwarranted diminution of the debtor's assets.²⁸ Creditors should thus be wary of the fact that even transfers of property for which consideration is provided may fall foul of the law. The effect of a transfer of property being rendered void is that the property is recovered for the benefit of insolvency proceedings.²⁹

Onerous Contracts

The Civil Code describes a contract as an agreement in which each of the contracting parties commits itself to give or do something which is considered to be the equivalent of what the other party gives or does for it.³⁰ The law on insolvency provides that all contracts entered into after the date of cessation of payments where the obligations of one party considerably exceed that of the other party will be void.³¹ It may be difficult to ascertain that there has been a disparity in the level of the parties' obligations and recourse may be had to valuations by an expert to determine whether the sale price was reasonable given the then market conditions. This is especially so in the case of disposal of real property. In one instance, the assignment of a claim by a debtor in favour of a bank in exchange for a credit line was held void as wanting for equivalency.³²

²³Bourgninaud, *Droit des Entreprises en Difficulté*, (Economica, Paris 1995) p.109.

²⁴Cassation Commerciale, 12 March 1963, D.1963.500.

²⁵Le Cannu et. al., op. cit. at p.279.

²⁶Cassation Commerciale, 13 May 1981, Bull. Civ. IV No. 228.

²⁷Cassation Commerciale, 28 November 1989, RPC 1990-4, p.387, no.6.

²⁸Cassation Commerciale, 28 November 1989, RPC 1990-4, P.387, no. 6. Compare *Agricultural Mortgage Corporation plc v Woodward* [1994] BCC 188.

²⁹Soinne, op. cit. at p. 1514.

³⁰Art. 1101, Civil Code.

³¹L. Art. 107 al. 2. This may be compared with the English law on 'extortionate credit bargains' under s244, Insolvency Act 1986. This involves, however, only those contracts for the provision of credit within 3 years prior to insolvency which require grossly exorbitant payments to be made or which grossly contravene principles of fair dealing.

³²CA Rouen, 20 April 1989, Juris-Data no. 48146.

It is clear from the case-law that the courts have an absolute discretion to determine that a disparity exists.³³ The law does, however, require that the disparity existed as at the date the contract was entered into.³⁴ The effect of a contract being found void will be that the parties are put back into the position as if the contract were never made.³⁵ It is unclear, however, whether the courts also have the discretion to order a variation of an onerous contract to make it more balanced.

The application of the general principle that voiding a contract puts the parties in their original position would require courts to order the restitution of any consideration to that creditor and the payment of a sum representing loss and damage suffered as a result of the lost opportunity for the contract.³⁶ In relation to this point, the decision in what appears to be the only case so far suggests that courts may not do so. In that instance, an option to purchase exercised pursuant to an agreement for sale was subsequently rendered void as it was deemed detrimental to the insolvent vendor. The court denied the purchaser any indemnity for the loss or damage resulting from the avoidance of the agreement.³⁷

Suspicious Payments

The law provides that all payments made by the debtor after the date of cessation of payments, whatever the method of payment, are void, where payment is in fact not due on the date payment is made.³⁸ In this respect, an assignment of receivables, in relation to a debt which had not yet fallen due, was declared void.³⁹ The rationale behind this provision is that payment of debts not due constitutes an unfair preference of a creditor and undermines the *pari passu* principle, i.e. that all creditors should be treated equally.⁴⁰ This provision does not catch the payment of a debt within the relation-back period where no specific date was agreed for that payment and the debt in theory remained due at any time during that period. Once the judgment opening proceedings is pronounced, the law provides that no payments may be made except by order of court or agreement of the relevant insolvency practitioners.

The fact that an insolvency judgment is in force does not render payable debts which were not due at the date of that judgment, all provisions to the contrary being deemed inapplicable.⁴¹ For that reason, creditors may wish to ensure that

³³Cassation Commerciale, 15 May 1990, Juris-Data no. 2269.

³⁴CA Nîmes, 31 October 1984, Juris-Data no. 585.

³⁵Soinne, op. cit. at p.1541.

³⁶Soinne, op. cit. at p.1515.

³⁷CA Bordeaux, 28 April 1988, RPC 1989-2, p.223, no.8.

³⁸L. Art. 107 al. 3. English law also recognises under s344, Insolvency Act 1986 that payments under a general assignment of existing or future book debts by a subsequently insolvent debtor is void as regards book debts unpaid before the presentation of the petition.

³⁹CA Montpellier, 23 February 1989, RPC 1990-4, p.388, no. 9.

⁴⁰Le Cannu et. al., op. cit. at p.280.

⁴¹L. Art. 56.

any standard clause in loan and other agreements, which provide that any outstanding amounts become immediately due and payable on the occurrence of a default event, be carefully drafted in relation to insolvency. It is suggested that the triggering event be geared to the date cessation of payments is declared as it may have more chances of avoiding the operation of the law than the standard reference to insolvency as a default. This may be achieved by defining the default event as one in which the debtor is not able to meet any one of its debts towards the particular creditor which is certain, quantifiable and payable, whether or not a court has pronounced on the fact.

The law also catches payments for debts which have fallen due but where the payments are not made in a manner commonly used in business relationships or authorised by law.⁴² The fact that a payment is made by an unorthodox method raises the presumption that it is an irregular payment.⁴³ The law specifically excludes from its scope certain modes of payments which are commonly found in business relationships, including payments in kind, by negotiable instruments, including bills of exchange, cheques and bank transfers, as well as those by assignments of receivables that are covered by the law regulating business credit.⁴⁴

Of interest to creditors is the fact that certain methods of payment, which although commonly used, could also be caught by the law. Assignments of receivables by a debtor during the relation-back period were not always an acceptable method of payment and may still not be so if that method of payment is one the business has not traditionally used.⁴⁵ The Supreme Court recently indicated that an assignment of receivables will be valid if that is a common method of payment in the context of the business relationships of the professional sector in question.⁴⁶ Creditors should err on the side of caution when receiving payment by any other method than those specifically mentioned as the effect of a finding that the payment is suspicious results in the payment being declared void. The creditor concerned will then be required to refund the payment received together with interest.⁴⁷

Deposits

General law provides that any deposits of sums, bills of exchange or shares pledged in favour of a creditor, pursuant to an action commenced by the creditor, will enjoy preferential ranking over claims by other creditors insofar as the items subject to pledge are concerned.⁴⁸ For the purposes of the law on insolvency, payments made subsequent to any pledge during the relation-back period may

⁴²L. Art. 107 al. 4.

⁴³Le Cannu et. al., op. cit. at p.281.

⁴⁴Law no. 81-81 of 2 January 1981.

⁴⁵CA Besançon, 12 June 1991, JCP éd E 1991.pan.886.

⁴⁶Cassation Commerciale, 30 March 1993, RPC 1994-2, p.250.

⁴⁷Cassation Commerciale, 12 June 1990, Juris-Data no. 1797.

⁴⁸Articles 2073 and 2075-1, Civil Code.

be declared void unless they are made by virtue of a judgment that is res judicata.⁴⁹

Security: Mortgages and Pledges

Of great significance to creditors is the fact that the law essentially provides that all mortgages and pledges, referred to collectively as “security”, granted over assets during the relation-back period to guarantee debts which arose prior to this time, are void.⁵⁰ The fact that the beneficiary of the security was unaware of the fact that the debtor was in a state of cessation of payments is irrelevant. Nevertheless, the law does state that the debt supported by a security must pre-exist the granting of the security, so as to avoid the granting of a general charge over future debts whose existence is doubtful.

The critical date for determining if a security is void is the date on which the security was granted, which must fall within the relation-back period. The courts have held that this date is that of the formation of the security, which does not take place until the documentation evidencing the security has been prepared and properly authenticated by a notary.⁵¹ For that reason, even if a security was agreed prior to the relation-back period but it was not formalised till after the date of cessation of payments, that security will be void.⁵² Creditors should at all times ensure that the formalities attendant on any security are immediately finalised so as to avoid the consequences of an intervening declaration of cessation of payments. The effect of a security being declared void is that the encumbrance on the property the subject of the security is lifted. For the purposes of proving debt, the proof relating to the debt to which the security attaches, will not be rejected but will instead be treated as a proof for an unsecured debt.⁵³

The position of reservation of title clauses as a species of security must also be considered. As is the case for other securities, reservation of title clauses inserted into a written agreement after the sales to which they refer may be considered void if made during the relation-back period. This is because this type of clause is treated as a guarantee obtained by the vendor to ensure payment of the sales price.⁵⁴ It should be noted that, where the clause is not contained in the primary contract but in an ancillary document dealing with, inter alia, general conditions of sale, there is a danger that the ancillary document could only be brought to the notice of the purchaser after the conclusion of the sale. As the clause is deemed to have been accepted only at the time of notice, if this occurs

⁴⁹L. Art. 107 al. 5.

⁵⁰L. Art. 107 al. 6. Compare this with the rules on ‘voidable preferences’ in English law and with the prohibition against the general assignment of book debts under s344, Insolvency Act 1986, which makes the granting of security void unless the assignment has been registered under the Bills of Sale Act 1878.

⁵¹Cassation Commerciale, 3 May 1988, RPC 1989-1, p.73.

⁵²CA Rennes, 14 January 1987, RPC 1988-1, p.77.

⁵³CA Rouen, 19 May 1983, Gaz. Pal. 1984.som.39.

⁵⁴CA Amiens, 3 March 1987, RPC 1989-2, p.222.

after the date of cessation of payments, the clause may be voided to the detriment of the vendor. A third party subrogated to the vendor's rights, for example a financial institution which accepts an assignment of receivables, will similarly be affected.

Enforcement of Security

The law backs up the provisions on security by also stating that all steps taken to formally enforce any security, whether by way of a notice on a register appointed for that purpose or a legal act seizing the property, will be void unless these measures were put into place prior to the date of cessation of payments.⁵⁵ This also includes the situation where provisional measures were ordered pending a definitive adjudication.⁵⁶

Discretionary Liability or Voidable Acts

In the case of those strict liability acts referred to above, third party knowledge that the debtor was in a state of cessation of payments is not relevant to a finding that those transactions are void. There are nevertheless other acts for which the law requires third party knowledge in order to render these transactions voidable. These are any payment for a debt which has already fallen due as well as the performance of an onerous contract, where payment or performance occurs during the relation-back period with the knowledge and consent of the creditor. These provisions expand the power of the courts considerably as it permits them a discretion to reverse the effects of a transaction which has not been caught under the strict liability provisions but which is nevertheless repugnant to the courts' sense of justice.

The onus is on the administrator, the creditors' representative, the liquidator or the rescue plan supervisor, whose right it is to bring an action for avoidance, to provide evidence of the requisite knowledge.⁵⁷ Nevertheless, the courts have absolute discretion to decide whether the existence of the requisite knowledge has been established or that knowledge on the part of the beneficiary of the transaction must be deemed to exist. The courts have deemed knowledge to exist in a number of diverse situations, mostly affecting the situation of creditor financial institutions.

Examples include where a bank enforced a number of securities granted to it by a debtor company following the loss of the benefit of a security from the debtor's holding company,⁵⁸ where a bank accepted payments from a debtor in the form of payments on current account in circumstances where the bank had

⁵⁵L. Art. 107 al. 7.

⁵⁶CA Paris, 12 September 1989, RDB 1990.50.

⁵⁷L. Art. 110.

⁵⁸CA Rouen, 4 February 1993, RPC 1994-2, p.254.

dishonoured cheques and subsequently rejected overdraft facilities,⁵⁹ where the bank kept a company artificially alive to allow it to conclude a sale of its main assets even though the sale would have a negative impact on the ability of the company to pursue its activities,⁶⁰ and even where a debtor banked with a financial institution, leading lead to the presumption that the bank could not have been unaware of the financial situation of the debtor.⁶¹ In exercising this discretion, the courts are not required to take into account whether the debtor or indeed the creditors have suffered any loss, as knowledge is in itself sufficient to render the act void.⁶² The effect of payment or performance of an onerous contract being found void is the same as in the situation of suspicious payments and of onerous contracts being voided under the strict liability provisions above.

Conclusions

The combination of three factors make the position in French law with respect to claw-back provisions quite unique compared with other jurisdictions. The first of these is the power of the court to backdate the date of cessation of payments up to 18 months before the date of the opening judgment, 24 months in the case of gifts, which has the effect of providing a wide window of opportunity for the application of the law to transactions within that period. The absence of any particular limitation period for the bringing of actions for avoidance during the currency of insolvency proceedings, means that as long as these last, which may be for up to 10 years, the relevant officials are able to exercise claw-back claims.

The last factor stems from the fact that the courts are known to treat actions for avoidance as a means for restoring the assets of the debtor, a phenomenon known in other jurisdictions as the 'deep-pocket' principle, i.e. that the person with the deepest pockets shoulders the burden. This has the effect of placing creditors, especially financial institutions and third parties in a very precarious position in relation to insolvent debtors. Furthermore, the 'deep-pocket' principle has a knock-on effect on insurance and professional liability, which may be called in to question as a means of supporting an adverse result in litigation. For all these reasons, creditors must be especially aware and exercise prudent behaviour when engaging in transactions of any significance with French companies facing financial difficulties.

30th March 1999

⁵⁹CA Metz, 2 April 1992, RPC 1994-2, p.254.

⁶⁰CA Pau, 7 April 1993, RPC 1994-2, p.254.

⁶¹CA Paris, 26 May 1994, Juris-Data no. 23113.

⁶²Cassation Commerciale, 16 February 1993, Bull. Civ. IV no. 62.