

**THE IMPACT OF THE EUROPEAN INSOLVENCY REGULATION
ON LENDERS, LENDING DECISIONS, THE STRUCTURING OF
TRANSACTIONS AND THE ENFORCEMENT OF SECURITY**

BY ROHINI SHARMA

A thesis submitted in fulfillment of the requirements of Nottingham Trent
University for the degree of Master of Philosophy

June 2011

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Rohini Sharma

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ABSTRACT

This Thesis seeks to shed light on the issue of how far secured creditor rights are protected in EU cross-border insolvencies by focusing on the perspective and position of English lenders. The main thread throughout is the legal concerns faced by lenders when lending to a company incorporated in England and Wales which operates across the European Union and has assets and creditors spread across various Member States.

The initial stages of the structuring of a cross-border security arrangement in terms of the enforceability of the lending transaction and underlying security interest under the ordinary civil/commercial law outside of bankruptcy are considered. The potential contractual and proprietary issues faced by lenders are discussed through the lens of English domestic law which for the present purposes includes EU law such as the Brussels I and Rome I Regulations. After ascertaining how lenders can ensure their lending transactions and underlying security interests are valid and enforceable pre-bankruptcy, the thesis explores the position of lenders in the face of insolvency proceedings and the issue of ‘insolvency effects’.

The thesis then goes on to analyze the impact of the EC Regulation on insolvency proceedings (the EIR) having regard to jurisdiction, recognition, applicable law and provisions which create exceptions to the application of the *lex concursus* and have

particular impact on the enforcement of lenders' rights in the event of default and formal insolvency. Developing case law is discussed especially in light of the potential impact on the interpretation and applicability of certain provisions of the EIR. The issue of 'insolvency effects' is discussed further in relation to how the EIR addresses the following: forum shopping; group insolvencies; effective co-ordination of insolvency proceedings across borders; dissipation of assets and other consequences which might be detrimental to creditors and devalue security; ascertainability; and the fact that the applicable insolvency law may have unanticipated effects on creditors.

The thesis concludes by drawing together the issues discussed and evaluating how successful the EIR has been overall in addressing the concerns of lenders. By discussing the practical measures used by practitioners to mitigate insolvency effects as far as possible and, by suggesting some areas for reform, this thesis seeks to illuminate the contrasting arguments regarding whether there is currently optimum protection of secured creditor rights in EU cross-border insolvencies and make a modest contribution regarding what can be done to improve this level of protection.

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INTRODUCTION

- 0.1 During the last few years some prominent insolvency proceedings have called attention to the application of the Insolvency Regulation¹ in matters of EU cross-border cases especially in relation to the treatment of secured creditors. The surging interest relating to issues arising from cross-border insolvency proceedings within the UK can be attributed to the emergence of case law such as *IMO Car Wash*² and the recent *Wind Hellas* case.³ There has been an increased trend of jurisdiction or forum shopping by debtors and creditors seeking to take advantage of the UK's favorable restructuring environment.
- 0.2 Aggrieved creditors have referred to Britain as a "bankruptcy brothel"⁴ and blame the procedure involved rather than the underlying business failure for their plight. Conversely, in a House of Lords debate on 11 March 2010, Lord Drayson⁵ said that:
- "Independent studies by the World Bank have shown that the United Kingdom's insolvency framework is highly regarded – above that of the United States, Germany and France – particularly on the basis of its protection to creditors, the costs of proceedings and the speed with which the process is able to be carried out."
- 0.3 A wider issue is how far secured creditor rights are currently protected in cross-border insolvencies within the European Union. This issue has brought pertinent insolvency legislation into scrutiny and hence the

¹ Council Regulation (EC) 1346/2000, hereinafter referred to as the 'EIR'.

² In the matter of *Bluebrook Ltd and others* [2009] EWHC 2114 (Ch). This case is discussed in more detail in 3.9-3.12.

³ *Re Hellas Telecommunications (Luxembourg) II SCA* [2009] EWHC 3199 (Ch). This case is discussed in more detail in 3.12.

⁴ R Watts & C Newell, "Firms flock to 'bankruptcy brothel' UK", *The Sunday Times*, (London, 7 March 2010: <<http://www.timesonline.co.uk/tol/news/politics/article7052729.ece>>

⁵ The former Minister of State, Department for Business, Innovation and Skills. See Hansard HC, col 342 (11 March 2010).

European Commission is required to report on EIR by 1st June 2012 and, if necessary, to produce proposals for its amendment.⁶

- 0.4 This thesis seeks to shed light on the issue of how far secured creditor rights are protected in EU cross-border insolvencies by focusing on the perspective and position of an English lender.⁷ The main thread throughout is the legal concerns faced by the Lender when lending to a company incorporated in England and Wales which operates across the European Union and has assets and creditors spread across various Member States. Cross border insolvency refers to the situation where such a company becomes insolvent and is unable to pay its debts⁸ consequently affecting the assets, business and creditors it has in more than one jurisdiction.
- 0.5 From the standpoint of the Lender, Chapter One discusses the initial stages of the structuring of a cross-border security arrangement in terms of the enforceability of the lending transaction and underlying security interest under the ordinary civil/commercial law outside of bankruptcy. The potential contractual and proprietary issues faced by the Lender are discussed through the lens of English domestic law which for the present purposes includes EU law such as the Brussels I and Rome I Regulations.⁹ After ascertaining how the Lender can ensure the lending transaction and underlying security interest are valid and enforceable pre-bankruptcy, the rest of Chapter One explores the position of the Lender in the face of insolvency proceedings and the issue of ‘insolvency effects’.

⁶ The Insolvency Service, ‘Evaluation of Council Regulation (EC) No 1346/2000 of 29 May 2000 on Insolvency Proceedings – Evaluation Questionnaire’, www.insolvency.gov.uk (The Questionnaire). See Chapter Three generally for a discussion of the issues identified in the Questionnaire which focuses on the problematic areas of the EIR over which there has been much controversy and practitioner input.

⁷ Hereinafter referred to as ‘the Lender’ as convenient shorthand.

⁸ Insolvency Act 1986 (IA 1986) s 122(1)(f) states that a company may be wound up if the company is ‘unable to pay its debts’. S 123 contains the definition of ‘inability to pay debts’ which encompasses the balance sheet test (s 123(2)) and the cash flow test (s 123(1)(e)).

⁹ Council Regulation (EC) 44/2001, hereinafter ‘Brussels I’; and Regulation (EC) No 593/2008, hereinafter ‘Rome I’.

- 0.6 What are ‘insolvency effects’? Under all national laws, insolvency proceedings may interfere and bring about changes in the legal position of the debtors and creditors. The type of system in a particular state is therefore of much importance to the Lender in terms of which systems are more ‘interventionist’ and redistributive than others. Whilst discussing ‘insolvency effects’, Chapter One also introduces the opposing camps of opinion regarding the principles of Universalism and Territorialism and why the attitude of different courts to these principles is of fundamental importance.¹⁰
- 0.7 Following from this, dependent on how interventionist a particular system is, what issues can rise in terms of enforceability of the lending transaction in the event of insolvency? If the security interest has been validly created according to the formalities of the applicable law and its validity is not affected by avoiding powers then, in the event of insolvency, the liquidator cannot interfere. Many insolvency systems have avoiding powers and/or asset claw back provisions. By way of example, Chapter One discusses some of the provisions under English domestic law and their potential effects.
- 0.8 As a prelude to Chapter Two, Appendix 1 considers the draft bankruptcy conventions which preceded the EIR. Chapter Two cross-refers to Appendix 1 in order to analyze the EIR’s successes and discuss the problems which remain unresolved. The importance of the two opposing principles of Universalism and Territorialism are discussed further in Chapter Two especially due to their influence over the preliminary draft conventions and the ‘modified universalism’ model that has consequently been adopted by the EIR.
- 0.9 When focusing on the development of the EIR’s core features,¹¹ the writer briefly explores the developments in insolvency in the United

¹⁰ The principles of Universalism and Territorialism are discussed further in 1.219-1.225, 2.10 and 2.11, especially in light of their influence on the drafting of the earlier Bankruptcy Conventions.

¹¹ Such as: COMI; rights in rem; and set off. See the following for further reference: 2.15 - 2.40; 2.111 -2.138; and 2.138 – 2.158.

Kingdom pre-EIR from the Lender's perspective in order to rationalize what prompted the need for a Convention among European member states to coordinate the conduct of insolvency proceedings. The impact of the EIR on risk assessment is discussed and reviewed.

- 0.10 Chapter Two analyzes and explores the relationship of the main features of the EIR having regard to jurisdiction, recognition, applicable law and to provisions which create exceptions to the application of the *lex concursus* and have particular impact on the enforcement of the Lender's rights in the event of default and formal insolvency. Developing case law is discussed especially in light of the potential impact on the interpretation and applicability of certain provisions of the EIR.
- 0.11 The issue of 'insolvency effects' is discussed further in relation to how the EIR addresses the following: forum shopping; group insolvencies; effective co-ordination of insolvency proceedings across borders; dissipation of assets and other consequences which might be detrimental to creditors and devalue security; ascertainability; and the fact that the applicable insolvency law may have unanticipated effects on creditors. The way in which insolvency effects can be mitigated will be of critical concern to the Lender and, by exploring the relationship between certain Articles under the EIR the writer aims to focus on problematic aspects.
- 0.12 Finally, in Chapter Three, some tentative conclusions are drawn regarding the legal implications of the EIR for the Lender by discussing the measures taken by practitioners to mitigate risks and how effective they have been in protecting the Lender's position. The concerns raised in Chapter Two are evaluated and suggestions made by which these shortcomings can be mitigated or overcome. For instance, in terms of making a transaction 'bankruptcy proof', the question arises whether COMI covenants provide a useful solution in protecting the secured creditor's position. In addition insolvency effects are discussed in relation to the controversial topic of COMI migration and whether secured creditors are benefiting rather than being prejudiced by forum

shopping. A helpful tool utilized in Chapter Three, regarding the possible shortcomings of EIR, is the Questionnaire.¹² Various responses to the Questionnaire are discussed in light of proposed reform of the EIR.

- 0.13 This thesis concludes by drawing together the issues discussed in the former chapters and evaluating how successful the EIR has been overall in addressing the concerns of the Lender. By demonstrating why the previous draft bankruptcy conventions were unworkable some light is shed as to why the position of ‘modified universalism’, as adopted by the EIR, is the only way in which the enactment of the EIR would have had any success. By referring to the historical evolution of the EIR, the writer demonstrates how the draftsmen of the EIR ‘learned’ from the failures of the earlier drafts and hence made essential changes to the text. By exploring the issue of COMI migration and forum shopping in light of emerging case law, the modernized attitude of creditors and debtors is portrayed and tentative conclusions are drawn about the fact that, despite Recital 4 of the EIR, not all forum shopping has negative implications.
- 0.14 Overall, by discussing the practical measures used by practitioners to mitigate insolvency effects as far as possible and, by suggesting some areas for reform,¹³ this thesis seeks to illuminate the contrasting arguments regarding whether there is currently optimum protection of secured creditor rights in EU cross-border insolvencies and make a modest contribution regarding what can be done to improve this level of protection.

¹² Insolvency Service Questionnaire (n 6).

¹³ See Chapter Three generally, e.g. the treatment of group insolvencies. See 3.21-3.40.

CHAPTER ONE

THE ENFORCEMENT OF CROSS-BORDER SECURITY

CROSS-BORDER ENFORCEMENT UNDER NON- BANKRUPTCY LAW

Introduction

- 1.1 The following example illustrates some of the problems the Lender will face at the inception of a security transaction. Where there is a facility financed in England and Wales and governed by English law, several multi-jurisdictional issues will come into play in relation to a cross-border security transaction. These include: guarantors that have not been incorporated in England; parties that have multinational branches and carry out business globally despite being incorporated in England;¹⁴ collateral consisting of various types of property (land, goods, contract rights) spread around different jurisdictions; the potential for changing circumstances during the lifetime of the transaction. In addition changes may arise from: companies setting up businesses in other jurisdictions; goods being moved from one jurisdiction to another; and a company entering into insolvency proceedings in a jurisdiction with which it only has minimal connection.¹⁵
- 1.2 Prior to entering into a security transaction the Lender's main consideration is the fact that different rules of private international law may be applicable due to the assets and other creditors being situated in

¹⁴ R Calnan, *Taking Security: Law & Practice* (Jordans, March 2006) 471-472, 13.1

¹⁵ *Ibid.* 471-472.

several countries. Hence there is potentially a conflict of laws affecting the conduct of the debtor company's affairs including the realization of assets subject to the Lender's security.

- 1.3 Conflict of laws is part of the law of England and Wales dealing with cases that have a foreign element. 'Foreign element' simply means "a contact with some system of law other than English law."¹⁶ The questions that arise in conflict of laws cases generally fall into three categories: jurisdiction; applicable law and recognition/enforcement of foreign judgments all of which categories can arise to a greater or lesser degree in cross border security transactions. In addition to domestic or internal law, modern countries generally all have rules regarding conflict of laws.¹⁷
- 1.4 When structuring a cross-border security arrangement the Lender will have to take into account the impact of any potential domestic and conflict of law rules in other jurisdictions as well as those rules applicable in England. In contrast to an English court, a foreign court may apply different criteria in deciding whether it should apply its law or another law to the outcome of a particular question.¹⁸
- 1.5 In practice it will be difficult for the Lender to get advice regarding each and every domestic and conflict of law rule that might come into play. At the outset the Lender must be aware of the risks and he will subsequently need to decide in which jurisdictions legal advice should be taken in relation to the cross-border security transaction.¹⁹ There could be creditors and assets in multiple jurisdictions and therefore, in conducting the risk assessment, the Lender will have to consider at least

¹⁶ See Dicey, Morris & Collins, *The Conflict of Laws*, (14th edn, Sweet & Maxwell, 8 December 2009) (D & M) 1-001 and David McClean & Kisch Beavers, *Morris, The Conflict of Laws*, (6th edn, Sweet & Maxwell, London 2005) (M & B) 1-002.

¹⁷ D & M (n 16) 1-001 :

"The main justification for the conflict of laws is that it implements the reasonable and legitimate expectations of the parties to a transaction or an occurrence."

See also 1-003 -1-006.

¹⁸ In the context of secured financing, the courts which will be likely to resolve the conflict will be those in the jurisdiction where the secured assets are situated or subject to whose laws they have been created. See Calnan (n 14) 472.

¹⁹ *Ibid.* 472.

the key legal jurisdictions. The Lender who wishes to lend and take security transnationally will potentially have connections with at least four legal systems each having some scope for change in identity during the lifetime of the security transaction. These are: the location of the Lender; the location of the debtor; the place of the transaction; and the jurisdiction within which the subject matter of the security is located.²⁰

Allocation of Jurisdiction

- 1.6 English courts apply rules of jurisdiction that consist of both EU law and English law.²¹ The issues that appear in a conflict of laws case fall into two main types: firstly, does the English court have jurisdiction to determine this case?; and secondly, if it does, what law should be applied?²² Once a court has assumed jurisdiction there is then a question of characterization and determining which juridical concept or category is appropriate in that particular case²³ and what choice of law applies. Then having exercised jurisdiction, in a cross border situation, the recognition and enforcement of its judgments in other jurisdictions will be critical in the efficient management, coordination and resolution of the case.
- 1.7 Conventions negotiated under the auspices of the Hague Conference on Private International Law and under the endorsement of the European

²⁰ IF Fletcher & H Anderson, 'The Insolvency Issues' in Michael Bridge & Robert Stevens (eds), *Cross Border Security and Insolvency* (Oxford University Press, Oxford 2001) 259. Note that the insolvency of the debtor introduces the possibility of a fifth legal jurisdiction, namely the place where the insolvency proceedings occur.

²¹ Prior to the Treaty of Lisbon coming into force, this reference would be to EC law under the EC Treaty. Brussels I and the EIR are strictly creatures of EC law made under the consolidated EC Treaty. However, after the Lisbon Treaty came into force, the pillar structure including the EC was eradicated and it is usual just to refer to EU law. Although the writer refers to both EU and EC, references to EC tend to be historic.

²² D & M (n 16) 1-003.

²³ *Ibid.*, 2-003.

Community have had a great impact on English conflict of laws rules.²⁴ The most important of these are: the Brussels Convention on jurisdiction and the enforcement of judgments in civil and commercial matters (and the parallel Lugano Convention); and the Rome Convention on the Law Applicable to Contractual Obligations (the Rome Convention)²⁵ which is now replaced by the Rome I Regulation.²⁶ The Rome II Regulation²⁷ has been established as a measure harmonizing domestic private international law rules applicable to torts.

1.8 The Brussels I Regulation,²⁸ which largely superseded the Brussels and Lugano Conventions, and Council Regulation (EC) 2201/2003 on jurisdiction and the recognition and enforcement of judgments in matrimonial matters and in matters of parental responsibility (Brussels II)²⁹ is directly applicable in the United Kingdom, as is the EIR, which regulates jurisdiction in insolvency matters.

1.9 Brussels I and Rome I form a network of provisions which regulate the assumption of jurisdiction and choice of law treatment of cases before UK and all other member state courts.³⁰ These two legal instruments are discussed in detail in the first half of this chapter in relation to the applicable law regarding the validity and enforceability of lending transactions and underlying security interests outside of bankruptcy. The second area of concern relates to the allocation of insolvency jurisdiction which could produce local insolvency effects that erode the Lender's position. The issues relating to the effects of insolvency proceedings and the applicability of the EIR are discussed later in Chapter One. Overall, issues relating to jurisdiction will only be

²⁴ See n 21 regarding the coming into force of the Lisbon Treaty.

²⁵ Civil Jurisdiction and Judgments Act 1982, Schs 1 and 3C; Contracts (Applicable Law) Act 1990, Sch 1: D & M (n 16) 1-020.

²⁶ Regulation (EC) No 593/2008. Hereinafter 'Rome I'.

²⁷ Regulation (EC) No 864/2000. Hereinafter 'Rome II'.

²⁸ Council Regulation (EC) 44/2001. Hereinafter 'Brussels I'.

²⁹ Council Regulation (EC) No 2201/2003 replacing Council Regulation (EC) 1347/2000 ('Brussels II').

³⁰ With the exception of Denmark. The effects of Rome II are not discussed as they do not relate directly to the validity and enforceability of cross-border lending transactions and are therefore beyond the scope of this thesis.

problematic to the Lender if the court that assumes jurisdiction is a practically inconvenient forum from the Lender's perspective and/or it leads to choices of applicable law that impact enforcement, whether or not the debtor is in formal insolvency proceedings.

The applicability of Brussels I

- 1.10 Brussels I sets out the rules for determining which national court of the EU Member States will have jurisdiction over disputes related to commercial contracts and facilitates the recognition and enforcement of judgments between Member States. It is therefore applicable when enforcing a security transaction outside of insolvency. The basic principle under Brussels I is that jurisdiction is to be exercised by the Member State in which the defendant is domiciled regardless of his/her nationality.³¹ In the case of companies or other legal persons, domicile is determined at the place where the company has its statutory seat or central administration or principal place of business.³²
- 1.11 As contracts will inevitably be involved in a security transaction, special jurisdiction provisions will also apply. Article 5 provides that:

³¹ See Art 2(1), Brussels I. Domicile is determined in accordance with the domestic law of the Member State where the matter is brought before a court. Persons who are not nationals of the Member State in which they are domiciled shall be governed by the rules of jurisdiction applicable to nationals of that State (see Article 2(2)). This is however subject to Art 22 which confers exclusive jurisdiction on the courts of particular Member States regardless of the domicile of the parties in defined circumstances.

³² See Art 60(1), Brussels I. Note that, for the purposes of the UK and Ireland, 'statutory seat' means the registered office or, where there is no such office anywhere, the place of incorporation or, where there is no such place anywhere, the place under the law of which the formation took place (see Art 60(2)). In relation to the application of Rome I, Art 19 states that the habitual residence of bodies and other bodies, corporate or unincorporated shall be the place of central administration. The contrast between jurisdictional rules based on place of incorporation and jurisdictional rules based on where a company has its 'seat' is blurred by Article 3 of the EIR which is a hybrid of 'seat' theory but with a default presumption that COMI equates to the place of incorporation and location of the registered office. Also see 2.21.

“A person domiciled in a Member State may, in another Member State, be sued in matters relating to a contract, in the courts of the place of performance of the obligation in question.”³³

“Contract” in the text of Brussels I has a meaning independent of the categories in national legal systems and encompasses any matters “having their basis in an agreement.” This is due to the fact that the concept of “contract” is not the same in every legal system, because of various understandings of delineations between contract, tort or property law.³⁴ Despite the fact that the notion of contract itself is allowed an independent interpretation, it is left to national law (including its rules of the conflict of laws) to identify “the place of performance.”³⁵ This general clause Article 5(1)(a) is likely to apply in the case of a security transaction as Article 5(1)(b) provides limited guidance in relation to assessing the place of the performance in the case of the sale of goods and in the case of the provision of services.³⁶

- 1.12 Inevitably, contracts governing security transactions will have clauses designating choice of court and choice of law. Article 23 of Brussels I allows parties to designate a court to have jurisdiction to settle any disputes which have arisen or which may arise in connection with a particular legal relationship. The choice of court agreement, or prorogation of jurisdiction has the effect of displacing the otherwise competent court. Hence, if the parties have made a choice of forum, that court shall have exclusive jurisdiction.³⁷

³³ See Art 5(1)(a).

³⁴ Case 9/87 *Arcado Spril v Haviland SA* [1988] E.C.R 1539. See also M & B (n 16), 70-74.

³⁵ See Case 12/76 *Industrie Tessili Italiana Como v Dunlop A.G* [1976] E.C.R 1473; Case C-288/92 *Custom Made Commercial Ltd v Stawa Metallbau GmbH* [1994] E.C.R I-2913; Case C-440/97 *GIE Groupe Concorde v The Suhadiwarno Panjan* [1999] E.C.R I-6307. See also M & B (n 16), 73

³⁶ In cases to which Article 5(1)(b) does not apply, the matter is governed by the general words of Article 5(1)(a); see Art 5(1)(c).

³⁷ See further Art 23(1). See also Case C-281/02 *Owusu v Jackson* [2005] ECR I – 1383 restricting the scope of *forum non conveniens* in the context of transnational civil litigation falling within Brussels I.

- 1.13 Rome I is discussed further in this chapter³⁸ as it acts as an extension or prolongation of Brussels I and complements the application of Brussels I in contractual matters. Rome I does not apply to choice of court clauses in a contract. The existence, formal and material validity of choice of court clause is therefore assessed solely by Brussels I, while a choice of law is governed by Rome I.³⁹
- 1.14 It is submitted that, in relation to conflict of laws in a secured financing, it is more probable that the courts in the jurisdiction where the collateral is located will resolve the conflict and, in the case of intangibles, this will be resolved by the jurisdiction under whose laws they have been created.⁴⁰ In practice, there are two key jurisdictions which the Lender will be concerned with: that where the borrower and guarantors are incorporated; and that where the assets which are the subject of the security are situated (if they are tangibles) or whose law governs their creation (if they are intangibles).⁴¹ When determining which law will govern the effectiveness of the security in a cross-border case, one of the first issues that arises is how the court will classify (or characterize or categorize) the matter.⁴² Characterization is discussed in the following section.

Characterization & Choice of Law

- 1.15 The technique of conflict of laws makes much use of legal categories. This is because, before the correct connecting factors can be identified, we need to know into which legal category the facts of the case, or the particular issues are properly placed. Therefore, in essence:

³⁸ See 1.27 – 1.43.

³⁹ See Rome I, Art 3.

⁴⁰ Calnan (n 14) 471-472, 13.5

⁴¹ *Ibid.* 472, 13.7

⁴² *Ibid.* 472-473, 13.9

“Characterization is a process of refining English conflict rules by expressing them with greater precision.”⁴³

- 1.16 The court’s primary consideration, after civil/commercial jurisdiction has been established under Brussels I or Rome I, is characterization of the issue which will ultimately decide which law will govern it. In a secured financing, one may have to consider several significant matters such as: the debtor’s capacity; the validity of the contract under which the security was created; the security’s proprietary effects in relation to key collateral; or the impact of the insolvency proceedings on the security. These varying issues may be subject to different laws.⁴⁴ Generally, English conflict of laws rules distinguish between: capacity; authority and breach of fiduciary duty; formal validity; material validity (including the absence of real consent); the effect of the contract; and the effect of insolvency.
- 1.17 English law does not characterize issues only on the basis of domestic English law concepts but gives broader consideration to the issues involved in any dispute. The first division in establishing categories is between personal and proprietary rights. Although this distinction appears obvious, problems have arisen in practice particularly in relation to intangible assets. It is nevertheless clear that different laws can govern the personal and the proprietary effects of a lending transaction.⁴⁵ It is important for the Lender to consider the issues at the point the lending transaction is entered into and security granted and at the point of default and insolvency when the Lender will need to enforce the security.
- 1.18 Assuming that the English courts have jurisdiction, the question arises of which law or laws will be applied to determine the validity and

⁴³ See D & M (n 16) 2-036 – 2-038. Mance L.J also said in *Raiffeisan Zentralbank Osterreich AG v Five Star General Trading LLC* [2001] Q.B 825 (CA) [2001] Q.B 825 (CA) at [27] when dealing with the characterization of issues: “the overall aim is to identify the most appropriate law to govern a particular issue. The classes or categories of issue which the law recognizes at the first stage [i.e. for characterization] are man-made, not natural. They have no inherent value, beyond their purpose in assisting to select the most appropriate law.”

⁴⁴ Calnan (n 14) 472-473.

⁴⁵ *Ibid.* 473.

priority of security rights. In order to answer this question it is necessary to distinguish between contractual (or in personam) validity and proprietary (or in rem) consequences.⁴⁶ The proprietary effect of the security will be of paramount significance if the debtor is insolvent. However, contractual issues will be discussed first because of the impact they may have on the validity of the Lender's proprietary rights. If, for instance, it is held by the law governing a contract that nothing is owed then there is no need to consider the proprietary effects of any security.⁴⁷

- 1.19 In relation to contractual issues, several further questions must be addressed in order to analyse comprehensively the contract's legal validity under its governing law: did the debtor have capacity to enter the contract; were any formalities required as a pre-condition for its enforcement; do its terms mean what the Lender understood them to mean; is the contract vulnerable to being set aside because of some vitiating factor such as operative mistake?⁴⁸ These issues will be explored in detail in the following section.

The personal / contractual issues involved in cross-border security transactions

- 1.20 The Lender's primary concern is how to structure the lending transaction and ensure that effective security is taken. This section

⁴⁶ Further defined: a judgment 'in personam' can be defined as a judgment that defines positively claims against competing individuals in respect of a particular matter, or to compel the performance of a particular act, e.g. the discharge of a debt, payment of an award for damages for breach of contract, or requiring a particular aspect of a contract is performed; a judgment 'in rem', on the other hand, amounts to a determination of the status of a particular matter, but is conclusive not only between the competing parties but also against the world. Lord Hoffmann in *Cambridge Gas Transport Corporation v Official Committee of Unsecured Creditors (of Navigator Holdings plc)* [2007] 1 A.C. 508 summarized the position as follows in relation to 'in rem' and 'in personam' judgments: "judicial determinations of the existence of rights; in one case rights over property and in the other rights against a person."

⁴⁷ R Stevens, 'The English Conflict of Laws Rules' in M Bridge and R Stevens (eds), *Cross Border Security and Insolvency* (Oxford University Press, Oxford 2001) 205.

⁴⁸ Calnan (n 14) 474, 13.14.

discusses the measures that the Lender needs to take to ensure the enforceability of the transaction and validity of the security interest under the ordinary civil/commercial law outside of insolvency.

- 1.21 Generally a creditor has three main concerns when taking security: is it effective in the debtor's insolvency?⁴⁹ will it have priority over other proprietary interests in the same asset; and will it be enforceable on default by the debtor?⁵⁰
- 1.22 When determining the validity and enforceability of the lending transaction as a matter of general law, the issue of the personal obligations of the debtor under the facility and security documentation needs to be considered. The most important personal obligation is the debtor's undertaking to pay the liabilities which are secured by the security documents. The security will be worthless if this obligation is ineffective.⁵¹ The issue of registration of the security documents will be discussed later in the chapter⁵² as it is directly relevant to whether the security will be enforceable in the event of insolvency.
- 1.23 Whether the debtor is contractually bound to pay the secured obligations will depend firstly on whether the substantive and formalities requirements of the law of contract have been complied with.
- 1.24 Whether the security taken by the creditor is effective also depends on whether the debtor has validly entered into the contract. This depends not only on the debtor's capacity to enter into agreement, but also on the authority of those who have entered into the documentation on the debtor's behalf. Thirdly, can the documents be set aside as a result of a vitiating factor? This depends on: the absence of any real consent by the party expressed to be bound (for instance, as a result of fraud, mistake,

⁴⁹ On 'bankruptcy proofing' as regards the effects of insolvency proceedings see further 1.115 – 1.119. The issues in relation to the taking of effective cross-border security as a matter of ordinary private law are separate from the issues once insolvency jurisdiction comes into play.

⁵⁰ Calnan (n 14) 139.

⁵¹ Calnan (n 14) 477.

⁵² See 1.110.

misrepresentation or undue influence); in the case of a company, the breach of directors' fiduciary duties; and the commencement of insolvency proceedings in relation to the debtor (and therefore the possibility of their constituting transactions at an undervalue or preferences).⁵³

Effective contracting

- 1.25 The law governing a contract ascertains its meaning and effect. The ability to enforce a contract will be undermined if there is no clarity regarding the relevant applicable law and its content. Doubts about whether or not the contract is enforceable will have an impact on its value as an asset.⁵⁴
- 1.26 Before discussing the impact of these issues on a Lender it is important to consider the applicability of Rome I as in the EU it determines which state's law governs contractual matters.⁵⁵ There are also a number of exceptions to Rome I that need to be considered, where domestic substantive law will apply.

The effect of the Rome I Regulation

- 1.27 The 1980 Rome Convention⁵⁶ established uniform rules for choice of law between EU Member States. Since 1991 the UK's choice of law rules in contract have been based on the Rome Convention. The fundamental principles of the Convention are that parties are able to

⁵³ Calnan (n 14), 477-478.

⁵⁴ See <'Rome I- should the UK opt in?' Consultation Paper CP05/ 08: <http://www.justice.gov.uk/docs/cp0508.pdf>> published 2 April 2008, para 5

⁵⁵ The relevance of Brussels I in relation to contractual matters is discussed earlier in this chapter. See 1.10 – 1.15.

⁵⁶ See n 25.

choose the law they want to apply to their contract⁵⁷ and that adequate legal certainty is provided to contracting parties regarding the law that will apply to their contract. Rome I originated as a proposal by the European Commission in 2005 to convert the 1980 Rome Convention into a European Community Regulation. This Regulation was formally adopted in the UK in 2008.⁵⁸

- 1.28 Rome I applies in situations involving a conflict of laws to contractual obligations in civil and commercial matters.⁵⁹ Its principal aim is to identify the means of determining the law which governs the contract and determine which contractual issues will be decided according to that governing law.⁶⁰
- 1.29 In the context of the law of security, the most important exceptions to Rome I are that it does not apply to: questions concerning the status or legal capacity of companies or natural persons;⁶¹ questions involving the authority of persons entering into contracts on behalf of companies or natural persons;⁶² or other issues concerning company law, including the winding up of companies.⁶³ In these circumstances domestic law will apply and therefore these issues will be considered in the next section relating to the formal validity of contracts under English substantive law.
- 1.30 However, where Rome I does apply, the principle of party autonomy in relation to choice of law plays a central role. The terms of Article 3 of both the Rome Convention and Rome I are substantively the same. However, the latter provides two useful clarifications. The first clarification is that a choice of law by the parties need not be made only in express terms. It is now deemed sufficient if the choice is clearly

⁵⁷ Rome Convention Art 3.

⁵⁸ Rome I is broadly similar to the Rome Convention but the provisions have been improved and clarified in the light of experience. Moreover the adoption of a Regulation better allows for amendment in the future as it is an EU legislative instrument rather than a multilateral treaty. See CP05/08 (n 55).

⁵⁹ See Rome I Art 1(1).

⁶⁰ Calnan (n 14), 479, 13.31

⁶¹ See Rome I Art 1(2)(a) and (f).

⁶² See Rome I Art 1(2)(f) and (g).

⁶³ See Rome I Art 1(2) (f). Also see Calnan (n 14) 479.

demonstrated by the parties by reference to the terms of the contract or the circumstances of the case.⁶⁴ By making clear that party choice can be express or implied, this amendment has removed the uncertainty that existed under the Rome Convention where Article 3 merely required that a choice be demonstrated with “reasonable certainty”.⁶⁵

1.31 In the absence of an express or implied choice, it is presumed that⁶⁶ the company’s place of central administration which has given the characteristic performance governs the contract.⁶⁷ As the Giuliano-Lagarde Report⁶⁸ on the Rome Convention refers to the ‘provision of security’ as being the characteristic performance in secured lending, the law of the place of the debtor’s central administration will apply.⁶⁹

1.32 One needs to determine what is meant by the expression ‘the performance which is characteristic of the contract’. With regard to a loan agreement, the characteristic performance is likely to be the making of the loan, and therefore refers to the location of the creditor. As discussed, in the case of security documents, it would refer to the granting of security, and therefore the location of the debtor is the likely location. Calnan suggests, and the writer agrees, that this would produce the somewhat odd conclusion that (unless the presumptions were ignored) the law of the creditor’s location will govern the loan agreement and the law of the debtor’s location will govern the security documents.⁷⁰ In practice, as loan agreements and security documents invariably contain express choice of law clauses, the point is largely academic.⁷¹

⁶⁴ See Rome I Art 3(1).

⁶⁵ See Rome I Art 3(1). See also CP05/08 (n 48).

⁶⁶ See Rome I Art 4(1).

⁶⁷ Stevens (n 47) 205

⁶⁸ The Report on the Rome Convention by Professor Mario Giuliano and Professor Paul Lagarde (OJ 1980 No C282 20) which the courts may use as an aid to the interpretation of the Rome Convention: see Contracts (Applicable Law) Act 1990 s 3(3)(a).

⁶⁹ Stevens (n 47) 205.

⁷⁰ Calnan (n 14), 485-486, 13.62.

⁷¹ Ibid. See further 1.11 where the “place of performance” is discussed in relation to Brussels I.

- 1.33 Though the governing contract law does not determine every dispute relating to the contract, it does determine some of the most important issues, including the existence and effect of the contract and its material validity. It is rare to find a contract (whether it is a loan agreement, a security document or otherwise) which does not have an express choice of law clause.

Formal validity of the contract

- 1.34 English law imposes few formal requirements on the creation of contracts or of security. In certain cases, the documentation needs to be in writing, sometimes accompanied by the signature of the person to be bound; and a deed is required to transfer land.⁷² Dispositions of land emphasize the most apparent necessity for formal requirements; however formalities are also needed for the disposition of equitable interests and in relation to guarantee obligations. Generally, however, apart from these formalities, security can be created informally.⁷³
- 1.35 Other jurisdictions may impose more formal conditions for the creation of security. They may necessitate the involvement of a third party such as notary in addition to the requirement of being in writing or drafted as a deed. It is therefore essential to be clear about which law governs the formal validity of contracts creating security as non-compliance with the relevant formalities may be fatal to enforceability.⁷⁴
- 1.36 Rome I sets out the choice of law which will govern the formal validity of a contract. A contract concluded between persons who, or whose agents, are in the same country at the time of its conclusion is formally valid if it satisfies the formal requirements of the law which governs it

⁷² See Land Registration Act 2002 and Companies Act 2006 in relation to registration requirements.

⁷³ Calnan (n 14) 480, 13.39.

⁷⁴ Calnan (n 14), 481, 13.40.

in substance under Rome I. The contract is also formally valid if it satisfies the law of either of the countries where either of the parties or their agent is present at the time of conclusion, or the law of the country where either of the parties had his habitual residence at that time.⁷⁵ Furthermore a contract concluded between persons, or whose agents, are in different countries at the time of its conclusion is formally valid if it satisfies the formal requirements of the law which governs it in substance under Rome I etc.⁷⁶ If these requirements are complied with then a contract cannot be set aside on the basis of lack of formal validity.

- 1.37 Where a contract is concluded by an agent, it is the country in which the agent acts which is the relevant country whose formal requirements need to be complied with. If the subject matter of the security is immovable property, the law of the country where the property is situated must be satisfied if those are imposed irrespective of the law governing the contract and those requirements cannot be derogated from by agreement.⁷⁷

Material validity of the contract

- 1.38 More important in practice are the requirements which relate to the material validity of the contract. This refers to those matters, other than formalities, which are required in order to create a contract. These include: the requirements for the creation of a contract (such as, in English law, agreement and consideration); and those matters relating to contracts generally which can vitiate a contract such as mistake, misrepresentation, duress and undue influence.

⁷⁵ Rome I, Art 11(1). Note that Rome I Art 11(1) and 11(2) also refer to the situation where a contract is concluded by an agent. On the habitual residence of companies see Art 19(1), (3).

⁷⁶ Rome I, Art 11(1).

⁷⁷ Rome I, Art 11(5).

- 1.39 Rome I provides that the existence and validity of a contract, or any term of a contract, shall be determined by the law which would govern it under the Regulation if the contract or term were valid.⁷⁸ The governing law determines:⁷⁹ how the contract is to be interpreted; how it is to be performed; when the contract is breached and its consequences including the assessment of damages; and discharge of the contract. Therefore, overall, the governing law of the contract establishes its material validity and effect; and a contract will be formally valid if it complies with the formalities imposed by the governing law.
- 1.40 It needs to be noted that the application of the law of any country specified by Rome I may be refused only if such application is manifestly incompatible with the public policy of the forum.⁸⁰ The wording makes it clear that the Lender need only be concerned in the most exceptional circumstances where it is absolutely clear that to enforce a foreign law would be contrary to public policy. It is difficult to envisage many such cases in the context of security law. As the existence of rules regarding conflict of laws is founded on the supposition that such differences do exist, it is not enough to solely establish that there is a conflict between the position under English law and that of a foreign law. One possible example of grounds for the public policy exception would be where a foreign law expropriated the Lender's rights under its security documentation; but, even in this case, one would have to demonstrate that such expropriation would not be allowed under any reasonable system of law.⁸¹

⁷⁸ Rome I Art 10(1).

⁷⁹ Rome I, Art 12 and 12(1)(e).

⁸⁰ Rome I Art 21.

⁸¹ Calnan (n 14), 483, 13.53.

Capacity & Authority

- 1.41 Lawyers acting for the Lender will consider a number of issues when establishing whether the transaction has been authorized by the debtor company: who the directors are; whether the board of directors have the authority to enter into the transaction; and whether the board of directors has properly exercised its authority to enter into the transaction.⁸²
- 1.42 The authority of a company's directors to bind the company or of agents to bind their principal also falls outside the scope of Rome I.⁸³ In accordance with the general law applicable to agents, whether a company's officer has actual authority should be determined by the law governing the relationship between the company and the officer.⁸⁴ Whether a director has been validly appointed⁸⁵ and who the officers authorized to deal on the corporation's behalf⁸⁶ should be is determined by the law of the place of incorporation.
- 1.43 The protection given to a lender dealing with a company acting without capacity may be contrasted with the situation where he deals with agents of the company who lack authority. Even if the persons who are purporting to act on behalf of the debtor company do not have actual authority to do so, the debtor will nevertheless be bound by their actions if it has conferred on them the apparent (or, as it is sometimes called, ostensible) authority to do so. This will be the case if the debtor

⁸² Calnan (n 14) pg 143.

⁸³ Rome I, Art 1(2)(g) excludes from its scope 'the question whether an agent is able to bind a principal, or an organ to bind a company or body corporateto a third party.'

⁸⁴ In English law, the question of whether a company is bound by the acts of its directors or other agents is a matter of company law governed by the law of the place of incorporation.

⁸⁵ *Sierra Leone Telecommunications Co Ltd v Barclays Bank plc* [1998] 2 All ER 821.

⁸⁶ *Carl-Zeiss Stiftung v Rayner & Keeler Ltd (No 2)* [1967] 1 AC 853.

has held out those who purport to enter into the transaction as having the authority to do so on its behalf.⁸⁷

- 1.44 It is submitted that the fact that a principal may be bound by contracts entered into by someone who lacks actual authority but possesses ostensible authority is easily justifiable by the general rule that a party may be bound according to the objective appearance of the agreement that he has created.⁸⁸ From the Lender's perspective, he will expect his rights to be determined by the law governing the contract he entered into. The law which should be applied to determine whether there is a contract between the principal and the Lender is that which would apply to determine the existence and the validity of a contract. Under Rome I this is determined by the putative governing law which is the law which would also govern the contract if the contract were valid.⁸⁹
- 1.45 The authority of the board of directors depends on the company's articles of association which generally gives the board of directors extensive powers to manage the company's business. Sometimes, specific provisions limit the amount of borrowings. Whether the board of directors has appropriately exercised its authority to enter into the transaction depends on whether an acceptable board resolution has been passed by the necessary number of directors required by the company's articles of association. It may be that some of the directors are interested in the transaction,⁹⁰ in which case it should be established whether (and, if so, on what terms) interested directors can be counted in a quorum and vote on the resolution).⁹¹
- 1.46 The other matter that can affect the authority of the board of directors is the commencement of insolvency proceedings. If the company goes

⁸⁷ See e.g. *Royal British Bank v Turquand* (1856) 6 E&B 327 and *Freeman & Lockyer v Buckhurst Park Properties* [1964] 2 QB 480. There is statutory recognition of this principle in s 40(1) Companies Act 2006.

⁸⁸ Reynolds (1994) 110 LQR 21. See Stevens (n 47) 208.

⁸⁹ See Rome I, Art 10 (1).

⁹⁰ e.g. because they are directors of other companies in the group which are guaranteeing the transaction. See s 177 Companies Act 2006.

⁹¹ Calnan (n 14) 143, 5.25.

into liquidation or administration, the authority of the board to bind the company is terminated and replaced by that of the relevant insolvency officer holder.⁹² In addition, if a petition is presented for the compulsory winding up of a company, and a winding up order is ultimately made, the liquidation dates back to the date of the presentation of the petition, and any disposition of the company's property entered into in the meantime is void unless the court validates it.⁹³ Where the debtor is incorporated outside England and Wales, advice will be required on these issues from lawyers in the appropriate jurisdiction.

Can the contract be set aside as a result of a vitiating factor?

- 1.47 The debtor may seek to have the contract with the Lender set aside or otherwise challenge its validity in certain circumstances.⁹⁴ In practice, however, the most likely circumstances in which a security transaction will be set aside is where the security has been created by a company and the directors have acted in breach of fiduciary duty when entering into the transaction. However under the general principles of the law of contract, the security transaction is capable of being set aside in circumstances including mistake, misrepresentation, duress, fraud, undue influence and illegality.

⁹² I A Act 1986, ss 91(2) and 103 and Sch B1, para 64.

⁹³ *Ibid.* s 127.

⁹⁴ The debtor may apply the protection afforded by Article 10(2), Rome I which allows a party to rely upon the law of the country in which he has his habitual residence to establish that he did not consent, if it appears from the circumstances that it would not be reasonable to apply the putative governing law. However it is unclear where the habitual residence of a body corporate is and indeed whether it can have one at all. Article 19(1) clarifies that the habitual residence of companies and other bodies, corporate or unincorporated, shall be the place of administration.

- 1.48 It is important to note that the governing law of the contract will determine most issues in relation to the effect of the contract.⁹⁵ However it is submitted that the question of whether or not there has been a breach of fiduciary duty is a matter for the law of the place of incorporation of the company concerned, not the governing law of the contract.⁹⁶
- 1.49 The likelihood of breach of fiduciary duty is most apparent in the case of the company guaranteeing the obligations of another company in the same group⁹⁷ to the Lender, or taking a third party charge over its property. It is fundamental that the directors do not concentrate exclusively on the interests of the group as a whole. It must be established that the directors have acted in what a reasonable board of directors would consider to be in the best interests of their particular company or the transaction is likely to be set aside.⁹⁸ This situation is likely to occur where so-called upstream guarantees are given by subsidiaries to secure facilities to their ultimate parent company which acts as the group's banker.⁹⁹ The board must demonstrate that they genuinely believed that they acted for the company's benefit and that they had reasonable grounds for their belief.¹⁰⁰
- 1.50 The company is able to avoid the transaction and reclaim any benefits granted if it can be proved that the directors have acted in breach of their duties and the Lender has actual or constructive notice of this

⁹⁵ See Rome I, Art 12.

⁹⁶ See Calnan (n 14), 13.46, 482; *Base Metal Trading Ltd v Shamurin* [2004] EWCA Civ 1316, [2005] 1 WLR 1157.

⁹⁷ Or an associated company.

⁹⁸ *Charterbridge Corporation v Lloyds Bank* [1970] Ch 62 at 74. See now Companies Act 2006, s.172; Calnan (n 14), 5.30, 145.

⁹⁹ In contrast, if a subsidiary is guaranteeing fellow subsidiaries or if the guarantee is of a facility which will not be used for the purpose of funding the existing group, the directors might find it harder to demonstrate sufficient reasons why they believe that the giving of this guarantee is in the best interests of their company. Calnan (n 14) 145.

¹⁰⁰ Calnan (n 14) 145, 5.31. See *Colin Gwyer & Associates v London Wharf (Limehouse)* [2002] EWHC 2748 (Ch), [2003] 2 BCLC 153 at [72]–[90].

fact.¹⁰¹ Given the nature of the relationship between the Lender and the company, there is a strong possibility that the Lender will have enough information about the company to give him constructive notice of such an irregularity.¹⁰²

- 1.51 There are two ways of preventing this problem from occurring: by taking steps to make certain that directors do not commit a breach of duty; or by getting an affirmation from the company of any probable breach of duty by the directors.¹⁰³ It is important for the Lender to ensure that the debtor's directors have good reasons for entering into the transaction and that they are properly documented in the company's board minutes.¹⁰⁴ The debtor company¹⁰⁵ will have to prove the following in order for the transaction to be set aside: it was not the honest belief of the directors that the transaction was in the company's best interests; or that no reasonable board of directors could have that opinion.¹⁰⁶

Summary of the contractual issues involved in cross-border security arrangements

- 1.52 Although personal issues in relation to security obligations are less important than proprietary issues, they are nevertheless of importance, not least because they establish the existence and extent of the secured obligations. A lender should be able to establish, with some degree of certainty, which laws will determine the contractual effect of the lending transaction. Proper execution of the documentation can be

¹⁰¹ *Wrexham Association Football Club Ltd (in Administration) v Crucialmove Ltd* [2006] EWCA Civ 237; [2008] 1 BCLC 508; *Rolled Steel Products (Holdings) Ltd v British Steel Corporation* [1986] Ch 246; and *Royal British Bank v Turquand* (1856) 6 E & B 327.

¹⁰² Calnan (n 14) 145, 5.32.

¹⁰³ *Ibid.*

¹⁰⁴ See the First Company Law Amendment Directive which came into force on the 1st January 2007 and makes companies legally obliged to include specific information on their websites, business letters, notices etc.

¹⁰⁵ acting normally through its liquidator or administrator.

¹⁰⁶ Calnan (n 14) 145, 5.31.

checked by reference to the place of incorporation of the debtor and the effectiveness of the contractual arrangements can be ensured by choosing an appropriate governing law.¹⁰⁷

- 1.53 These rules only apply, however, where England is the forum for the dispute. Where the dispute is litigated abroad, it will be the courts of the forum concerned which will determine the conflict of law rules to be applied. However where the country concerned is a Member State, there should be a substantial degree of consistency of approach to those matters to which Rome I applies. Unfortunately there are still some areas of uncertainty in relation to matters which are not the subject of Rome I which will depend on the domestic law of the jurisdiction concerned.

The proprietary issues involved in cross-border security arrangements

- 1.54 In terms of proprietary issues, the Lender's fundamental concern, when taking security, is to ascertain that a valid proprietary interest is acquired in each and every asset that the security comprises of. It is crucial that a proprietary interest is obtained by the Lender that will bite effectively on all the assets involved in the cross-border transaction wherever these assets are situated.¹⁰⁸
- 1.55 The complicated issues that arise in cross-border secured financings can be illustrated by an example given by Calnan¹⁰⁹ but with slight modifications to reflect the focus of this thesis (which is on English-incorporated lenders lending within the European Union. The debtor

¹⁰⁷ Calnan (n 14), 486, although these are not the only two laws which can affect the outcome, they are by far the most important in practice.

¹⁰⁸ See Calnan (n 14) 486-487, 13.67.

¹⁰⁹ Calnan (n 14) 487, 13.68.

creates security over goods situated in France and over a contract governed by the law of Italy. The security documents are expressed to be governed by English law, and are executed in Belgium. The goods are subsequently moved to Spain.

- 1.56 Which laws may be relevant in this case? They are numerous. English law expressly governs the security documents. Belgian law is relevant to the creation of the security as the documents were executed in Belgium. Italian law governs the debtor's rights under the contract which forms part of the security package. French law is clearly in play because France was the *lex situs* of the goods when the security was created. However, the goods have now moved bringing Spanish law into play as the current *lex situs* of the goods.¹¹⁰
- 1.57 The question that arises is which law will govern the proprietary effects of the security. This depends on the law of the forum (*lex fori*) and, if that is English law, then the answer will depend on the classification of the asset over which the security is taken. The problem lies in which classification should be used as different rules apply to different types of asset. It should also be noted that only in a situation of conflict will a court need to decide between two different systems of law. It may be that, upon further review, a conflict does not actually exist.¹¹¹

The distinction between movables and immovables

- 1.58 Although for domestic purposes, English law distinguishes between real property and personal property, in English conflict of laws, the

¹¹⁰ Calnan (n 14) 487, 13.69.

¹¹¹ Calnan (n 14) 488, 13.76.

more universal distinction between movables and immovables is used.¹¹² The following extract from *Re Hoyles* makes this clear:

“In order to arrive at a common basis on which to determine questions between the inhabitants of two countries living under different systems of jurisprudence, our courts act on a division otherwise unknown to our law into movable and immovable.”¹¹³

The distinction between movables and immovables must not be confused with the distinction between tangible and intangible things. Tangible things are either movable (e.g. goods) or immovable (e.g. land). In practical terms a distinction between movables and immovables is not suitable for intangible things such as debts, stocks and shares, patents, trademarks, copyright and goodwill since “a thing which cannot be touched obviously cannot be moved.”¹¹⁴

- 1.59 It is submitted that, logically, things should be classified as tangible things, which may be either movable or immovable, and intangibles.¹¹⁵ This is despite the fact it is usual practice to classify all things as being movable or immovable for the purposes of conflict of laws, and to include intangible things in movables, and even to give an artificial *situs* to intangible things to allow them to come within the ambit of the rules of law expressed in the terms of the *situs*.¹¹⁶
- 1.60 Calnan argues that the categorization of assets as ‘movable’ or ‘immovable’ is not particularly helpful in relation to commercial transactions and what the courts actually do in practice.¹¹⁷ His

¹¹² *Re Hoyles* [1911] 1 Ch 179 (CA); *Re Berchtold* [1923] 1 Ch 192; *Macdonald v Macdonald*, 1932 SC (HL) 79.

¹¹³ *Re Hoyles* (n 110) 185, Farwell L.J suggested that the English courts only adopt the distinction between movables and immovables when the conflict is between English law and the law of a country which does not recognize the distinction between realty and personalty, and not when the conflict is between English law and the law of a country which does recognize that distinction.

¹¹⁴ D & M (n 16), 22-010.

¹¹⁵ *Ibid.*, 22-010. Some learned authors prefer categorizing between movables and immovables and between tangible and intangible movables. See M& B (n 16) 15-002, p. 394.

¹¹⁶ D & M (n 16), 22-010, Rule 120.

¹¹⁷ Calnan (n 14), 13.73, 488.

argument is that the terms ‘movables’ and ‘immovables’ cannot effectively be used in evaluating which law governs the proprietary effects in a specific transaction. This is based on studies of cases regarding the consensual transfers of certain assets including the creation of security.¹¹⁸

- 1.61 The Lender will have to consider, however, that different systems of law may characterize things as movable and immovable in varying ways. In all systems, some physically movable things are so closely connected with land that, for legal purposes, they are characterized as immovables. There may, therefore, be a conflict between the *lex fori* and the *lex situs* as to whether a particular thing is movable or immovable. In such a situation it is well established that it is the *lex situs* that determines the characterization.¹¹⁹
- 1.62 The Lender will also need to be aware of the difficulties that might arise if there is a change in *situs* of things that are physically movable. For instance it is problematic if things that are physically movable are moved from a jurisdiction which regards them as legally immovable to a jurisdiction which regards them as legally movable. It has been established that the new *lex situs* should determine their character.¹²⁰

The distinction between tangible/intangible

- 1.63 The subdivision of movables/immovables into tangible and intangible assets appears to bear more relationship to the law as it is actually applied by the courts in relation to commercial transactions.¹²¹ There are two basic principles which the court’s decision will be based on regarding the law which governs the proprietary effects of a transaction.

¹¹⁸ *Ibid.*

¹¹⁹ See n 110: *Re Hoyles ; Re Berchtold*; and *Macdonald* .

¹²⁰ *Middleton v Cottesloe* [1949] AC 418.

¹²¹ *Calnan* (n 14), 13.74, 488.

In order to consider these principles it is convenient to divide tangible assets into the categories of land and goods and adopt a separate category for intangibles.

1.64 Calnan expresses these two principles in the following terms:

“The proprietary effect of a transaction in respect of a tangible asset is decided by the law of the place where the asset is located (ie the *lex situs*) at the time the transaction is effected. The proprietary effect of a transaction in respect of an intangible asset is decided by the law under which that intangible asset has been created. Where the asset concerned is created by contract, the relevant law will be the governing law of the contract.”¹²²

Taking security over land

1.65 The general rule in English law, as in other systems, is that the *lex situs* is the governing law for proprietary issues relating to immovable property. Therefore when taking security over land, the proprietary effect of the documentation will be governed by the *lex situs* and, in practice, any security documentation should comply with, and be expressed to be governed by, that law.¹²³ The justification usually given for the application of the *lex situs* is that any other rule would be ineffective, because in the last resort land can only be dealt with in a manner which the *lex situs* allows.¹²⁴

1.66 Art 6(4) of Brussels I enables the court of the situs of immovable property to combine an action relating to a contract with an action (against the same defendant, one domiciled in a Member State) relating

¹²² Calnan (n 14) 488, 13.74. See also Rome I, Art 3(1).

¹²³ Rule 121, D & M (n 16), 23R-001. Where an action concerns immovable property, the courts of the country where the land is situated will also have exclusive jurisdiction under Article 22(1) of Brussels I.

¹²⁴ D & M (n 16) 23-003.

to rights in rem in the property even if the court would not otherwise have jurisdiction over the contractual action. It follows from this that if the land in question is in England and Brussels I does not apply, the English court may take jurisdiction by allowing service out of the jurisdiction under the Civil Procedure Rules on the basis that the whole subject matter of a claim relates to property within the jurisdiction.¹²⁵ Where the land is in another part of the United Kingdom or another Member State, the jurisdiction of the English court will be excluded in accordance with Brussels I. However, if the land (any immovable) is situated outside England then, as a general rule, English courts have no jurisdiction to entertain an action for the determination of the title to, or the right to possession of that particular land (immovable).¹²⁶ There is no doubt, however, that it would be extremely unusual for a document creating or transferring an interest in land to be governed by any law other than the law of the jurisdiction in which the land is located.¹²⁷

- 1.67 One potential difficulty for the Lender is that it may be necessary to ascertain the scope of application of a relevant foreign law. For example, an English company may give a charge over land in a European country (X) to the Lender. Confusion will arise if in X unregistered charges granted over land are void. The question then becomes the potentially difficult one of ascertaining whether X's law applies to charges over land situated in X or merely to charges created by companies incorporated in X. If the latter, it may be that a court in X will not have to apply registration requirements, in which case the English courts should do likewise.¹²⁸
- 1.68 The Lender should note that the proprietary effect of the documentation will be governed by the *lex situs* and, in practice, any security documentation should comply with, and be expressed to be governed by, that law. The scope of application of registration requirements will

¹²⁵ CPR, r 6.20(10). See D & M (n 16) 15-009 – 15-011.

¹²⁶ *British South Africa Co. v Companhia de Mocambique* [1893] AC 602; *Re Polly Peck International plc (No. 2)* [1998] All ER 812, at 829-830. See now Brussels I, Article 22(1).

¹²⁷ See Stevens (n 47) 210.

¹²⁸ *Bank of Africa v Cohen* [1909] 2 Ch 129. See Stevens (n 47) 210.

probably be discoverable by the mode of registration, whether in a land registry or a companies' register or both.¹²⁹

- 1.69 The Lender also needs to consider whether the *lex situs* or the *lex fori* will govern the order of priorities where there is more than one security interest created over foreign land. It is suggested that it is 'possible' that the priority of claims is governed by the *lex situs*.¹³⁰ However it would be more convenient to apply the same system of law to determine both the validity and the priority of a security interest over land.¹³¹ There are strong justifications for applying the *lex situs* which is a single unchanging system of law. Although the application of the *lex fori* has the advantage that it may give a uniform result when applied to charges granted over assets in disparate jurisdictions, it may also encourage forum shopping.¹³²

Taking security over goods

- 1.70 In terms of proprietary issues, the Lender needs to be aware of the general doctrine that the *lex situs* at the time of the transaction governs the proprietary effects of a transaction. Any transaction regarding the creation or transfer of a proprietary interest in goods,¹³³ whether legal or

¹²⁹ If the debtor company is registered in England and Wales the certain types of security that are registrable are charges created by the company falling within the one of the categories listed in s 860(7) of the Companies Act 2006 (previously s 396(1) of the Companies Act 1985). Failure to comply with registration requirements threatens the value of the security and, although it will not render the security wholly void, the secured creditor will be put at a considerable disadvantage in a priority dispute against a third party. See further Calnan (n 14), 157-189.

¹³⁰ D & M (n 16) 170; *Norton v Florence Land and Public Works* (1877) 7 ChD 332; *Macmillan Inc v Bishopsgate Investment Trust plc (No 3)* [1996] 1 WLR 387, 399.

¹³¹ See Stevens (n 47) 210.

¹³² *Ibid.*

¹³³ The term 'goods' includes all types of tangible property besides land. It encompasses not just goods in the ordinary sense of that term but extends, in addition, also to intangibles which are the subject of a document of title, the transfer of which (with any required endorsement)

equitable, by way of security or outright, and whether consensual or by operation of law are covered by this principle. However, general transfers of goods by operation of law, such as under the rules of succession on death or bankruptcy, are not included. The law of the domicile of the person concerned will govern the potential effects of such general transfers by operation of law. However, generally the *lex situs* of the goods at the relevant time governs the effectiveness of specific transfers.¹³⁴

- 1.71 Where the goods remain in one jurisdiction, this rule has great merit as it is certain and probably corresponds with reasonable expectations. Where, however, a charge is granted over movables in different jurisdictions, the *situs* of which change over time, the justification for applying the *lex situs* of each asset at the time that the charge is granted to determine validity is overwhelming. It can probably be argued that applying the *lex situs* of the assets at the time of the transaction is far less predictable than applying the *lex fori*. However the most important factor is what renders the most fair, just and practical solution according to practical examples and case law.
- 1.72 The application of the rule is more easily understood in practice when looking at three specific cases. The subject matter of the first two cases was an outright transfer whereas the third case is concerned with a transfer by way of security. The case of *Cammell v Sewell*¹³⁵ is important as laying down clearly the principle that the proprietary effect of a purported transfer of goods is governed by the *lex situs* of the goods at the time of transfer. The judgment of the majority of the court was given by Crompton J who held that:¹³⁶

passes title not just to the document but also the underlying intangible (examples of which include negotiable instruments and bearer securities). See Calnan (n 14), 490, 13.82.

¹³⁴ *Cammell v Sewell* (1858) 3 H & N 617; (1860) 5 H & N 728. See also Calnan (n 14), 13.83, 490.

¹³⁵ *Cammell* (n 132).

¹³⁶ *Ibid*, 744-745.

“ if personal property is disposed of in a manner binding according to the law of the country where it is, that disposition is binding everywhere.”

1.73 Relying principally on *Cammell v Sewell*, Slade J also followed the approach taken by Crompton J and applied it in *Winckworth v Christie Manson and Woods*.¹³⁷ Artistic works were stolen from the claimant in England, transported to Italy and subsequently purchased by the defendant. The question that arose was which law governed the proprietary effects of the sale in Italy, English law or Italian law? It was decided that Italian law applied and hence this case emphasizes the extent of the principle that the *lex situs* at the time of the transfer governs the proprietary effects of the transfer.¹³⁸

1.74 In *Inglis v Robertson*¹³⁹ the House of Lords decided that the issue as to whether an individual had obtained effective security over goods stored in a warehouse in Scotland was a matter of Scots law. Lord Watson said:¹⁴⁰

“It would, in my opinion, be contrary to the elementary principles of international law, and so far as I know, without authority, to hold that the right of a Scottish creditor when so perfected can be defeated by a transaction between his debtor and the citizen of a foreign country which would be according to the laws of that country, but is not according to the law of Scotland, sufficient to create a real right in the goods.”

1.75 The three cases demonstrate the broad application of the principle.¹⁴¹ They establish that the proprietary effect of a transaction is governed by the law of the jurisdiction where the goods are located at the time of the

¹³⁷ [1980] Ch 496.

¹³⁸ See Calnan (n 14), 13.90-13.93, 491.

¹³⁹ [1898] AC 616.

¹⁴⁰ *Ibid.*, 625.

¹⁴¹ See also *Glencore International v Metro Trading International* [2001] 1 Lloyd's Rep 284; *Hardwick Game Farm v Suffolk Agricultural Poultry Producers Association* [1966] 1 WLR 287.

transaction even if the goods were removed to that jurisdiction without the knowledge or consent of their owner¹⁴² and the goods are subsequently returned to the jurisdiction in which they were originally located.

- 1.76 In *Alcock v Smith*¹⁴³ it was held that the same principle is applicable in relation to documentary intangibles.¹⁴⁴ In this case the asset was a negotiable instrument, but the principle is equally applicable to bearer securities and other similar transferable instruments. What matters is that the instrument can be transferred by delivery (and, if necessary, endorsement) and so, in this respect, analogous to goods.¹⁴⁵

Exceptions to the principle

- 1.77 There are exceptions to the principle that the proprietary effects of a transfer are governed by the *lex situs*. The principle will not be applied if to do so would be manifestly contrary to English public policy.¹⁴⁶ Although, in practice, English law is unlikely to refuse to apply the *lex situs* on these grounds, a jurisdiction that has more restrictive laws may not want to recognize security formed in the more liberal jurisdiction if the relevant asset is moved into its own jurisdiction and the security fails to meet its requirements and formalities.¹⁴⁷
- 1.78 English law, for instance, recognizes a broad concept of non-possessory security. It is unlikely to find that security created in accordance with a foreign law offends against the fundamental principles of the English law of security. However this will not always be the case in jurisdictions which have a more restrictive concept of non-possessory

¹⁴² See especially *Winckworth* (n 135) where the assets were taken to Italy without the owner's consent.

¹⁴³ [1892] 1 Ch 238.

¹⁴⁴ *Calnan* (n 14) 492, 13.96.

¹⁴⁵ *Calnan* (n 14) 493.

¹⁴⁶ Byles J gave a dissenting judgment on this ground in *Cammell* (n 132) 747-752.

¹⁴⁷ *Calnan* (n 14), 13.107, 495.

security. For example, in Scotland, there is authority for the proposition that a security interest created in another jurisdiction in accordance with its laws is ineffective in Scotland if it does not comply with the more stringent requirements of Scots law as to the creation of security.¹⁴⁸

- 1.79 There are four other potential exceptions of which the Lender needs to be aware.¹⁴⁹ The first is recognition that the *lex situs* principle applies to particular transfers of goods, not to general assignments of goods on bankruptcy or succession. The second suggested exception is ‘where a purchaser claiming title has not acted bona fide’.¹⁵⁰ The third exception is where ‘a statute in force in the country which is the forum in which the case is heard obliges the court to apply the law of its own country’.¹⁵¹ Finally, ‘if a tangible movable is in transit, and its *situs* is casual or not known, a transfer which is valid and effective by its applicable law will (semble) be valid and effective in England.’¹⁵² However, in practice, most of these exceptions are only likely to occur in limited circumstances.¹⁵³

Priorities in Property Law¹⁵⁴

- 1.80 One of the Lender’s main concerns is to ensure that his security is effective against third parties who also obtain a proprietary interest in the tangible assets concerned. Whether or not his security is effective against them depends on the priority rules, which must now briefly be considered. The basic priority rule of English law is that priorities between two competing security interests in an asset depend on the time

¹⁴⁸ *Hammer and Sohne v HWT Realisations* 1985 SLT 21 and *Inglis* (n 137).

¹⁴⁹ These were discussed by Slade J in *Winkworth* (n 135).

¹⁵⁰ *Winkworth* (n 135) 501. This exception was doubted by Moore-Bick J in *Glencore* (n 139) 295.

¹⁵¹ *Winkworth* (n 135) 501.

¹⁵² *D & M* (n 16), Exception to Rule 116.

¹⁵³ *Calnan* (n 14) 496.

¹⁵⁴ Contrast statutory priorities which are ‘insolvency effects’.

of creation of each interest. The first in time prevails. There are, however, a number of exceptions to this basic principle, the five most important of which in practice are: the bona fide purchaser rule;¹⁵⁵ the rule in *Dearle v Hall* (governing priorities in relation to dealings with choses of action such as receivables);¹⁵⁶ registration;¹⁵⁷ cases where ‘the equities are unequal’;¹⁵⁸ and the ‘purchase money security interest’.¹⁵⁹

1.81 Another issue for consideration is whether there is a separate rule governing priorities in tangible movables. It was held that the *lex situs* principle does not apply to determine the priority of two security interests created over the same asset; and that priorities in movables are an issue for the *lex fori*.¹⁶⁰ Applying the *lex fori* to issues of priority, however, may encourage forum shopping, something which the English rules on jurisdiction will not necessarily prevent.¹⁶¹ It is argued, and the writer agrees, that there is not really a separate rule for priorities. The *lex situs* of the goods at the time of the transaction should also determine all issues regarding the priorities in a transaction relating to goods.¹⁶²

1.82 The reasoning behind the fact that there is no separate rule for priorities is based on case law that establishes that the *lex situs* governs the

¹⁵⁵ See generally R Calnan, ‘Taking Security in England’ in Michael Bridge & Robert Stevens (eds), *Cross Border Security and Insolvency* (Oxford University Press, Oxford 2001) 27-28.

¹⁵⁶ (1828) 3 Russ 1. See Calnan (n 153), 28 for further discussion.

¹⁵⁷ Certain types of security interest are registrable in order to be effective when enforced. For discussion of how registration can affect priorities, see Calnan (n 153).

¹⁵⁸ A further exception to the basic priority principle is that it only applies ‘where the equities are equal’. The courts may decide that the basic priority rules should be overridden because, in the particular circumstances of the case, it is inequitable to apply the first in time rule. See Calnan (n 153), 30.

¹⁵⁹ Where a creditor has specifically financed the acquisition by a debtor of a particular asset on the basis that the asset will be charged to that creditor, its charge (‘purchase money security interest’) will take priority over an earlier general charge over the present and future assets of the company. See *Abbey National Building Society v Cann* [1991] 1 AC 56 (HL). See also Calnan (n 153), 30-31.

¹⁶⁰ The decision of the Privy Council in *Bankers Trust International v Todd Shipyards Corpn, The Halcyon Isle* [1981] AC 221.

¹⁶¹ See Stevens (n 47) 213. See also 2.45 – 2.55 & 3.7 – 3.17 regarding the issue of ‘forum shopping’ and whether the EIR addresses this issue.

¹⁶² Calnan (n 14), 13.117, 497.

proprietary effect of transfers of goods,¹⁶³ and that it also governs the creation of proprietary interests by way of security.¹⁶⁴ What distinguishes a proprietary right from a personal one is the ability of the owner of the proprietary right to enforce it against persons other than those by whom it was created.¹⁶⁵ In principle, the *lex situs* at the time of the transaction should govern all issues relating to the proprietary effect of a transaction involving goods¹⁶⁶ and hence there is no separate rule for priorities.¹⁶⁷ If the *lex situs* principle governs the effect of the creation of a proprietary interest in goods, it should subsequently also resolve not only whether the transfer is effective between its immediate parties but also its impact on third parties.¹⁶⁸

- 1.83 The issue relating to priorities becomes problematic in situations where there is more than one transaction relating to the goods in question. In the absence of much instructive case-law, one of the major difficulties perceived is that the *lex situs* of tangible movables may change, unlike the *lex situs* of immovables or the law governing an intangible movable. The following example demonstrates the intricacies involved.¹⁶⁹ The debtor company (A Ltd) grants a fixed charge over goods located in country X to the Lender (B). The goods are subsequently moved to country Y. A Ltd there sells the goods to C Ltd making representations that it possesses an unencumbered title. C Ltd takes the goods in good faith. The validity of B's charge will be determined by the law of X. The law of Y (where the goods were situated when A Ltd sells them to C Ltd) should establish the consequences of the second transaction. A Ltd is selling goods subject to a charge to a third party however, if by the law of Y, a bona fide purchaser acquired good title then C Ltd's title

¹⁶³ *Cammell* (n 132); and *Winkworth* (n 132).

¹⁶⁴ *Inglis* (n 137).

¹⁶⁵ This is based on the general proposition that property rights bind the world (with certain exceptions in the case of equitable proprietary rights).

¹⁶⁶ It is submitted that *Halcyon* (n 158) does not say anything to the contrary. See Calnan (n 14), 496-497.

¹⁶⁷ Calnan (n 14), 497.

¹⁶⁸ Calnan (n 14), 496.

¹⁶⁹ Drawn from *D & M* (n 16) 24-014 and referred to in *Stevens* (n 47) 211.

would prevail against B.¹⁷⁰ The question that arises is whether, under the law of the *lex situs* of the goods at the time of transaction, the third party is treated as a bona fide purchaser and takes the goods free of any incumbrances.¹⁷¹

- 1.84 Questions of priority can lead to grave difficulties where more than two jurisdictions are involved. The problem is that, if the goods are transferred to a third state, Z, where a further security interest is created in favour of H bank, which law or laws are to determine priority? Again, assuming that all three charges have been validly created, one solution would be to determine whether E bank has priority over G bank according to the law of Y, and for the law of Z to determine the consequences of the third transaction. If by the law of Z, unregistered charges,¹⁷² over movables are void as against other creditors, H bank's charge should have priority.¹⁷³
- 1.85 Difficulties may arise due to varying inconsistent approaches favoured by the different choices of law resulting in circularity problems. For instance, D bank having priority over E bank which has priority over F bank which in turn has priority over D bank. The difficulties are emphasized in the situation where a company grants successive charges over movables located in different jurisdictions. Over all, the complexities are obvious when working out the priorities with reference to the consequences of each successive transaction by the law of the *situs* of each asset at the relevant time. Although the negative implications have been discussed, it has been conversely argued that applying the *lex fori* may be simpler as it establishes a single system of law by which to rank the various claims, each of which may be

¹⁷⁰ *Ibid.* 24-021.

¹⁷¹ The issue also arises whether, by the law of Y (where the assets are situated at the time of the transaction), a non-possessory security is void as against a bona fide purchaser unless formal registration requirements are complied with. See Stevens (n 47) 212.

¹⁷² Whether foreign or domestic.

¹⁷³ Stevens (n 47) 212.

governed by different laws over assets which might be located in a number of jurisdictions which vary over time.¹⁷⁴

Taking security over Intangibles

- 1.86 When it comes to establishing the law which governs the proprietary effect of transactions involving intangible assets such as book debts, assignable contract rights and intellectual property rights,¹⁷⁵ the Lender needs to be wary as the position is much less clear than it is in relation to tangible assets. One of the main reasons for the lack of clarity and complexity is due to the fact that there are not many decided cases regarding the proprietary aspects of transactions in relation to intangibles.¹⁷⁶
- 1.87 It is not easy to clearly state the choice of rules which govern the assignment or transfer of intangible property due to the fact that the category of intangible things encompasses a broad range of property and rights. This includes not only simple contractual debts and bank deposits but also shares in companies and the securities and other financial instruments whose issue and trading supports the majority of the capital markets of the developed world.¹⁷⁷
- 1.88 Debts and securities are intangible property which is substantially contractual in origin. However, other intangibles, such as rights to sue a tortfeasor, rights arising under trusts, rights in intellectual property, etc, do not have an obviously contractual origin.¹⁷⁸ It therefore appears

¹⁷⁴ *Ibid.* 212

¹⁷⁵ In relation to IP rights see P Torremans, *Holyoak and Torremans, Intellectual Property Law* (6th edn, Oxford 2010).

¹⁷⁶ Calnan (n 14), 499.

¹⁷⁷ D & M (n 16) 24-051.

¹⁷⁸ Even if they have previously been assigned by way of contract: *Peer International Corp v Termidor Musical Publications Ltd* [2003] EWCA Civ, 1156, [2004] Ch 212.

unrealistic for a single choice of law rule to govern all issues relating to the assignment of all such property.¹⁷⁹

- 1.89 In relation to the assignment of intangible property the choice of law rules have to include quite a broad range of legal situations therefore necessitating caution to be exercised when stating and applying a rule to a factual context to which it has not formerly been held to extend, or in applying a rule in a context in which rights have arisen consensually (based on contract) to a context where rights have arisen by other means.¹⁸⁰
- 1.90 Today, some categories of intangible property may be represented by certificates or other pieces of paper which may themselves be taken to be the “thing” in respect of which the rules governing the assignment are to operate; this may mean that the choice of law rules for tangible movable property apply to them.¹⁸¹
- 1.91 Other examples of intangible assets may be recorded on a register which means that acting in accordance with the law of the place where the register is maintained may be key in deciding any issues of transfer, or of competing transfers, of rights. Furthermore, other types of intangible property may be held, traded and dealt with in computerized dealing and settlement systems, and in these cases a choice of law rule developed for the assignment of simple contractual debts may not be suitable. With regard to those intangibles which are not contractual in nature, a choice of law rule designed for the assignment of contractual rights will not be obviously justifiable.¹⁸²
- 1.92 A proprietary right is a right which is available not just against the other contracting party (in this case, the assignor) but also against other persons (in this case, the debtor). Overall there appear to be two

¹⁷⁹ D & M (n 16) 24-051.

¹⁸⁰ *Ibid.*

¹⁸¹ Where the document itself is negotiable, and dealings are undertaken by the negotiation of the document, the choice of law rules will be those applicable to negotiable instruments. See D & M (n 16) 33R-322 et seq.

¹⁸² D & M (n 16) 24-051.

possibilities for which law will govern the proprietary effect of transactions involving intangibles:

“the law of the place where of the intangible asset is located (the *lex situs*) at the time of the transaction;¹⁸³ and the law which governs the intangible (i.e., in the case of an intangible asset created by contract, the law which governs that contract).”¹⁸⁴

The application of Rome I and whether Article 14 governs the proprietary effect of a transaction in relation to an intangible

- 1.93 Article 14(1) of Rome I¹⁸⁵ clarifies some uncertainties and simply expresses that the personal rights and obligations of the assignor and assignee are governed by the law of the contract between them. Article 14(2) establishes that the law which governs the intangible concerned determines: whether the right is of a kind which can be assigned as a matter of general law and whether any contractual prohibition on assignment is effective; the relationship between the assignee and the debtor and the conditions and whether, as a result of the assignment, the assignee is entitled to recovery from the debtor; and the circumstances in which the debtor has to pay the assignee and will not obtain a good discharge by paying the assignor.¹⁸⁶
- 1.94 Controversy arises in establishing the extent to which Article 14 is determinative of the proprietary consequences of assignment. Article 14(2) refers to ‘assignments’ and ‘contractual subrogation’ and Article 14(3) includes within the ambit of the provision outright transfers of

¹⁸³This was the view initially favoured by D & M (n 16) and was subsequently adopted by a number of cases. Calnan argues that later D & M changed its mind, in favour of the law which governs the intangible asset concerned. See Calnan (n 14), 500, 13.130.

¹⁸⁴ Calnan (n 14), 500.

¹⁸⁵ Previously Rome Article 12(1) which did not expressly include ‘contractual subrogation of claim’.

¹⁸⁶ Calnan (n 14), 500-501.

claims, transfers of claims by way of security and pledges or other security rights over claims. This appears to extend to any consensual transaction by which proprietary rights are transferred or created, including by means of a charge. There are however some limits on its application.¹⁸⁷

- 1.95 Firstly, it only applies where there has been ‘a voluntary assignment of a right against another person’. It does not, therefore, have an impact on general assignments on bankruptcy or succession, in respect of which there are separate rules (in relation to both tangibles and intangibles) which refer to the law of the domicile of the person concerned. Secondly, it does not apply to transfers of all types of intangible. It does not extend to transfers of shares¹⁸⁸ or to certain types of insurance contract,¹⁸⁹ although these are relatively minor exceptions. There are also special rules for financial collateral.¹⁹⁰
- 1.96 Some commentators have taken the view that the proprietary consequences of assignment are outside the scope of Rome I.¹⁹¹ Some support for this contention may be derived from the Giuliano-Lagarde Report on the Rome Convention which states that, ‘since the Convention is concerned only with the law applicable to contractual obligations, property rightsare not governed by these provisions.’¹⁹² Article 14(1) is clearly concerned with the personal effect of the contract between the assignor and assignee. Article 14(2) is, however, different and does not deal with the relationship between assignor and

¹⁸⁷ Calnan (n 14), 501.

¹⁸⁸ Rome I, Art 1(2)(f). See *Macmillan* (n 128) regarding the governing law in relation to the proprietary effect of a transfer of shares.

¹⁸⁹ Rome I, Art 1(2)(j).

¹⁹⁰ In the case of financial collateral arrangements, there are particular rules which govern conflict of law issues where security is taken over securities the title to which is evidenced by book-entries in accounts with intermediaries. In such cases, the proprietary effect of the security is governed by the domestic law of the country in which the relevant account is maintained. See Financial Collateral Arrangements (No 2) Regulations 2003, SI 2003/3266, reg 19. See also Calnan (n 14), 13.153, 506.

¹⁹¹ R Goode, *Commercial Law* (Penguin, 2nd edn 1995) 1127-1129; Moshinsky (1992) 108 LQR. 591; Struycken [1998] LMCLQ 345, 346.

¹⁹² Giuliano-Lagarde (n 68), 10.

assignee but with their relationship with the debtor,¹⁹³ and therefore has a proprietary effect.

- 1.97 The juxtaposition of Article 14(1) and (2) suggests clearly that a distinction is being drawn between the law which governs the relationship between the assignor and the assignee and the law which governs their relationship with the debtor. The latter is clearly concerned with the proprietary effects of the assignment. Where there is more than one assignment the law governing the right assigned determines to which of the assignees the right has been transferred. The law governing the right assigned should therefore determine priority.¹⁹⁴
- 1.98 Overall there will only be one law governing the right in question and, in the case of multiple assignments, in different locations, governed by different laws, it establishes a unilateral system which will determine the order of priority. Furthermore, the debtor and the original creditor may have expressly or impliedly chosen a system of law to govern the obligation. Where this is the case, the debtor will justifiably presume that the obligations he is under, including to whom they are owed, will be determined by the law governing the right chosen.¹⁹⁵
- 1.99 One potential disadvantage of the approach suggested is that, a creditor needs to be wary of making a global assignment of present and future debts, as different laws may apply to different debts. It would not therefore be possible for an assignee to refer to a single law to determine which debts are assignable and what is required in order to perfect the assignments and establish priority.¹⁹⁶ However whilst this disadvantage is real enough, in practice, there are issues that help in alleviating risk. For instance, a supplier who wishes to assign the debts

¹⁹³ Calnan (n 14) 501, 13.137.

¹⁹⁴ See Stevens (n 47) 214.

¹⁹⁵ See Stevens (n 47) 214. By way of example, if under the law chosen to govern, a right may not be assigned until notice is given to the debtor, it would be unsatisfactory to allow rights to be acquired against the debtor by applying a system of law which imposed no such requirement.

¹⁹⁶ For example, whether notice to debtors is required.

owed by purchasers may, if the contracts of sale were in a standard form, have stipulated that the same law was to apply to each sale. Furthermore, even where no law has expressly been stipulated for, the law of the country where the party required to effect the characteristic performance of the contract has his habitual residence would be presumed to apply to all the debts.¹⁹⁷

1.100 It needs to be noted, however, that there is a substantial body of opinion that favours the application of the *lex situs* of the debt to determine proprietary issues.¹⁹⁸ The main reason for this view is that Rome I is concerned with contractual matters and not with proprietary issues although we have discussed¹⁹⁹ the weakness of this contention in this context. Furthermore, it makes little sense, in terms of global assignments of existing and future debts, as the places of residence of the various debtors may be unascertainable and multifarious.²⁰⁰ Some commentators who have supported the application of the *lex situs* have suggested that an exception should be made for global assignments and the law of the assignor's place of residence applied.²⁰¹ However, in relation to this contention, clarification is required regarding what is deemed to be a global assignment for these purposes and in terms of two debts or more where the residence of the debtors is different.²⁰²

1.101 On the whole, it appears that confusion in understanding the principles applicable to the transfer of title to intangible property is caused by the search for a *lex situs*.²⁰³ There is no doubt that, if necessary, it is possible to attribute a location to an intangible asset.²⁰⁴ There are, therefore, rules which can be applied for attributing a location to an

¹⁹⁷ Rome I, Art 4(2). See also Stevens (n 47) 215.

¹⁹⁸ See n 186.

¹⁹⁹ See 1.96-1.98.

²⁰⁰ Stevens (n 47) 215.

²⁰¹ See n 186.

²⁰² Stevens (n 47) 216.

²⁰³ Application of the *lex situs* initially appears attractive as it conforms with the approach taken in relation to tangible property however any *situs* that intangible property may have is a metaphysical one that cannot be justified by appeals to the analogy of the application of the *lex situs* to tangible property. See Stevens (n 47) 215.

²⁰⁴ *New York Life Assurance Company v Public Trustee* [1924] 2 Ch 101; *Re Maudslay, Sons & Field* [1900] 1 Ch 602.

intangible. However there is equally no doubt that to do so involves a very artificial and imprecise exercise that does not always correspond with commercial reality and lacks certainty.²⁰⁵

- 1.102 In the absence of statutory clarity, the Lender should take note of recent case law. The leading English case on the application of Article 12 of the Rome Convention²⁰⁶ is *Raffeisen*²⁰⁷ in which the Court of Appeal confirmed that the application of Article 12(2) of the Rome Convention has the effect that the rights of an assignee or chargee of most types of intangible asset are determined by the law governing that asset and not by the *lex situs*.²⁰⁸
- 1.103 In contrast with the application of the *lex situs*, the use of the governing law of the intangible has several benefits. It acknowledges the real differences between tangibles and intangibles and the fact that it is not possible simply to apply to intangible rules which were created for tangibles. It acknowledges that an intangible only exists because it has been created by a legal system and that it is therefore appropriate that its proprietary effects should be governed by that system. It is also consistent with the parties' reasonable expectation of what the rules should be.²⁰⁹
- 1.104 The problem regarding 'global' assignments has been discussed earlier. However, if the *lex situs* did govern the proprietary effects of the transaction, there would be the same difficulties. The principle that the proprietary effects of security over intangibles is determined by the governing law allows the creditor a level of certainty in establishing the relevant applicable laws and a firm basis on which to make decisions as

²⁰⁵ Atkin LJ in *New York Life* (n 202) at 119. See 1.95 & 1.105-1.107.

²⁰⁶ As mentioned this provision is superseded by Rome I, Art 14 (2) which has the same effect and wording as Art 12(2) apart for also applying to the relationship between assignor and assignee under a contractual subrogation of a claim against another person (the debtor). It is therefore safe to assume that *Raffeisen* (n 43) is still good law.

²⁰⁷ See n 43.

²⁰⁸ *Raffeisen* (n 43) [20] (Mance LJ).

²⁰⁹ Calnan (n 14), 506-507.

regards due diligence including the extent to which it is necessary to take advice on their effect.²¹⁰

Shares

- 1.105 It is clear that Rome I does not apply to the transfer of shares.²¹¹ The leading modern authority on the law applicable to validity and priority of proprietary rights in shares however is the Court of Appeal's decision in *Macmillan*.²¹² Instead of alleviating the confusion that already existed, the members of the Court of Appeal did not speak with one voice. They were agreed that the *lex situs* should apply but there was no unanimity as to where the *lex situs* of the shares actually is.²¹³
- 1.106 Aldous LJ's view was that shares are situated at the place of incorporation. Staughton LJ agreed, unless the shares are negotiable instruments by English law, when, presumably, the *lex situs* would be the *lex situs cartae*. He also considered it arguable that the *lex situs* may, in certain cases, be the law of the place where the share register is kept. Auld LJ's opinion was that the *lex situs* will be the country where the share register is kept, normally but not always the place of incorporation, unless the shares are negotiable when the *lex situs* will be the *lex situs cartae*.²¹⁴ It is submitted that, although Article 14(2) does not expressly apply to the transfer of shares, the logic behind Article 14(2)²¹⁵ is also relevant to shares. The correct proposition is that:

²¹⁰ Calnan (n 14), 507, 13.157.

²¹¹ Rome I, Art 1(2) (f).

²¹² Text to n 128.

²¹³ See Stevens (n 47) 217. .

²¹⁴ See Stevens (n 47)217. The Court of Appeal's decision was considered by Neuberger J in *Re Harvard Securities Ltd (in liq)* [1997] 2 BCLC 369 but this decision did little to clarify the situation.

²¹⁵ Which is that a transfer of an intangible should be governed by the law by which the intangible has been created.

“the creation of a proprietary interest in shares should be governed by the law of the place of incorporation of the company whose shares are in dispute because that is the law which governs the shares.”²¹⁶

Summary

- 1.107 At the inception of a security transaction, the Lender’s main concern is ensuring the lending transaction and underlying security interest are valid and enforceable pre-bankruptcy. By considering the main issues in the appropriate legal systems concerned it is possible for the Lender to obtain some level of comfort and minimize potential risk factors. The Lender will need to be aware of the potential effects of Brussels I and Rome I, which form the network of provisions which regulate the assumption of jurisdiction and choice of law treatment of cases before UK and all other member state courts.
- 1.108 In relation to the underlying security, the Lender will need to ascertain that the formalities regarding contract formation have been complied with; and the substantive and material issues ensuring there is a valid agreement in the first place. As discussed earlier, the parties can choose which law will govern the facility documentation, and most of the important personal effects of a contract will be determined by its governing law. The law of the place of incorporation of the debtor company will resolve issues such as: whether or not a debtor has duly executed the documentation it has entered into; and issues such as the debtor’s capacity to enter into agreement and also the authority of those who have entered into the documentation on the debtor’s behalf.
- 1.109 The Lender will want to minimize, as far as possible, circumstances that might lead to the security documents being set aside as a result of a

²¹⁶ Calnan (n 14), 505-506, 13.152.

vitiating factor. It has been identified that the most likely situation in which this will happen is where directors have acted in breach of their fiduciary duties when entering into the security transaction. Therefore the Lender should obtain from the debtor company an affirmation of any potential breach of duty by the directors and ensure that the directors had good reasons for entering into the security transaction and that they are properly documented in the company's board minutes.

- 1.110 In terms of predictability for the Lender, it is safe to assume that both the governing law of the contracts and the law of the debtor's place of incorporation can be ascertained with certainty, and appropriate investigations can be made. Although these laws may not cover every issue which might arise in relation to the security documents, complying with them will help in ensuring that the main problems concerning the personal effect of the transaction have been resolved. Complying with the formal registration requirements in each country where assets are known to be located will also aid the Lender in ensuring effective enforceability of the lending transaction and the underlying security interest.²¹⁷
- 1.111 As far as the proprietary effects of the transaction are concerned, the key distinction is between tangible and intangible assets. As discussed, in relation to taking security over land, the proprietary effect of the documentation will be governed by the *lex situs* and, in practice, any security documentation should comply with, and be expressed to be governed by, that law. In relation to tangible assets, the law is also reasonably clear. The proprietary effect of a transaction is determined by the *lex situs* of the asset concerned at the time of the transaction. In most cases this will not be difficult for the Lender to determine. There are exceptions to the *lex situs* principle however these are limited and overall not a great cause for concern.

²¹⁷ See Calnan (n 14) 507, 13.159.

- 1.112 The position in relation to intangibles is less clear. However Article 14(2) of Rome I and the decision in *Raiffeisan*²¹⁸ are helpful in clarifying what is likely to happen in respect of most types of intangible assets. They indicate that the law which governs the proprietary effect of a transaction in respect of most types of intangible is the law which governs the intangible concerned. The main exception to this rule is shares where the *lex situs* appears to be the determining factor. However, note that the *lex situs* will almost always be the law of the place of incorporation of the company whose shares are in dispute, and that will itself be the law which governs those shares.
- 1.113 In practice, therefore, the most important determining factor in relation to intangibles and, which will normally be easy for the Lender to identify, is the law which governs the intangible.
- 1.114 Therefore, when considering the proprietary effect of a transaction, the Lender will need to consider: the *lex situs* of the tangibles which form part of the security; and the governing law of the intangibles which form part of the security. Since the effectiveness of the proprietary elements of the security will be determined by these laws, it would be prudent for the security document to be governed by the law concerned. It is submitted,²¹⁹ and the writer thinks it makes good sense, to insist that the security document is governed by the law which represents the majority of assets or the predominant assets in the case of widespread assets that are governed by the laws of more than one jurisdiction .

²¹⁸ See n 43.

²¹⁹ See Calnan (n 14) 507, 13.159.

INSOLVENCY JURISDICTION AND INSOLVENCY EFFECTS

Bankruptcy proofing at the inception of the lending transaction

- 1.115 The logical preliminary consideration for the Lender, *ex ante*, before making any lending decisions is to conduct a risk assessment and take steps to ensure, in so far as possible, that realization of his security will take place subject to insolvency laws that do not erode the security in favour of other creditors. In this sense, the Lender will try and make the transaction as ‘bankruptcy proof’ as possible.²²⁰
- 1.116 If the Lender wants to make a transaction ‘bankruptcy proof’, he must consider the fact that the courts of a country may assert insolvency jurisdiction for different purposes in different circumstances. In the advent of insolvency proceedings the question arises of which regime provides the governing jurisdictional rules. The jurisdictional scope of the EIR can be identified by reference to the application of Brussels I, specifically Article 1(2)(b), which indicates that Brussels I does not apply to “bankruptcy proceedings relating to the winding up of insolvent companies or other legal proceedings, judicial arrangements, compositions and analogous proceedings”.²²¹
- 1.117 The first step will be to identify the jurisdictions in which insolvency proceedings might occur in order to assess the effects of the insolvency laws of those jurisdictions upon the transaction in question.²²² This

²²⁰ F & A (n 20) 258, 261-263.

²²¹ The case law of the European Court of Justice (ECJ) suggests that the Article 1(2)(b) exclusion applies to any action which derives directly from and is closely linked to insolvency proceedings: see: *Gourdain (Liquidator) v Nadler* (C-133/78)[1979] E.C.R. 733; *Seagon v Deko Marty Belgium NV* (C-339/07)[2009] 1 W.L.R. 2168; *SCT Industri AB (in Liquidation) v Alpenblume AB* (C-111/08) [2010] CEC 47; *German Graphics Graphische Maschinen GmbH v van der Schee* (C-292/08) [2010] CEC 499. See Bob Wessels, ‘On the edges of the EIR’, *Insolv Int.* 2010, 23(2), 22-25.

²²² See F & A (n 20) 255.

involves focusing on the contractual and proprietary issues faced by the Lender in each of those jurisdictions where insolvency proceedings might occur and discussing the traditional approach in English private international law and other countries. Generally, at the start of a security transaction, the Lender will assess risks in relation to enforceability of the transaction outside insolvency (such as when the company debtor defaults under the facility documentation) as well as analyzing the potential effects of insolvency. These issues were considered earlier in this chapter.

- 1.118 The rest of the chapter focuses on the impact and effects of insolvency proceedings. As a starting point, and by way of context, it would be helpful for the Lender to consider the attitude of the different courts to the principles of Universalism and Territorialism.

The attitude of different courts to Universalism and Territorialism

- 1.119 National systems have responded to cases of insolvency containing international elements by developing their rules of private international law, employing traditional techniques and concepts, to determine jurisdiction, choice of law, and international recognition in accordance with locally accepted norms of decision. Due to the resulting diversity of response, the quest for unifying principles has proved elusive.²²³ The historic struggle between opposing principles has, however, crystallized into two contrasting camps of opinion regarding the correct approach to be applied in questions of international insolvency. These are universalism and territorialism and generally they raise three main issues of debate: the issue of *ex ante* predictability to creditors of the bankruptcy laws applicable to the debtor's financial failure; the issue of

²²³ IF Fletcher, *Insolvency in Private International Law*, second edition, (2005, Oxford University Press), 11.

protection of local creditors and policies; and the issue of value maximization of insolvent transnational companies. For the purposes of this thesis, the overall concern is which theory will best protect secured creditors and maximize the value of their security.²²⁴

1.120 The following account briefly summarizes the contrasting arguments. Universalists argue that there should logically be a unified process of administration of the estate in the event of insolvency ensuring equal treatment of all creditors. In theory, a single insolvency representative means reduced administrative costs and more efficient decisions maximizing security value for creditors. A single insolvency representative will also better facilitate the rescue/reorganization of a viable multinational enterprise by effectively coordinating the use of assets located in different countries and preserving going concern value. Also, the most important *ex ante* advantage would be the higher predictability to creditors, resulting in a reduction in transaction costs and a more accurate pricing of credit. In contrast, universalists argue that a territorial system hinders value-maximization as it presents a clear risk that asset grabbing by local creditors in countries where assets that are necessary for the continuation of the business are situated will lead to piecemeal dismembering of the company's business with a resulting loss of going concern value. Territorialism would also adversely affect *ex ante* predictability to creditors by not guaranteeing foreign lenders exactly the same position as they have under their own home-country laws.²²⁵

²²⁴ See the following for more detailed arguments regarding the above and the advocates of territorialism: LM Lo Pucki, "Cooperation in International Bankruptcy: A Post-Universalist Approach" (1999) 84 Cornell Law Review: 696; LM Lopucki, "The Case for Cooperative Territoriality in International Bankruptcy", (2000) Michigan Law Review 98: 2216; LM Lo Pucki, "Universalism Unravels", American Bankruptcy Law Journal (2005) 79:143; F. Tung, "Is International Bankruptcy Possible?" (2001) 23 Michigan Journal of International Law, 31; F Tung, "Fear of Commitment in International Bankruptcy", 33 Geo. Wash Int'l L.Rev. 555 (2000 - 2001); F Tung, "Skepticism about Universalism: International Bankruptcy and International Relations, the Berkeley Law & Economics Working Papers, Volume 2001, Issue 1, Article 7.

²²⁵ *Ibid.*

1.121 The Lender will therefore have to take into account the attitude of any given jurisdiction to these principles in assessing ‘bankruptcy risk’ in relation to security. The principles of unity and plurality operate in close connection with the aforementioned principles of territoriality and universality and also need to be discussed.²²⁶

1.122 Bebchuk and Guzman assert that :

“Universalism implies that the assets of an insolvent company should be administered on a worldwide basis.”²²⁷

In its purest form, universalism would have all bankruptcy claims settled within the debtor’s ‘home country’ and would apply the substantive laws of that country.²²⁸ The territoriality principle applied in its strictest form entails that insolvency proceedings only affect assets situated in the State where the proceeding has been opened. In certain cases the scope of the domestic insolvency proceeding is restricted to assets located in the State where the proceeding has been opened.²²⁹ Furthermore an insolvency proceeding that under the law of the State where the proceeding has been opened encompasses the assets of the debtor world-wide may not have any or only limited effects in States that apply the territoriality principle.²³⁰ This would inevitably lead to

²²⁶ See 2.10 – 2.11 & Appendix 1, A.1 – A.21 in relation to the influence of these principles on the earlier draft Insolvency Conventions and the compromised solution of ‘modified universalism’ that was consequently adopted by the EIR.

²²⁷ L Bebchuk and A Guzman, ‘An Economic Analysis of Transnational Bankruptcies’ (1999) 42 *Journal of Law & Economics* 775; H Buxbaum, ‘Rethinking International Insolvency: The Neglected Role of Choice-of-Law Rules and Theory’ (2000) 36 *Stanford Journal of International Law* 23; A Guzman, ‘International Bankruptcy: In Defence of Universalism’, *Michigan Law Review* (June 2000), p.2177-2178; Westbrook, J L (2005), ‘Universalism and Choice of Law’, *Penn State International Law Review* 23: 625; S Franken, ‘Three Principles of Transnational Corporate Bankruptcy Law: A Review’ (2005) 11 *European Law Journal* 232.

²²⁸ Article 3(1) of the EIR adopts a ‘centre of main interests’ test for determining the home country: see 2.12 – 2.15. Problems abound in relation to determining the home country of multinational groups: see 2.24 – 2.30.

²²⁹ This is the case for instance with respect to territorial insolvency proceedings opened by virtue of Article 3(2) or (4) of the Regulation. See M Veder, *Cross Border Insolvency Proceedings and Security Rights* (Kluwer, 2004) 85.

²³⁰ This entails that the opening of an insolvency proceeding abroad does not affect assets situated in that State. The view of insolvency proceedings as a manifestation of the exercise of a State’s sovereign powers is central to the territoriality principle (especially where the opening of an insolvency proceeding is regarded as resulting in a general attachment on the debtor’s assets). See Veder (n 227) 85.

the opening of multiple parallel insolvency debtors in respect of the same debtor, in order to include the debtor's entire estate in the realization of the estate and the distribution of the proceedings among his creditors.

- 1.123 Unity contrasts with plurality in that, in the event of insolvency, the affairs, business and property of the insolvent company should be subjected to a single procedure. Unity contrasts with general Universalist theories as the latter are compatible with the existence of secondary insolvency proceedings in jurisdictions where assets of the insolvent company are located.
- 1.124 Overall these principles do not, of themselves, reduce the possibility of other proceedings in other jurisdictions. Their real significance lies in assessment of the prospective consequences for the secured creditor of proceedings commenced in the subject jurisdiction.²³¹ Furthermore the possibility of secondary insolvency proceedings, based on a weakened form of territorialism,²³² emphasizes the need for lenders to inform themselves *ex ante* on the bankruptcy laws of each country in which the debtor has assets, so they can price the risk connected with such legal uncertainty. This leads to the issue of which laws will be applied to determine the validity and priority of security rights.

²³¹ Although the international trend is towards universality, the same is not true of unity – i.e. most domestic insolvency laws will claim extraterritorial effect but this will not preclude the possibility of territorial insolvency proceedings being opened in other jurisdictions where assets are situated (except as regards other proceedings within the jurisdiction in which the insolvency proceedings have been commenced). The failure of harmonization initiatives to keep pace with an increasingly international trading environment appears to have led to more rather than less plurality of proceedings. See F & A (n 20) 264. Art 3 of the EIR promotes universality rather than unity in that it allows for the possibility of secondary as well as main proceedings: see 2.12.

²³² In the sense that they are ancillary proceedings under the EIR. See 2.12 and 2.59 in relation to 'secondary proceedings'.

The significance of Insolvency Proceedings for the Lender

- 1.125 As a general principle, under English law, the insolvency of the debtor does not affect the validity or enforceability of the Lender's security. However the Lender needs to be aware that there are exceptions from this principle that derive from insolvency legislation. Different jurisdictions display differing degrees of sympathy in relation to upholding secured creditors' rights despite the fact that the concept of security is quite well recognized universally. In assessing insolvency risk and trying to make a transaction 'bankruptcy proof', the Lender needs to take an informed view of the potential effects of the systems most likely to be encountered.²³³
- 1.126 The effects of insolvency proceedings on the Lender's security rights in different jurisdictions can be profound. The Lender potentially faces some of the following risks dependent on the attitude of the foreign country towards upholding secured creditors' rights: being subject to foreign avoidance law; the transaction being re-characterized; being subordinated to local preferred creditors; and being subject to a wide reaching automatic stay. The other issues which arise from the extra-territorial application of insolvency laws, which the Lender will need to be aware of, include the effect on other proceedings in foreign jurisdictions and the scope of a stay or moratorium in reorganization proceedings.²³⁴
- 1.127 An important concern for the Lender is whether the commencement of insolvency proceedings can lead to the re-characterization of transactions. For instance, a finance lease could be construed as a disguised security and invalidated due to not complying with the

²³³ One consideration is that the underlying policy tensions in different jurisdictions reflect an intention to accord priority either to the importance of ensuring the availability of finance for enterprise within the economy (pro-creditor) or the importance of preserving existing enterprises and employment (pro-debtor). See F & A (n 20), 259-261.

²³⁴ See F & A (n 20) 267.

necessary requirements and formalities..²³⁵ Other examples include the subordination of security rights to special priorities such as tax and employment claims. The insolvency representative may also possess far-reaching powers to terminate onerous obligations.²³⁶

1.128 If reorganization procedures are preferred in a particular jurisdiction,²³⁷ the remedies of the Lender are likely to be temporarily suspended and the insolvency representative²³⁸ may be able to enforce dealings with the subject matter of the security which are contrary to the wishes of the secured creditor. Given lack of predictability, the Lender will need to focus on the rules which address common issues in insolvency proceedings.

1.129 These are: commencement; regulation of subsequent creditor activity; stays on individual creditor enforcement; clawback of antecedent transactions; set-off; and powers of collection, realization and distribution. This section therefore deals with the potential effects of insolvency procedures on a creditor's security. The three main ways²³⁹ in which security can be affected will be discussed as well as (albeit briefly by way of example) the effect of English administration on secured creditor rights. The Lender also needs to be aware that existing differences in the treatment of cross border insolvency cases may facilitate debtors to commit fraud especially by concealing assets or moving them to a jurisdiction that does not recognize the effects of a

²³⁵ This is a risk in particular where the assets are in a jurisdiction that treats title based security (e.g. a lease or a retention of title) as functional security and requires such interests to be protected by registration (e.g. see Article 9 relating to secured transactions, Uniform Commercial Code.

²³⁶ See F & A (n 20) 260.

²³⁷ It is common to find both terminal and reorganization procedures in a developed system of insolvency law.

²³⁸ One important consideration is whether the jurisdiction in question requires the appointment of an insolvency representative to administer the process. If 'debtor in possession' insolvency proceedings are allowed, the interests of creditors may be overshadowed by the management's priorities. See F & A (n 20) 261.

²³⁹ Validity; Enforceability; and the effect on floating charge holders, as perceived by Calnan (n 14) 325-326.

foreign insolvency proceeding.²⁴⁰ This is due to the minimal recognition of foreign insolvency proceedings in some countries.²⁴¹

1.130 In many jurisdictions a distinction is made between domestic insolvency proceedings and foreign insolvency proceedings. Some jurisdictions will not recognize the cross border effects of foreign insolvency proceedings despite insisting on the unlimited extraterritorial effect for insolvency proceedings opened within its own jurisdiction. States that provide for the extension of effects of a foreign insolvency proceeding to assets situated within its jurisdiction do so in varying manners.²⁴²

1.131 If there is a local presence or local assets within that jurisdiction then proceeding to enforce security elsewhere may attract adverse consequences. The Lender should be wary of concluding that insolvency proceedings occurring in a jurisdiction other than that where his security is located and with which he has no other dealings, can be disregarded. A decision to deliberately disregard the insolvency laws of any jurisdiction should take into account not only present connections but also the possibility of future connections or involvement in other proceedings in the courts of that country.²⁴³

²⁴⁰ These issues demonstrate there is a need for at least a minimum degree of harmonization of the approach to problems arising in cross border insolvencies (see Veder (n 227) 92) and the question arises as to how successful the EIR is in achieving this.

²⁴¹ See 2.60 – 2.71 regarding discussion of recognition provisions under the EIR.

²⁴² See Veder (n 227) 90. As a matter of domestic private international law (excluding for these purposes the directly applicable rules in the EIR), foreign insolvency proceedings are automatically recognised in Germany; this is to be contrasted with the position under Irish law. For the position in these and other jurisdictions see the PLC Cross-border Restructuring and Insolvency Handbook at:

<http://restructuringandinsolvency.practicallaw.com/crossborderhandbook6-500-0025>. See also 2.12 & 2.59 regarding the application of the EIR in relation to ancillary or secondary proceedings.

²⁴³ See F & A (n 20) 268. See also 2.45 – 2.59 & 3.7 – 3.17 regarding the possibility of forum shopping.

Validity and Enforceability of the Security

1.132 The validity of security, depending on when it was taken, may be affected by the ability under general insolvency law to set aside transactions which were entered into shortly before insolvency proceedings were started. An example is the setting aside of preferences which will be discussed later in this chapter. In addition, compliance with rules or legislation regarding the registration of charges and mortgages is of paramount importance to ensuring the validity and hence the enforceability of the security. If the security has been validly created, in the event of insolvency, a liquidator is unable to interfere with it provided that the security cannot be set aside under claw-back provisions. The ‘claw-back’ measures provided in insolvency legislation in relation to which the Lender will need to be wary are discussed in the section below.

Claw-Back Provisions

1.133 The Lender needs to be aware of the provisions of insolvency legislation which enable the court to set aside transactions which are intended to defraud or prejudice other creditors. Many jurisdictions have claw back provisions²⁴⁴ and, by way of example, English law will be referred to as a means of identifying the effect and extent of such provisions. Under English insolvency law, the wide scope of the IA 1986 enables the court to set aside transactions, even if they were not made with the intention of defrauding creditors, if their effect is to prejudice the debtor’s general body of creditors. Prejudice against

²⁴⁴ UNCITRAL 30th Session, 12-30 May 1997: Official Records of the General Assembly of the United Nations, 52nd Session, Supplement No 17 (A152/17), Part II, 12- 225. Legislative Guide on Insolvency Law, 2004 which indicates that, in most countries, claw back provisions, are generic features of insolvency codes.

creditors can be inflicted by: reducing the value of the debtor's assets (e.g. a transaction at an undervalue); or by giving some creditors an advantage over the others (e.g. a preference).

1.134 There are three main provisions of the IA 1986 under which transactions are capable of being set aside. These will be discussed briefly and are as follows: transactions at undervalue,²⁴⁵ voidable preferences;²⁴⁶ and floating charges.²⁴⁷

Transactions at an undervalue

1.135 The Lender will need to be aware that, in the event of liquidation, administration or bankruptcy, transactions the Lender entered into with a debtor²⁴⁸ can potentially be set aside if they fall within the IA 1986, ss 238, 240, 339 and 341. This would be the case if the liquidator²⁴⁹ was able to establish that the transaction did not benefit the debtor after considering the following: firstly, that the transaction occurred took within the requisite time frame prior to insolvency commencing and that the debtor was insolvent at that time or became insolvent due to the transaction; and secondly, that the debtor disposed of assets, either because the debtor received no consideration or received less than they were worth.²⁵⁰

1.136 In practice, the setting aside of transactions at undervalue may not be of major concern to the Lender when dealing with a company debtor especially where security is given by the company to secure its own liabilities. It can be argued that the mere creation over a company's

²⁴⁵ IA1986 s 238.

²⁴⁶ *Ibid.*, s 239.

²⁴⁷ *Ibid.*, s 245.

²⁴⁸ This refers mainly to recent transactions that occurred within a couple of years before the debtor was declared insolvent.

²⁴⁹ Or administrator or trustee in bankruptcy.

²⁵⁰ See Calnan (n 14), 328.

assets does not deplete them and does not come within s. 238(4) of the IA 1986.²⁵¹ The Lender should be wary, however, that each case will turn on its particular circumstances and there is some room for unpredictability in relation to the court's decision. The Lender will usually be able to rely on the defence that: the debtor entered into the transaction in good faith and for the purpose of carrying on its business; and when it did so, there were reasonable grounds for believing the transaction would benefit the company.

Preferences

- 1.137 Many transactions carried out by the debtor in the period immediately before insolvency proceedings commence will have the effect of putting one creditor at an advantage. If the Lender finds himself in this position there is the risk that the transaction between the Lender and the debtor may be set aside as a preference. The liquidator will need to show that the debtor's actions put the Lender into a better position than he otherwise would have been in, and that the debtor either did it himself or (having the ability to stop it) allowed it to happen.²⁵²
- 1.138 Overall, the scope of transactions being set aside as a preference will be limited to situations where the debtor was influenced in giving the preference by a desire to put the Lender in a better position than he would have been if the transaction had not been done.²⁵³

²⁵¹ See *Re MC Bacon* [1990] BCLC 324, Millett J's judgment at 340-341. However note Arden L.J.'s judgment in *Hill v Spread Trustee Co Ltd* [2006] EWCA Civ 542; [2007] 1 WLR 2404 which suggests that *MC Bacon* may be ripe for reconsideration. In the light of the observations in *Hill*, it should not be assumed that *MC Bacon* necessarily remains good law. In some circumstances, the granting of security in respect of existing indebtedness may constitute a transaction at undervalue.

²⁵² IA 1986: ss 239, 240, 340 and 341.

²⁵³ If there is a connection between the debtor and the Lender, a desire to give the preference is normally presumed, in the absence of evidence to the contrary.

- 1.139 If the Lender is a bank presumably there will be little connection between the Lender and the debtor company. The circumstances would therefore make it difficult for the liquidator to establish that the debtor had a subjective desire to prefer the Lender. For instance, the directors of the debtor company will not be seeking to put the bank in a better position if they have to give the bank a debenture in order for the bank to continue its facilities.²⁵⁴
- 1.140 Therefore, where one of the conditions for granting the facility is the creation of the security and this is created prior to the facility being made available,²⁵⁵ no question of a voidable preference arises in any event. The Lender who is making the facility does not become an actual creditor until after the money has been lent, by which time the security has already been put into place. In this case, as the Lender has not yet lent the money, he will not have attained a more beneficial position as a direct consequence of the granting of the security.²⁵⁶

Floating Charges

- 1.141 The Lender needs to be wary of s 245 of the IA 1986 which limits the effectiveness of certain floating charges in a liquidation or administration of the debtor. Therefore if the floating charge is created within the relevant time period before insolvency proceedings in order to secure existing indebtedness, it will be invalid. If it is created within the relevant period to secure finance made available after it was created it will be valid. If it is created within the relevant period to secure both

²⁵⁴ See *MC Bacon* (n 249). In the words of Millett J, “it was the price he had to pay for the bank’s continued support”.

²⁵⁵ As will be the case with a secured creditor.

²⁵⁶ See *Calnan* (n 14), 331-332.

existing indebtedness and new money, it will secure only the new money, and not the existing indebtedness.²⁵⁷

The overall effect of claw-back provisions on the Lender

1.142 Having reviewed all the potential pitfalls that might be faced in the event of the commencement of insolvency proceedings, what effect do these provisions have on the rights of secured creditors in practice? It is argued that they do not have any effect on what might be called a ‘normal financing transaction’.²⁵⁸ If the Lender takes security from the solvent debtor before the facility is made available, none of the claw-back provisions will have an impact on the Lender’s rights. Security given by the debtor to secure its own obligations are likely not to constitute a transaction at an undervalue however, in the light of new case law, this issue depends on the particular facts of the case. The floating charge, in this case, will be effective because it will be securing new money. Furthermore, the security will not amount to a preference as the beneficiary of the security will not have been a creditor at the time the security was entered into. Generally, the provisions only have effect if the debtor was insolvent at the time of the transaction as a result of it. Although the Lender should be aware of them, the claw-back provisions are of little concern to a creditor in such a case.²⁵⁹ They will be more relevant to distressed lenders. The pattern in other jurisdictions is broadly similar.

²⁵⁷ *Ibid.*, 333. The rule in Clayton’s case (1815 – 16) 1 Mer 572 can work to assist the creditor see *Re Yeovil Glove Company* [1965] Ch 148; *Re Fairway Magazines* [1992] BCC 924.

²⁵⁸ Calnan (n 14), 338.

²⁵⁹ Calnan (n 14), 338.

The potential effects of Administration on the Lender²⁶⁰

- 1.143 The effect of administration will be of particular concern for the Lender. If the debtor company goes into administration, a secured creditor may not enforce his security without the consent of the administrator or the court. Although the Lender will retain the security, he loses the flexibility to realize it at what he considers to be the best time. In addition, to the extent that his security consists of a floating charge, the assets concerned can be used by the administrator and the administrator can pay his expenses out of their proceeds. The secured creditor's main defence will be the ability to challenge what the administrator has done on the basis that it is improper or unreasonable.
- 1.144 It is argued that the Lender would be prudent to take a debenture over all of the company's assets which will enable the Lender to appoint his own administrator. In contrast, a creditor who has security only over a specific asset or assets can have an administrator imposed upon him. Whilst they both owe the same duties, the creditor is likely to feel more comfortable with his own choice of administrator.

The effects of a wide reaching stay

- 1.145 One of the consequences of the commencement of insolvency proceedings may be a stay on further proceedings in the same jurisdiction where the insolvency proceedings have been opened. Such a rule exists in English law but is not treated by the English courts as

²⁶⁰ The writer refers to administration proceedings, by way of example, in relation to the potential effects of similar reorganization procedures in other Member States and the impact on the Lender's rights.

being applicable to proceedings in a court outside the United Kingdom.²⁶¹

- 1.146 Where a stay on further proceedings is possible in a cross-border insolvency case, individual creditors can use proceedings in foreign jurisdictions to circumvent the insolvency process and to achieve a priority. However creditors need to be wary as there are various ways, besides attempting to control the conduct of litigation in foreign courts, by which a legal system can try and resolve this problem.²⁶²
- 1.147 From a practical point of view, when the Lender is attempting to enforce security in a foreign jurisdiction, a worldwide stay becomes an issue of recognition. The Lender has to consider the steps which may be taken to give the stay local effect which includes, for example, orders in aid of secondary proceedings. Additionally, the Lender needs to be wary of the possible consequences within the jurisdiction in which the insolvency proceedings have been commenced.
- 1.148 The extra-territorial effect of a stay on foreign proceedings and remedies raises more difficult policy issues when the stay in question forms part of a reorganization procedure. A terminal insolvency procedure respects the proprietary rights of secured creditors and is unlikely to seek to impose any obstacles on the enforcement of security abroad. However, a moratorium for the purposes of reorganization raises entirely different considerations.²⁶³ Principles of comity may be relied on more readily in achieving a stay if the procedure is to have any prospect of success. The first question is always whether the stay purports to be extra-territorial. The automatic stay in Chapter 11 proceedings²⁶⁴ has worldwide effect and it has been assumed, but not

²⁶¹ IA s 130; *Re Oriental Inland Steam Co*, ex parte Scinde Railway Co (1874) LR 9 Ch App 557. See also *Mazur Media Ltd v Mazur Media GmbH* [2004] EWHC 1566 (Ch) (2004) 1 WLR 2966, from para [53].

²⁶² For instance a personal order could be made to restrain a creditor located within the jurisdiction in which insolvency proceedings have commenced from having recourse to foreign courts. Alternatively, a creditor who resorts to such proceedings may be treated as being in contempt of the insolvency proceedings. See F & A (n 20) 267-268.

²⁶³ *Ibid.* 268.

²⁶⁴ Section 362 US Bankruptcy Code.

yet decided, that the English courts would take a similar view of the effect of an administration order.²⁶⁵

- 1.149 It is argued that rules requiring the Lender to bring receipts into account have little relevance where the receipts in question represent security realizations and the underlying purpose of the stay is to prevent realizations rather than to make distributions to creditors.²⁶⁶

The Enforceability of Security

- 1.150 Overall, the reason why a creditor takes security is to protect himself against the insolvency of the debtor and to ensure that he gets repaid even if the debtor becomes insolvent. Regardless of insolvency proceedings, a creditor can generally enforce his security in accordance with its terms and does not need the court's involvement to do so.²⁶⁷ Failure to comply with registration requirements undermines the value of the security and, although it will not render the security void, the secured creditor will be put at a considerable disadvantage in a priority dispute against a third party. A prudent secured creditor should therefore make sure that registration requirements are complied with in all jurisdictions within which he has taken security.
- 1.151 The Lender wants as much control as possible to minimize the erosion of his security rights. The question arises as to what measure of control can be exerted through banking covenants. This issue is explored in more detail in Chapter Three. It does not seem reasonable however to assume that that the courts of any country would refuse to accept jurisdiction, where it could otherwise be established, just because the

²⁶⁵ *Banque Indosuez v Ferromet Resources Inc* [1993] BCLC 112.

²⁶⁶ See F & A (n 20) 268.

²⁶⁷ Calnan (n 14), p, 325-326.

circumstances bringing the debtor within its jurisdiction involves a breach of banking covenants.²⁶⁸

To what extent can a secured creditor protect himself by relying on the set off rights in insolvency?

- 1.152 In strict terms, set-off rights cannot be construed as security interests. However, as they amount to security in a more broader functional sense, the availability of the right to set-off is useful to a creditor when the debtor faces financial troubles.²⁶⁹ Set off is mandatory and automatic in England where a company goes into liquidation where there are mutual debts between a creditor and the company such as loans and deposits on different accounts.²⁷⁰
- 1.153 The effect of this in an international context was determined in *Re Bank of Credit and Commerce International SA (No 10)* which illustrates the wide reaching impact on secured creditors.²⁷¹ The English winding up was ancillary to the main proceedings in Luxembourg, where BCCI SA was incorporated. A judicially sanctioned agreement had authorized the transmission of funds collected elsewhere for distribution according to the law of Luxembourg. The rules of set off which would be applied

²⁶⁸ F & A (n 20) 263.

²⁶⁹ There are different types of rights of set off which mainly consist of three categories: “those which are available outside insolvency proceedings; those which are available against assignees; and those which are available in insolvency proceedings”. See Calnan (n 14) 427, 427.7, and also 427-468. The three main statutory provisions governing set-off in insolvency are as follows: in liquidation, r 4.90 of the Insolvency Rules 1986, SI 1986/1925; in administration, r 2.85 of the Insolvency Rules 1986; in bankruptcy, s 323 of the Insolvency Act 1986. This section is largely concerned with the rights of set off which are available in insolvency proceedings. In practice, these are the most important type of set off, for the obvious reason that creditors are most likely to need to rely on such rights when the debtor is insolvent.

²⁷⁰ *Stein v Blake* [1996] AC 243.

²⁷¹ [1997] Ch 213.

in Luxembourg would be far more restrictive than those applied in England.²⁷²

- 1.154 Scott V-C held that, even in an ancillary winding up, the English insolvency set-off provisions were mandatory and could not be disapplied, regardless of the law governing the claims or the place of residence of the creditors who had entered proofs in the English winding up. Before any assets were transferred to Luxembourg the English liquidators were required to retain sufficient funds to compensate those creditors who would be prejudiced by the application of the Luxembourg rules of set-off.²⁷³
- 1.155 This case illustrates that identical claims will be treated differently in the principal and ancillary liquidations. Some claimants with no connection with England, whose debts and claims are not governed by English law and who may have no expectation that English law will apply, will be able to prove in an English winding-up and take the benefit of English law's extremely generous set-off provisions. This is due to the fact that set-off legislation is, on its face, subject to no territorial restriction and gives no guidance as to what criteria might be applied to confine it.²⁷⁴
- 1.156 Insolvency set-off provisions will only apply where there is an English winding-up. However the English courts have a very wide jurisdiction to wind up companies. Any company registered in England may be wound up and any company incorporated outside the United Kingdom may be wound up if there is a 'sufficient connection' between the company and England, and there are persons who would benefit from the making of the order.²⁷⁵

²⁷² Stevens (n 47) 221.

²⁷³ *Ibid.*

²⁷⁴ *Ibid.*

²⁷⁵ D & M (n 16) Rule 155; *Re Real Estate Development Co* [1991] BCLC 210; *Stocznia Gdanska SA v Latreefers Inc* [2001] 2 BCLC 116, CA; *Flame SA v Primera Maritime (Hellas) Ltd* [2010] EWHC 2053 (Ch).

- 1.157 It therefore appears, as seen in the context of set-off, that in English insolvency proceedings the courts have consistently applied English insolvency law and ignored any foreign insolvency law. Where, for example, it is sought to recover a payment as having been a preference, the claim as it arises from English insolvency proceedings will be governed by English law.²⁷⁶
- 1.158 Generally rights of set-off have always been of particular importance to banks and other creditors involved in financial transactions due to a number of advantages. A right of set-off gives the creditor effective security without the necessity to create (and in most cases, to register) a security interest. It is easier to enforce than a security interest.²⁷⁷ The value of the right of set-off is certain because it is expressed as a monetary amount whilst the value of other assets held as security will fluctuate. There are also circumstances where a right of set-off can give the creditor greater rights than a charge. This applies, for instance, where the charge is found to be a floating charge, and therefore subject to the rights of third parties unlike a right of set-off.²⁷⁸
- 1.159 Overall the Lender can greatly strengthen his position prior to the debtor entering into insolvency proceedings by making contractual arrangements with the debtor. By documenting these arrangements, substantial benefits can be gained by the Lender in practice. It is argued that the additional benefit obtained by taking a charge is more minimal although there are cases where the flexibility of a charge (in contrast to the rigidity of insolvency set-off) can be an advantage in the debtor's insolvency.²⁷⁹ The issues of recognition and comity are directly relevant to the enforceability of a security interest and are discussed in the section below.

²⁷⁶ *Rousou v Rousou* [1953] 3 All ER 486.

²⁷⁷ Insolvency set-off happens automatically and there is no necessity to sell the charged asset. See *Stein* (n 268).

²⁷⁸ In practice the most important alternative method of achieving the same commercial result as a right of set-off is by 'netting' which is beyond the scope of this thesis. See Calnan (n 14) 427.

²⁷⁹ See Calnan (n 14) 468.

Summary

- 1.160 The potential destabilizing effects of insolvency proceedings on security rights has been discussed as well as the varying attitude of different courts in relation to recognition of foreign insolvency proceedings. As explained, the issue of recognition is of particular importance for the Lender as foreign insolvency proceedings have the effect of potentially suspending his powers of enforcement of security or of rendering the security wholly or partially voidable. Overall, the issues discussed in this chapter demonstrate the means by which it is possible for the Lender to obtain some assurance from the fact that he has considered the main issues in the appropriate legal systems concerned both at the pre-insolvency point of grant of security and the post-insolvency point of enforcement.
- 1.161 As discussed, it is essential for the Lender, when structuring a cross-border transaction involving the taking of security over moveable property, to investigate the different jurisdictions in which insolvency proceedings could possibly take place, and to consider the effect of such proceedings on his position as a secured creditor, especially taking into account that the security may comprise movable assets.²⁸⁰ This, undeniably, will be a complex assessment, involving the investigation of the insolvency laws, and private international law rules of a number of different countries which will not render a thoroughly conclusive result. The fact is that companies can end up in insolvency proceedings in unpredicted jurisdictions.
- 1.162 In terms of assessing ‘bankruptcy risk’, the Lender will have to take a practical decision about the extent to which it is possible to investigate the laws of other jurisdictions which may be relevant. It is helpful, in this instance, for the Lender to take into account the attitude of the courts in those various jurisdictions to the principles of universalism

²⁸⁰ F & A (n 20) 287.

and territorialism. Ultimately, however, it is impossible for the Lender to be certain that, regardless of these checks, the security will be effective in every jurisdiction which may be relevant due to the large volume of security being taken and the number of jurisdictions involved.²⁸¹ As discussed, ‘insolvency effects’ can have a profound impact on the Lender depending on a number of factors such as the attitude of the courts and the applicable law. Chapter Two discusses the EIR in detail and focuses on some essential safeguards which are established to counter these ‘insolvency effects’ and protect the Lender’s rights and underlying security interest.

²⁸¹ Calnan (n 14) 507.

CHAPTER TWO

TEXTUAL ANALYSIS OF THE EIR

Introduction

- 2.01 This chapter provides a detailed textual analysis of selected provisions of the EIR¹ and, in doing so, focuses on the concerns of the Lender in relation to the potential effects of insolvency proceedings on cross border security and the associated risks that need to be addressed by the Lender in order to ensure, in as far as possible, that the realisation of his security will take place subject to insolvency laws that do not erode the security in favour of other creditors. The issue of insolvency effects and how these effects can be mitigated is of critical concern to the Lender and, by exploring the relationship between certain Articles under the EIR, the writer will focus in particular on how the EIR addresses the following: forum shopping; effective co-ordination of cross-border insolvency proceedings; the dissipation of assets; other consequences which might be detrimental to creditors and devalue security; and the issue of ascertainability as applicable insolvency law might end up having unanticipated effects on creditors.
- 2.02 What are ‘insolvency effects’? Under all national laws, insolvency proceedings may interfere with and disrupt the legal position of the debtors and creditors. The effects brought about by the *lex concursus* are linked to specific insolvency law policies. They encompass those legal consequences and legal variations which the procedural and the substantive rights of the debtor and the creditors must undergo in order

¹ Due to the limited scope of this thesis it has not been possible to discuss each and every provision of the EIR in detail.

to achieve the objectives of the insolvency proceedings, as set forth by the *lex concursus*. From this perspective, the *lex concursus* displaces, in so far as insolvency policy requires, the general law governing the affected act or right itself. These insolvency policy-founded effects are ‘insolvency effects’ which can be greater or lesser depending on the legislative policy decisions of each State. The type of system in place in a particular State is therefore of much importance to the Lender. For instance, there are systems which significantly alter the positions of the parties and there are others which respect those positions as far as possible.² The concepts of universalism and territorialism³ (revisited later in this chapter) have a considerable influence on insolvency policies and which systems are more ‘interventionist’ than others.

- 2.03 In terms of insolvency policies the EIR itself is neutral; it respects national diversity and leaves it to the national *lex concursus* to establish the degree to which the insolvency proceedings need to interfere in the rights and relationships of the debtor and creditor. The EIR establishes some safeguards against an excessive ‘interventionism’ by the *lex concursus* in the following ways: exceptions in favour of a different national law expressly established in Articles 5-15; the possibility of opening territorial proceedings, which would entail a different *lex concursus* being applied; and, in extreme cases, the public policy clause. However the current approach taken by the EIR reflects an evolution from the previous draft conventions.⁴
- 2.04 Certain provisions of the EIR come to the forefront when exploring the standpoint of the Lender: the interrelationship between jurisdiction and applicable law; recognition of proceedings and the effects thereof in other Member States; and the ‘carve out’ provisions to the applicable

² See M Virgos & F Garcimartin, *The European Insolvency Regulation: Law & Practice*, (Kluwer Law, 2004), 11-12.

³ See 1.120 -1.125 which identifies the difference between these two principles.

⁴ A brief history of the EIR and discussion of the evolution of the text is contained in Appendix 1. This is background information to enable the reader to fully understand why the EIR has evolved into the instrument that it is today.

law which are of such importance to the Lender.⁵ These Articles of the EIR will be focused on in detail, not in numerical chronology, but by using the best method to portray how the various Articles interact with one another and work in practice. The provisions considered are: Articles 3, 27, 16, 17 and 26 in relation to jurisdiction, types of proceedings and their effects in Member States; Articles 4 and 28 in relation to the applicable law; and then Articles 5, 6 and 13 which are ‘carve out’ provisions in relation to Article 4.

2.05 The key provisions of the EIR relate to jurisdiction and applicable law and because these Articles are integral to the functionality of the EIR, these are the provisions that form the starting point of my textual analysis. As far as jurisdiction is concerned, Article 3 lays down the general principle that “the courts of the Member State within the territory of which the centre of the debtor’s main interests is situated shall have jurisdiction to open insolvency proceedings”.⁶ For a company or legal person, the centre of its main interests is presumed to be the place of its registered office in the absence of proof to the contrary.⁷ In addition, the court of another Member State shall only have jurisdiction to open ‘secondary proceedings’,⁸ if “the debtor possesses an establishment within the territory of that other Member State”.⁹ These important provisions will be focused on in detail especially with reference to emerging interpretative case law.

2.06 Chapter II of the EIR (articles 16-26) focuses on recognition of insolvency proceedings and operates in close connection with the application of Article 3 in terms of insolvency effects in other Member States. The principle of universality of main proceedings encompassing all the debtor’s assets and in principle affecting all creditors, implies recognition of the proceedings and their effects in the other Member

⁵ Especially in terms of protecting the ‘legitimate expectations and the certainty of transactions’ as provided in Recital 24 to the EIR.

⁶ Article 3(1).

⁷ *Ibid.*

⁸ In order to discuss the opening of proceedings and applicable law in relation to secondary proceedings, Articles 27 and 28 will also be discussed.

⁹ Article 3(2).

States in which those assets or creditors are situated. Article 16 is an important provision for discussion as it is the means by which the EIR sets up a system of mandatory and automatic recognition in all the Member States (except Denmark) and guarantees the universality of main proceedings. This means that in any other Member State the same legal effects (both procedural and substantive) are immediately produced as under the law of the *lex concursus* without the need for any further formalities and cannot be challenged in other Member States.¹⁰ A discussion of Article 26 is required as it is the only ground for opposing recognition. Article 26 provides that recognition can be refused only where the judgment handed down in a Member State would be ‘manifestly contrary to that State’s public policy, in particular its fundamental principles or the constitutional rights and liberties of the individual’.

- 2.07 In terms of the uniform rules on conflict of laws replacing national rules of private international law, Article 4 lays down the basic rule on conflict of laws of the EIR, determining the law applicable to the insolvency proceedings, the product thereof and their effects. Unless otherwise stated by the EIR, the *lex concursus* is applicable.¹¹ Article 4 warrants careful inspection as the law of the *lex concursus* determines all the effects of the insolvency proceedings, both procedural and substantive, on the persons and legal relations concerned. The *lex concursus* governs all the conditions for the opening, conduct and closure of the insolvency proceedings, the admissibility of claims and the rules on distribution and priorities etc. Article 4 is of fundamental importance to the Lender as it provides that the *lex concursus* shall determine a range of issues including the following: the debtors against which insolvency proceedings can be commenced on account of their capacity,¹² the assets which form part of the estate and the treatment of

¹⁰ Article 17(1) and 17(2) which relate to the ‘effects of recognition’.

¹¹ This rule also applies to secondary proceedings by virtue of Article 28. The effects of secondary proceedings referred are however restricted by Article 3(2) to the assets of the debtor situated in the territory of that other Member State.

¹² Article 4(2)(a).

assets acquired by or devolving on the debtor after the opening of insolvency proceedings;¹³ the respective powers of the debtor and the liquidator;¹⁴ the conditions under which set-off may be invoked;¹⁵ the effects of insolvency proceedings brought by individual creditors;¹⁶ the rules governing the lodging, verification and admission of claims;¹⁷ the effects on proceedings by individual creditors;¹⁸ and other insolvency related items, like who is to bear the costs and expenses incurred in the insolvency proceedings;¹⁹ and the rules relating to the voidness, voidability or unenforceability of legal acts detrimental to all the creditors.²⁰ Article 28 will be discussed briefly as it defines the law applicable in relation to secondary proceedings and clarifies that the applicable law in relation to this type of proceedings will be that of the Member State in which the secondary proceedings are opened.

2.08 To ‘protect legitimate expectations and the certainty of transactions’,²¹ in a Member State other than the State in which proceedings are opened, provisions have been made for a number of exceptions to the general rule provided in Article 4. These provisions are especially important to the Lender and will be discussed at some length. Article 5, for example, recognizes the rights of secured creditors with a valid claim to assets under the law of the place where the assets are situated. Creditors can acquire security by fulfilling the relevant conditions under this rule, safe in the knowledge that their secured status will not be disturbed by the commencement of insolvency proceedings in another EU State. Article 6 preserves certain set-off rights and provides that the opening of insolvency proceedings does not affect a creditor’s

¹³ Article 4(2)(b).

¹⁴ Article 4(2)(c).

¹⁵ Article 4(2)(d).

¹⁶ i.e. stay of enforcement given its importance in the context of secured creditors.

¹⁷ Article 4(2)(h).

¹⁸ Article 4(2)(f).

¹⁹ Article 4(2)(l).

²⁰ See Article 4(2)(m). See also B Wessels, ‘The European Union Insolvency Regulation: An Overview with Trans-Atlantic Elaborations’, 2003 Norton Annual Survey of Bankruptcy Law, 481-507.

²¹ Recital 24 of the EIR.

rights of set off where they are permitted under the law applicable to the debtor's claim. Whilst being highly relevant to lenders especially banks,²² set-off is often referred to as a quasi-security as it is not strictly a security interest under English law. However it is significant as it is something the Lender can rely on at the moment of contracting or incurring the claim. With regard to the interaction between the different articles of the EIR, it should be noted that the recognition effects of Article 16 also encompass the exceptions to Article 4. The *lex concursus* of the one Member State is 'exported' to another Member State under the recognition provisions, therefore the same exceptions (Articles 5-15) apply. Article 13 is one of those exceptions and represents a defence against the application of the (foreign) law of the State of opening, when that law would lead to unenforceability because a legal act would be detrimental to all the creditors. These provisions (Articles 5, 6 and 13) will therefore be discussed in detail with regard to the importance of these provisions in relation to the 'insolvency effects' on secured creditors.

- 2.09 Prior to proceeding with a detailed textual analysis of the provisions discussed above, an introduction to the history of the EIR and evolution of the various draft conventions is warranted to examine, from the Lender's standpoint, why the EIR's current approach of allowing multiple proceedings within the European Union in relation to the same debtor is more beneficial to the secured creditor than the position adopted in previous draft conventions. The theory behind modified universalism is that insolvency proceedings with pan-European extra-territorial effects will produce better returns for creditors than an agglomeration of separate national proceedings.²³ The counter-argument is whether it would be more cost effective and beneficial for

²² Particular significance for banks arises where there are loans (assets) and deposits (liabilities) on several accounts with the same bank.

²³ See JL Westbrook, "Theory and Pragmatism in Global Insolvencies: Choice of Law and Choice of Forum" (1991) 65 *American Bankruptcy Law Journal* 457 at 465 "A universalist rule would so increase values available for all local claimants in all general defaults as to offset by far the losses that particular local claimants might suffer in some cases. That assertion is persuasive because the preservation of going concern values and the maximizing of liquidation values by integrated sales will likely increase returns to creditors greatly".

creditors if insolvencies were administered on a national territorial basis alongside measures designed to encourage cooperation with courts in other countries. The concepts of universalism and territorialism are at the heart of international insolvency and practice and are also referred to in Appendix 1 when discussing the various drafts that comprise the evolution of the EIR. When critically evaluating the successes and weaknesses of the EIR, from a lender standpoint, it will be helpful to explore which alternative concepts were used in the previous draft conventions and why they were not popular or workable in practice.

Universality, territoriality, unity and plurality

2.10 As discussed in Chapter One²⁴ cross-border aspects of insolvency proceedings are generally approached from the principles of universality and territoriality. It is arguable that English insolvency law has long been committed to a universalist vision. Traditionally an English liquidation has universal effect and applies to all assets of the company irrespective of location,²⁵ though, of course, there can be practical difficulties in securing the recognition of the winding up in the relevant foreign jurisdiction where assets happen to be situated. The Privy Council in *Cambridge Gas*²⁶ underscored the universal application of insolvency proceedings.²⁷ In *HIH*²⁸ Lord Hoffmann was prepared to give free rein to the principle of universalism holding that

²⁴ See 1.119 – 1.125. See also A.5-A.10 regarding the extreme universalist approach adopted in the Phase 1 draft conventions. See A.11-A.15 in relation to the more flexible approach adopted by the Istanbul Convention. See A.16, A.19 – A.20 regarding ‘modified universalism’.

²⁵ See the comments of Wynn-Parry J in *Re Azoff-Don Commercial Bank* [1954] Ch 315, 333 and Browne-Wilkinson VC in *Re Bank of Credit and Commerce International SA (No 2)* [1992] BCLC 570, 577.

²⁶ *Cambridge Gas Transport Corporation v Official Committee of Unsecured Creditors (of Navigator Holdings plc)* [2007] 1 AC 508.

²⁷ [2007] 1 A.C. 508 at [16], Lord Hoffmann stated that: “There should be a single bankruptcy in which all creditors are entitled and required to prove. No one should have advantage because he happens to live in a jurisdiction where more of the assets or fewer of the creditors are situated”.

²⁸ *Re HIH Casualty and General Insurance Ltd* [2008] 1 WLR852; on appeal from [2007] 1 All ER 177.

“surplus” assets in an English ancillary liquidation could be transferred to a foreign main liquidator despite the fact that the basis of distribution in the foreign main proceedings was different from that in the English proceedings. The remission of assets could be ordered at common law on the basis that the foreign main proceedings in the country of incorporation should, *prima facie*, be allowed to have universal effect.²⁹ Given the current attitude of the courts and the position adopted by the EIR regarding universalism, it may be useful to consider earlier developments regarding the workability in practice of extreme forms of universalism and territorialism.

2.11 The principles of unity and plurality operate in close connection with the aforementioned principles of territoriality and universality. Plurality of insolvency proceedings means that the debtor might be subject to more than one insolvency proceeding.³⁰ In the concept of unity of insolvency proceedings the debtor’s insolvency is dealt with in one single proceeding. Unity of bankruptcy contemplates an idealized state of affairs under which, for any given debtor, there would be only one legitimate forum for the opening of insolvency proceedings. However, as shown by the EIR, the idea of unity has to concede to demands of reality and political willingness to give up jurisdiction and the application of a State’s own law.³¹ It follows from these models that, depending on what approach insolvency legislation takes, the degree to which they alter the position of creditors in terms of ‘insolvency effects’ and are ‘interventionist’ varies considerably. A brief synopsis is provided in Appendix I in relation to the history of the texts prior to the EIR and the general lay out of each of those conventions. The following section contains an analysis of the articles

²⁹ Other members of the House of Lords were more conservative and decided the case by reference to the statutory jurisdiction to aid the courts of designated territories in Insolvency Act 1986 (IA) s 426. Article 21(2) of the UNCITRAL Model Law on Cross-Border Insolvency (brought into force in Great Britain by the Cross-Border Insolvency Regulations 2006 SI 2006/1030) gives the English courts a statutory discretion to turn over assets to a foreign insolvency representative. See McCormack G, (2009), “Jurisdictional competition and forum shopping in insolvency proceedings”, C.L.J., 68(1), 169-197, FN 11.

³⁰ Territoriality necessarily leads to the plurality of insolvency proceedings.

³¹ M Veder, *Cross Border Insolvency Proceedings and Security Rights* (Kluwer, 2004) 88.

of the EIR in force today. However the relevant paragraphs of Appendix I are referred to so the reader can: compare the current provisions with the articles in these early drafts; understand the gradual recognition over the years (as reflected in transition between draft conventions) that the concept of universality is not exclusively dependent on that of unity; determine to what extent the Lender's concerns have been addressed in the culminating EIR; and draw some conclusions regarding the scope for reform.

Council Regulation (EC) No 1346/2000 on insolvency proceedings (29th May 2000)³²

Article 3 of the EIR: International jurisdiction

2.12 The EIR applies a “limited universalist approach” which lies between the principles of universalism and territorialism and has been acknowledged³³ as the most suitable means of co-ordinating the different substantial provisions contained in the legislation in force in each Member State, such as those on security interests and preferential rights. Accordingly under Articles 3(1) and 3(2) of the EIR, a main insolvency proceeding is opened where the COMI of the insolvent debtor is situated, but subsequently one or more secondary proceedings may also be opened in countries where the debtor has an establishment.³⁴ Therefore Article 3 is of fundamental importance to

³² The text of the EIR is largely based on the European Union Convention on Insolvency Proceedings (EU Convention) which opened for signature, Nov 23, 1995, 35 I.L.M 1223 (1996). See A.15 – A.22.

³³ See Recital 11 of the EIR.

³⁴ Secondary proceedings may only be opened after the opening of the main insolvency proceeding. Beforehand ‘territorial proceedings’ may be opened in defined circumstances: see Article 3(4) of the EIR. For examples of the previous unsuccessful draft conventions prior to the EIR, which influenced the adoption by the EIR of a more workable ‘limited universalist approach’, see: A.5 – A.7; A.8 – A.10; A.16; A.19 – A.20.

the Lender as it sets out the fundamental principles in relation to the allocation of international jurisdiction in respect of insolvency proceedings where the debtor's circumstances place it within the ambit of the EIR. Particular attention will be paid to the specific wording of Article 3 especially in light of whether creditors' expectations are being met regarding jurisdiction and in corresponding with their legitimate interests regarding the location of insolvency proceedings.

- 2.13 Contrary to the initial impression generated by the use of the words 'shall have jurisdiction to open insolvency proceedings', the jurisdictional rules in Article 3 operate in an exclusive manner by generating main proceedings which in principle have universal scope and encompass all of the debtor's assets wherever located within the European Union.³⁵ Thus Article 3(1) does not merely generate an additional basis of jurisdiction to operate in parallel with national rules.³⁶ The EIR does not deal with the allocation of jurisdiction within a Member State. This is left to national rules. Furthermore it does not set out the criteria for exercising jurisdiction under domestic law.³⁷
- 2.14 The direct rules of jurisdiction, which must be respected and applied throughout the Member States as a matter of obligation generated by EC law, are unfortunately drafted in obscure terms that do not express the intended scope or effect clearly. For instance it is only in paragraph 14 of the Recitals to the EIR that there is a clear statement that: 'This Regulation applies only to proceedings where the debtor's centre of main interests is located in the Community'.³⁸

³⁵ With the exception of Denmark: see Recital 33 of the EIR.

³⁶ It is submitted that this essential principle would be more clearly conveyed if Article 3(1) had been drafted so as to declare 'subject to this Regulation, only the courts of the Member State within the territory of which the centre of main interests is situated shall have jurisdiction to open insolvency proceedings...' See IF Fletcher, *Insolvency in Private International Law* (2nd ed OUP, Oxford 2005) 356, FN 70.

³⁷ Article 4(2) of the EIR.

³⁸ Although assets and interested parties may be situated within the European Union in many cases, the EIR only applies to those cases where the debtor's centre of main interests is in the EU. See further G Moss, I Fletcher and S Isaacs, *The EC Regulation on Insolvency Proceedings, A Commentary and Annotated Guide*, (2nd ed OUP, Oxford 2009) (M, F & I) 45, para 3.10.

What is COMI and why is it so important to the Lender?

- 2.15 The debtor's COMI is the pivot around which the whole structure of the EIR is based as its location determines where main proceedings may be opened and the fact that the office holder in the main proceedings will generally be entitled to deal with all of the company's assets across the jurisdictions of the European Union. There can be significant differences in the outcome for the Lender depending on which country's law applies.³⁹
- 2.16 Given the vital role played by the concept of the COMI, it is surprising that there is no definition contained in the main text of the EIR and instead there is a sentence within the Recitals⁴⁰ which has since, rather inaccurately, been referred to as a "definition".⁴¹ The wording of Recital 13 is a concise description or statement of fact rather than a definition which is supported by the fact that the wording is taken from the Virgos-Schmit Report.⁴²

³⁹ For example, UK law is traditionally creditor-friendly and is reasonably well-understood. French insolvency law tends to favour employees, while in Germany fairly onerous requirements are placed on an insolvent company's directors to file for insolvency within a set time period. See K. Stones, 'The quest for COMI', *Euro Law* 2006, 62, 16. See A.7 outlining how 'centre of administration' as first conceived in the Phase 1 draft conventions. See A.12 – A.13 for the development of the concept of COMI as it is known under the EIR. See A.18 regarding use of COMI under the EU Convention and the ambiguity behind the COMI concept which is an issue that remains unaddressed under the EIR.

⁴⁰ Recital 13: The 'centre of main interests' should correspond to the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties.

⁴¹ See G Moss, 'Group Insolvency – Choice of Forum and Law: the European Experience under the Influence of English Pragmatism', (2007) 32 *Brooklyn Journal of International Law*, 1005, 1007. The author agrees that Recital 13 merely expands on the nature and purpose of Article 3 and submits that if it were meant to be read as a definition then the draftsmen of the EIR would have inserted the wording as a definition in Article 2.

⁴² The Report on the Convention on Insolvency Proceedings, prepared by Professor M Virgos and ME Schmit (hereafter referred to as 'Virgos-Schmit'), para 75. The rationale of this wording is explained in terms of insolvency being a foreseeable risk. It is important that international jurisdiction be based on a place known to the debtor's potential creditors. This enables the legal risks, which would have to be assumed in the case of insolvency, to be calculated.

2.17 The ECJ in *Eurofood*⁴³ used the word ‘definition’ in relation to Recital 13, however, as a definition, Recital 13 leaves several key questions unresolved, for example, the elements which constitute the process of ‘administration’, ‘regular basis’ and the sense in which the term ‘interests’ is to be understood. Overall Recital 13 seems to indicate that the COMI connecting factor is aimed at providing:

“[A] test in which attributes of transparency and objective ascertainability are dominant factors. This should enable secured creditors who have dealings with a debtor to base their expectations on the reasonable conclusions to be drawn from systematic conduct and arrangements for which the debtor is responsible”.⁴⁴

2.18 Some scholars⁴⁵ consider that, in addition to the wording of Recital 13, the use of the generic term “interests” serves as evidence of the Community legislator’s purpose of allowing any Member State’s courts to use a certain degree of discretion in construing the meaning of COMI. These authors conclude that the national judge should determine the COMI exclusively through the application of bankruptcy provisions set out in the legislation of the Member State in which the insolvency proceeding had been opened. Therefore, the provisions of the *lex concursus* would establish the meaning of the debtor’s COMI and consequently its location. Under this school of thought, which the writer considers confusing and risky from the standpoint of the Lender, the COMI would not have a meaning *per se*, but it would potentially assume different meanings depending on the provisions of the internal legislation.⁴⁶ Accordingly, there would potentially be as many COMIs as proceedings opened which would lead to the difficulty of the Lender

⁴³ C-341/04 *Re Eurofood IFSC Ltd* (2006) ECR I-3813, [2006] BCC 639 ECJ [511], 33

⁴⁴ See M, F & I (n 38), 45-46, para 3.11. Para 75 does not restrict the relevant third parties to creditors. It will be open to a court to take into account what would be objectively ascertainable and so a court could presumably take into account what would be ascertainable to other third parties such as employees.

⁴⁵ See, for example., Luigi Fumagalli, “Il Regolamento Comunitario sulle Procedure di Insolvenza” in *Rivista di Diritto Processuale* (Padua: CEDAM, 2001), p.688, FN 29 cited in Simona Di Sano, ‘COMI: the sun around which cross-border insolvency proceedings revolve: Part 1’, *JIBLR*2009, 24(2), 88-101, 94, FN 36.

⁴⁶ See Di Sano (n 45) 94.

needing to be aware and perhaps seek legal advice in relation to the law in all the jurisdictions where collateral is situated.⁴⁷

2.19 The more sensible view, in the writer's opinion, is that there is only one COMI, whose meaning has to be construed by the national judge on a case-by-case basis in the light of criteria derived from the content of the EIR as interpreted by the ECJ.⁴⁸ The lack of definition of COMI in the EIR is therefore an expression of the Community legislator's intention to leave some scope for judicial discretion and common sense to be exercised after consideration of the circumstances encountered in each case.⁴⁹ Therefore in practice case law demonstrates the problems faced by creditors in relation to the concept of COMI.

2.20 When reviewing case law, the important issue to consider is whether the lack of a comprehensive definition of COMI creates problems for the Lender in practice. The first issue to consider is the wording of Article 3(1) regarding the case of a company or a 'legal person' where the place of the registered office is presumed to be the COMI unless there is proof to the contrary. It is argued that there is no proper clarification regarding the nature or degree of proof needed to rebut this presumption. The burden of proof lies with the party that contests the outcome regarding the location of the COMI of a legal person that would otherwise follow from the application of Article 3(1).⁵⁰ It is there not enough for secured creditors to investigate the law of the state of incorporation of the debtor company when trying to assess the impact of insolvency law upon their rights and interests and calculate the extent of their commercial or financial risk.⁵¹ The second issue to consider, if it is not so apparent that the COMI is the registered office and this is contested, is where exactly the debtor conducts the

⁴⁷ This view appears to be based on the reasoning that the EIR recognizes and upholds the substantial differences among the internal legislations of the Member States, each of them aimed at safeguarding its own autonomy. See Recitals 11 and 15 of the EIR. See also Di Sano (n 45), 94, FN 39.

⁴⁸ This view is held by many legal scholars. See Di Sano (n 45) 94.

⁴⁹ Fletcher (n 36) 457.

⁵⁰ M, F & I (n 38), 46, para 3.13

⁵¹ See M, F & I (n 38) 46, para 3.13.

‘administration of his interests’ on a regular basis which is therefore ‘ascertainable by third parties’.⁵²

2.21 This seems to suggest that, in determining COMI, functional realities are capable of displacing the effects of such formal criteria as the place of registration, or state of incorporation, for the purpose of determining the EIR’s application, and also for the purpose of deciding questions of jurisdiction. In practice it is therefore essential to conduct a thorough investigation into the possible locations where a company’s interests are being administered from and take any necessary precautions if it appears that the administration of a debtor company’s interests are regularly being carried out from another Member State.⁵³ This issue was considered by the ECJ in *Eurofood*⁵⁴ which is a clear example of a problematic situation that arose due to the lack of a clear definition of COMI and the possibility of different interpretations.

2.22 In relation to COMI, the ECJ was asked the following question: where an EU Member State opens insolvency proceedings in respect of a company, but the registered office is not situated in that Member State and the company does not conduct the administration of its interests on a regular basis in a manner ascertainable to third parties in that Member State, does that Member State have jurisdiction to open main proceedings?⁵⁵ In response, the ECJ ruled that the ‘simple presumption’ laid down by Article 3(1) in favour of the registered office of the company as to the whereabouts of the COMI ‘can be rebutted only if factors which are both objective and ascertainable by third parties enable it to be established that an actual situation exists which is

⁵² Recital 13. See the criticism of the wording of this Recital in 2.16-2.19.

⁵³ Which might create the possibility of the Article 3(1) presumption being rebutted. See M, F & I (n 38) 46, para 3.12-3.13.

⁵⁴ *Eurofood* (n 43).

⁵⁵ From the point of view of creating useful guidance, it is disappointing that the Irish Supreme Court framed its question to the ECJ regarding COMI in the way that it did. The ECJ was asked to assume that Eurofood conducted the administration of its interests in Ireland. For this reason, there is no detailed analysis by the ECJ of what is meant by “the administration of its interests”. There is however guidance provided in the Advocate General’s Opinion. See *Eurofood* (n 43). See also J. Marshall and M. Haywood, Allen & Overy LLP and ¾ South Square, Case Law on the EIR, European Cross Border Insolvency R4, Sweet & Maxwell, (September 2006), section 2.1.

different from that which locating it at that registered office is deemed to reflect'.⁵⁶ Furthermore, where a company carries on its business in the territory of the Member State where its registered office is situated, the mere fact that its economic choices⁵⁷ are or can be controlled by a parent company in another Member State is not enough to rebut the registered office presumption.

2.23 One test that has emerged as a principled basis for rebutting the presumption is the 'head office functions test', The final sub-paragraph of paragraph 75 of the Virgos-Schmit Report states that :

“[w]here companies and legal persons are concerned, the Convention presumes, unless proved to the contrary, that the debtor’s centre of main interests is the place of his registered office. This place normally corresponds to the debtor’s head office.”

To understand the import of this statement, one has to recall that domestic law in Europe has two different approaches. In the U.K the historic approach was based on the place of registration. According to this approach, if there were to be proceedings in more than one country, the main proceedings would take place in the jurisdiction of the place of registration, and proceedings in other jurisdictions would be ancillary to the main proceeding. In Europe (excluding Scandinavia), however, the approach was to focus on the “seat” of the company. Overall it appears that the “seat approach” has taken precedence over the “place of registration”. Article 3 seems to take a balanced approach between the two theories by introducing a rebuttable presumption that the COMI is in the place of registration.⁵⁸ Paragraph 75 tactfully glosses over the

⁵⁶ An example would be a “letterbox” company which does not carry out any business in the territory of the Member State in which its registered office is situated. See *Eurofood* (n 43), para 34.

⁵⁷ It is unclear from *Eurofood* (n 43) what “economic choices” are in this context and why the ECJ focused on such choices. Therefore several questions are left unanswered. For further discussion, see Marshall & Haywood (n 55) , section 2.1 .

⁵⁸ See Moss (n 41) 2006-2007, 1008.

conflict and simply states that the registered office is normally the debtor's "head office".⁵⁹

- 2.24 Does the 'head office functions test' overcome the difficulty for the Lender in relation to the unclear definition of COMI in the EIR? Does the test overcome the problem of determining COMI in relation to group insolvencies? In practice, in the case of legal persons, the place where "a debtor conducts his interests on a regular basis and [which] is therefore ascertainable by third parties"⁶⁰ has been equated with the place where the 'head office functions' of the debtor are carried out.⁶¹ There was progression pre-Eurofood in relation to use of the 'head office functions test'.
- 2.25 For instance, the head office functions test has been developed in the following case law: *Re Enron Directo SA*;⁶² *Re BRAC Rent-A-Car International Inc*;⁶³ *Re Daisytek-ISA Ltd*.⁶⁴ The test has also been followed in various other cases both in the U.K.⁶⁵ and in other EU states.⁶⁶

⁵⁹*Ibid.*. See also M. Christina di Luigi, 'The European Insolvency Regulation: A Criticism of the Jurisdiction Paradigm', *International Corporate Rescue*, Volume 3, Issue 6, 2006 Kluwer Law International, p.344.

⁶⁰ EIR recital (13).

⁶¹ See M, F & I (n 38) 255, para 8.81.

⁶² Lightman J, 4 July 2002, no judgment given. A summary of the decision is available on the website of the International Insolvency Institute at <http://www.iiiglobal.org/> under 'European Union-Articles'.

⁶³[2003] EWCH (Ch) 128; [2003] 1 WLR 1421. This is also a notable decision regarding the scope of the EIR. It established the EIR may apply to companies incorporated or registered in any country, whether a member of the EU or not, provided the company has its COMI in the EU. A number of commentators have queried whether the EIR was intended to have such broad effect. See Marshall & Haywood (n 55), section 2.10.

⁶⁴ 2003 WL 21353254; [2003] BCC 562; [2004] BPIR 30. The court took into account that the most significant third parties in relation to the operation of Recital 13 were potential creditors and mainly based its decision on the fact that a large number of the creditors were aware that the majority of key functions of the German and French subsidiaries were carried out in Bradford. The decision in relation to COMI was mainly influenced by the following factors: the location where contracts with main suppliers were administered and negotiated; and where the arrangements regarding finance were made. These issues carried more weight than the location where the services to customers were actually carried out. See Chris Lawrence, "Restructuring and Insolvency Briefing": <<http://www.macfarlanes.com>>.

⁶⁵ To name but a few, *Re Aim Underwriting Agencies (Ireland) Ltd* [2004] EWHC 2114 (Ch); *Re Ci4net.com Inc* [2004] EWHC 1941 (Ch), [2005] BCC 277; *Re TXU German Finance BV* [2005] BCC 90, [2005] BPIR 209; *Re Collins & Aikman* [2005] EWCH 1754 (Ch); [2006] BCC 606.

⁶⁶ For example, in France, *Re MPOTEC GmbH* [2006] BCC 681, Tribunal de Commerce de Nanterre; and *Re Eurotunnel Finance Ltd* (Paris Commercial Court, 2 August 2006). In

- 2.26 Based on *Eurofood*, however, it is not clear whether the administration orders made in *Daisytek* and similar cases (where the managerial and administrative control exercised by a parent company over its subsidiaries has been used as the grounds for submitting that the COMI of each of the subsidiaries is in the same jurisdiction as the parent) would have been made had the application come before the court following the ECJ decision in *Eurofood*.⁶⁷
- 2.27 One of the cases that followed the head office functions test but which came after the *Eurofood* decision is that of Eurotunnel Plc.⁶⁸ Seventeen companies in the Eurotunnel group⁶⁹ requested that the Paris Tribunal de Commerce open safeguard proceedings⁷⁰ on the grounds that they would permit the long-term continuation of the Eurotunnel's business. The Tribunal de Commerce focused on the fact that the strategic and operational management of the companies was run by a single committee based in Paris and that the financial management was also carried out there. Safeguard proceedings were therefore opened as main proceedings under the EIR in respect of all 17 companies. Having considered Article 3 and Recital 13 of the EIR, the Tribunal de Commerce, in accordance with European case law, relied upon objective elements which were verifiable by third parties to rebut the registered office presumption.⁷¹
- 2.28 It should be noted that the Tribunal de Commerce did not refer outright to the *Eurofood* decision but seems to have referred to the main aspect of the ECJ's guidance on COMI when holding that factors that were

Germany, *Re Hettlage-Austria* (Amtsgericht, Munich, 4 May 2004), see <<http://www.eir-database.com>>. In Hungary, *Re Parmalat Slovakia* (Municipal Court of Fejer/Szekesfehervar, 14 June 2004). For more detailed references see M, F & I (n 38) 256, FN 110, 111 and 112.

⁶⁷ Depending on the evidence put before the court. See Marshall & Haywood (n 55), section 4.14

⁶⁸ Tribunal de commerce de Paris, August 2, 2006 (17 decisions).

⁶⁹ Whose registered offices were situated in different Member States across the EU, including France, the UK, Germany and Belgium.

⁷⁰ Broadly this is a debtor in possession, Chapter 11 style proceeding and can be opened prior to the actual cash-flow insolvency of the debtor. See chapter on 'French Jurisdiction' in Marshall & Haywood (n 55).

⁷¹ For instance, the Tribunal de Commerce considered factors such as where the strategic and operational management of the various Eurotunnel entities were carried out, the location of the registered offices and the location of where the group's financial management was conducted.

objective and ascertainable by third parties established that the actual situation regarding the COMIs of the Eurotunnel companies varied from that which the registered office presumption would imply. No detail was however provided in the written judgments regarding how the factors used to rebut the registered office presumption were objectively ascertainable to third parties and which third parties these were. Furthermore, in *Eurofood*, as discussed earlier, the ECJ stated that just the fact that its economic choices are or can be controlled by a parent company in another Member State is not sufficient to rebut the presumption laid down by the EIR. The Tribunal de Commerce does not appear to have considered this part of the *Eurofood* decision. However it is significant to note that the ECJ did not consider the actual meaning of “the administration of the debtor’s interests on a regular basis” as referred to in Recital 13. This leaves the factors which can be used to rebut the registered office presumption and their relative importance unclear.⁷²

2.29 Furthermore it is also unclear from the *Eurofood* judgment which choices controlled by a parent company in another Member State will be construed as ‘economic choices’. Following the ECJ’s decision in *Eurofood*, it appears that establishing that a parent company can or does control a subsidiary’s economic choices will be insufficient to rebut the registered office presumption; something more needs to be demonstrated.⁷³ The “something more” relied on by the Tribunal de Commerce in *Eurotunnel* was that the major part of Eurotunnel’s business was in France, various aspects of administration were carried out in France and restructuring negotiations had taken place in France. It is also not clear whether a debtor’s COMI should be determined on a snapshot basis or whether historical factors can also be referred to.⁷⁴

⁷² See Marshall & Haywood (n 55), section 4.38.

⁷³ *Ibid.*, section 4.38.

⁷⁴ One respected practitioner states that this is the first case she is aware of in which the location of restructuring negotiations has been used as a factor in the assessment of a company’s COMI. She argues that the restructuring of a company’s debts could be seen as part of ‘administering its interests’ but questions the practical implications of whether this takes place on a ‘regular basis’. See Marshall & Haywood (n 55), section 4.38.

- 2.30 In *Shierson v Vlieland-Boddy*⁷⁵ the Court of Appeal held that historical factors can be taken into account when assessing a debtor's COMI, and that a court should be slow to accept that an established COMI has been changed by activities that may turn out to be temporary or transitory. Prior to the decision of the Court of Appeal however there were two conflicting High Court decisions in England regarding the relevance of historical factors. The High Court held in the *Shierson* case that only factors that exist at the date of the hearing to open insolvency proceedings should be considered. This conflicted with the High Court's approach in *Ci4NET.com*⁷⁶ where it was held that the ascertainment of COMI by the court should be achieved by a close analysis of the recent history and present situation of a company. It should be noted however that the ECJ in *Staubitz-Schreiber*⁷⁷ held that the test has to be applied at the time when the application to commence insolvency proceedings is filed which supports the contention that a snapshot approach should be taken by applying the facts at that time.⁷⁸
- 2.31 If a snapshot basis is to be preferred, the presence of restructuring negotiations in a particular place at the time an application for insolvency proceedings is filed may carry more weight than where the company conducted its business prior to such negotiations. However this could lead to problems if particular groups of creditors refuse to travel to the place of negotiations for fear of influencing the location of the debtor's COMI. If historical factors can be taken into account, the business activities of the company prior to such negotiations may be more significant factors in rebutting the registered office presumption.⁷⁹

⁷⁵ [2005] EWCA Civ 974, [2005] 1 WLR 3966, the Court of Appeal held that historical factors can be taken into account when assessing a debtor's COMI, and that a court should be slow to accept that an established COMI has been changed by activities that may turn out to be temporary or transitory.

⁷⁶ See n 65.

⁷⁷ Case C-1/04 [2006] ECR I-701.

⁷⁸ See Marshall & Haywood (n 55), section 4.22.

⁷⁹ *Ibid.*, section 4.37.

2.32 The ‘head office functions test’ was endorsed by the Advocate General in *Eurofood*⁸⁰ as ‘sensible and convincing’:

“...Dr Bondi and the Italian Government submit that if it is to be demonstrated that the centre of main interests is somewhere other than the State where a company’s registered office is located, it consequently needs to be shown that the ‘head office’ type of functions are performed elsewhere. The focus must be on the head office functions rather than the location of the head office because a ‘head office’ can be just as nominal as a registered office is head office functions are not carried out there. In transnational business the registered office is often chosen for tax or regulatory reasons and has no real connection with the place where the head office functions are actually carried out. That is particularly so in the case of groups of companies, where the head office functions for the subsidiary are often carried out at the place where the head office functions of the parent of the group are carried out”.

2.33 It appears in practice that the ‘lack of a comprehensive definition of COMI’ has been overcome to some degree by the example set by the ‘head office functions test’ whereby the registered office presumption is only seen to be rebutted if there is ‘something more’ than the fact that a parent company can be shown to control a subsidiary’s economic choices which is shown especially by the location where the main aspects of administration are carried out.⁸¹ Therefore any evidence designed to show that the COMI is in a Member State other than that in which the registered office is located, must demonstrate that the head office functions were carried out in that other state.⁸² Start here

⁸⁰*Eurofood* (n 43), paras 111-112.

⁸¹ See 2.26 above for a discussion regarding the presence of restructuring negotiations as a means of assessing COMI. Also, following the decisions in *Eurofood* (n 43) and *Re Sendo* [2005] EWHC 1604, Chancery Division, 29 June 2005, the jurisdiction in which a company pays its taxes is becoming a factor that the courts will take into account in assessing the location of a company’s COMI.

⁸² In practice the registered office of a company is not always the debtor’s ‘head office’ however importance is placed on where the head office functions are carried out rather than on the location of the head office.

2.34 One commentator however questions this interpretation and states that the relevant part of paragraph 75 of the Virgos-Schmit Report⁸³ only explains the logic of the choice of presumption and does not present an independent criterion for determining COMI.⁸⁴ He argues that a ‘contact with creditors’ approach better reflects the description of COMI given in Recital 13 and that despite no definition being provided for “head office functions” it is suggested⁸⁵ that the place in which “head office functions” will be carried out will be the place where activities such as strategic, executive and administrative decisions regarding accounting, IT, corporate marketing, branding etc are performed. There remains a shortfall in the approach in that it does not take into account the second part of Recital 13’s requirement that COMI should be “ascertainable by third parties”. As third party creditors are generally not involved in the integral functions of the debtor company, they will not have the necessary awareness of the majority of the aforementioned head office functions.⁸⁶ Therefore it is argued that the head office functions theory does not follow from the interpretation of the text, the history and the system of the EIR. The head office functions theory goes against the principles stated in Virgos-Schmit, paragraph 75, that, in every system of insolvency law, third parties should always be able to assess their risks. Third parties will have to investigate the group structure of a debtor company if it is established that they need to be aware of the operational and managerial structure of the group as well as contract and corporate law issues. It is argued that, if the group’s management decide to move its place of

⁸³ “... the debtor’s centre of main interests is the place of the registered office. This place normally corresponds to the debtor’s head office”.

⁸⁴ See B Wessels, ‘The place of the registered office of a company: a cornerstone in the application of the EC Insolvency Regulation’ (2006) 3 European Company Law 187.

⁸⁵ See M,F & I (n 38) 255, para 8.81. See also *Re Stanford International Bank Ltd (In Receivership)* [2009] EWHC 1441 (Ch), [2009] BPIR 1157; [2010] EWCA Civ 137.

⁸⁶ See Wessels (n 84) 187. There are a number of advantages in connection with the “the head office functions test.” For instance, there are less procedural costs and, because there is access to all of the group’s documents, there is a transparent means of tracing assets. This strengthens the possibility of selling those parts of the business which may function as economic units even though they are operated by various legal entities. See Wessels (n 84) 189.

control, then the ‘head office functions’ approach could be viewed as an invitation for forum shopping.⁸⁷

- 2.35 In light of the above arguments, it is left for Member States to determine whether provisions should be incorporated into the EIR in order to specifically address the insolvency of corporate groups.⁸⁸ The author agrees that, in ascertaining the COMI of a company, particular attention needs to be given to the issue regarding which factors are both objective and ascertainable by third parties (particularly creditors) in order to demonstrate that reality can conflict with legal form (the location of the registered office).⁸⁹ This view was taken in *Re Daisytek* where the English court found that this requirement in Recital 13 of the EIR is of great importance as, if there are to be insolvency proceedings, the creditors need to know where to go to contact the debtor and what legal risks they are incurring in dealing with the debtor. The reliability of the “head office functions test” has been called into question by Lewison J. in *Stanford Bank*, a decision upheld by the Court of Appeal.⁹⁰ Furthermore there needs to be more definitive guidance as to whether a ‘snapshot’ approach or a ‘historic approach’ should be adopted in determining the location of a company’s COMI.
- 2.36 In the absence of further clarification from the ECJ there is a continuing risk that local Member State courts may consider different objective factors when ascertaining COMI and afford them different weightings in terms of importance. Furthermore the continuing uncertainty may also have the consequence that different courts would find that a company’s COMI is in more than one Member State at the same point in time. This leaves the unsatisfactory situation of a possible race to court by competing creditors to try and establish jurisdiction.
- 2.37 Analysing the impact on the Lender of Article 3 and the lack of a comprehensive definition of COMI is not complete, however, without

⁸⁷ See Wessels (n 84) 189-190.

⁸⁸ See Wessels (n 84) 190.

⁸⁹ See Wessels (n 84)190.

⁹⁰ See 3.25-3.27 for further discussion.

considering problematic issues such as what constitutes the opening of proceedings under Article 2(f) of the EIR; the ‘mobile COMI’ phenomenon; and possibility of forum shopping by debtors. Analysing the effects of Article 3 on the Lender also warrants a discussion of the lack of special provisions dealing with group companies which is detrimental to the efficiency and effectiveness of cross border insolvency proceedings.

Uncertainty as to the location of the debtor’s COMI and the impact on the Lender

- 2.38 Uncertainty in relation to a debtor’s COMI causes difficulties for creditors as their risk and remedies might be different in a different Member State. This issue is of particular importance to banks and other secured lenders as the COMI of the debtor may effect both on their ability to enforce and the effectiveness of their security. It is also possible that different creditors may perceive COMI to be in a number of different Member States in cases where the debtor has wide spread operations. One of the issues that directly relates to ascertaining the location of a debtor’s COMI by a secured creditor is determining the time of “opening” a reorganization or insolvency proceeding.
- 2.39 Ascertaining the time at which COMI is assessed or the ‘opening’ of insolvency proceedings is a key factor that creditors or other parties will need to take into account when assessing the risks of entering into business transactions. Being the first to open can have great strategic advantages;⁹¹ it is also the precise point of opening that is critical in order to be able to judge the date at which the “effects” of the “opening” occur and are exported to other jurisdictions by the automatic recognition provisions of Articles 16 -18;⁹² and it is also at

⁹¹ *Eurofood* (n 43).

⁹² With the exception of Denmark.

the point of opening that jurisdiction must exist.⁹³ The concept of ‘opening’ is central to Article 3 and determining the COMI however the word is not defined in the EIR. As discussed in the paragraph below, under Article 2(f) of the EIR, the definition of the ‘time of the opening of proceedings’ only helps in a very limited way.

2.40 Article 2(f) states that ‘the time of the opening of proceedings’ shall mean the time at which the judgment opening proceedings becomes effective, whether it is a final judgment or not.⁹⁴ It is suggested that two points are being made here: First, if the judgment is stayed or if its effectiveness depends on some other step such as registration, filing or advertising, those factors affect the time at which the opening takes place; Secondly, the decision does not need to be final: the order opening a proceeding can be provisional in the sense that it is subject to review.⁹⁵ Other than this clarification, Article 2(f) does not provide much of a definition and it is case law that we have to turn to for some interpretative guidance.⁹⁶

2.41 The automatic recognition provisions of Article 16 add to the importance of being able to clearly identify when proceedings are ‘opened’ for the purposes of the EIR by the courts of a Member State. Given the above issues, it is apparent that an amendment to the EIR would be welcomed, in the interests of transparency, for greater clarity to the meaning of the expression “the opening of insolvency

⁹³ However the ECJ held that the jurisdiction stays in the court where jurisdiction is established at the time of filing. See *Staubitz* (n 77). It should be noted, in addition, that Article 43 only allows the provisions of the EIR to take effect once insolvency proceedings have been commenced. There could subsequently be further conflicts of law if there is any confusion as to when insolvency proceedings are opened due to the potential impact on the application of Articles 5-15. See ‘Evaluation of Council Regulation (EC) No 1346/2000 of 29 May 2000 on Insolvency Proceedings’, Response form for Evaluation Questionnaire completed by The Insolvency Law Committee of the City of London Law Society:

<<http://citysolicitors.org/Default.aspx?sID=920&IID=0>> accessed April 2010.

⁹⁴ In relation to a CVL, a question arises as to whether the proceedings are opened when the meeting of members passes a resolution for the company to be wound up (at which point the company goes into liquidation under English law: Insolvency Act 1986 s 247(2)) or when there is subsequent court confirmation of the liquidation (as required by Annex A of the EIR). For competing views see M, F & I(n 38) 238, para 8.27, FN 46 and 304, para 8.260.

⁹⁵ See G Moss, ‘When is a Proceeding Opened?’ (2008) 21 *Insolvency Intelligence* 33.

⁹⁶ See *Staubitz* (n 77), *BenQ Mobile Holding BV* [2008] BCC 489 and see generally Moss (n 92).

proceedings”. However due to the differences in national laws as to when the various proceedings are opened this may be a challenge.

- 2.42 Another issue that needs to be considered by the Lender in relation to the uncertainty of the location of COMI is the possibility of forum shopping inherent in the COMI concept. It was established earlier through cases such as *Staubitz-Schreiber* that debtors can move their COMI provided they do so before the request for opening proceedings is filed. This gives debtors a window to shift their COMI away from the place where its creditors are located or where relevant debts were incurred. However, any attempt to shift COMI after proceedings are lodged will be ineffective.

COMI Migration

- 2.43 COMI migration involves the movement of a company’s COMI from one jurisdiction to another to make use of a favourable restructuring regime in the new jurisdiction. There are a number of reasons why the insolvency regime of a given jurisdiction may be attractive to a Lender, especially when restructuring a large group of companies based in various locations. A particular insolvency regime may: have a more transparent, flexible and efficient restructuring environment; be more familiar to the Lender; allow the imposition of a restructuring on other dissenting secured or unsecured creditors either by class or as a whole; allow more pre-planning than the regimes of certain jurisdictions;⁹⁷ give the Lender some say in who is appointed as officeholder;⁹⁸ require less court involvement; and enhance employee protection.⁹⁹

⁹⁷ The UK allows pre-pack administrations whereby a company may be placed into administration and immediately sell all or part of its business or assets on terms negotiated by the insolvency practitioner before his appointment as administrator.

⁹⁸ In certain jurisdictions, office holders are appointed by the court on a panel basis with no input from the appointer, which can cause particular problems where industry knowledge is required; in others, the office holder may be a lawyer with limited resources to manage a large-scale financial restructuring. Further, where different regional courts may have jurisdiction

2.44 Ironically, although one of the EIR's main aims is to eradicate forum shopping, it appears instead to have encouraged it, and migration is the most current mechanism for forum shopping.¹⁰⁰ It is argued however that nevertheless, one should contrast "good" and "bad" forum shopping and emerging case law demonstrates that courts are generally keen to distinguish between the two.¹⁰¹ The former is where a jurisdiction is selected based on the interests of all the stakeholders involved, whereas the latter is where a certain stakeholder chooses a jurisdiction solely to promote his own best interests.¹⁰² In *Staubitz-Schreiber*¹⁰³ the ECJ held that COMI is "frozen" at the time of the request to open insolvency proceedings.¹⁰⁴ COMI shifts that occur after that point in time do not affect the allocation of jurisdiction under the EIR.¹⁰⁵ However, apart from the anti-forum shopping sentiment in Recital 4, there is nothing in the text of the EIR that prevents COMI shifts on the eve of insolvency before the debtor files a request to open proceedings.

2.45 The Lender's first concern is whether, in the first step to legitimate forum shopping, there has been a genuine shift in COMI. It will be necessary to ensure that enough is done within the migration process so that COMI can really be established in the new location. As discussed

over different entities, it may not be possible to have a sole office holder even if the entities are incorporated in the same jurisdiction. See L Webb and M Butter, 'Insolvency proceedings, shopping for the best forum': www.practicallaw.com/8-500-7219 published 26 November 2009.

⁹⁹ For further explanation of reasons for COMI-shifting see Webb & Butter (n 98).

¹⁰⁰ S Moore, 'COMI migration: the future', *Insolv. Int.* 2009, 22(2), 25-28, 25

¹⁰¹ Moore (n100) 25. The Advocate General discussed forum shopping in his opinion in *Staubitz* (n 77): 'Forum shopping is merely the optimization of procedural possibilities and it results from the existence of more than one available forum, which is in no way unlawful. However, where forum shopping leads to unjustified inequality between the parties to a dispute with regard to the defence of their respective interests, the practice must be considered and its eradication is a legitimate legislative objective'.

¹⁰² Moore (n100) 25.

¹⁰³ See *Staubitz* (n 77).

¹⁰⁴ If one were to acknowledge a COMI shift after an insolvency petition has already been filed, insolvency proceedings would be much less efficient. This is especially in light of costs being spent in the first proceedings and temporary measures already taken such as appointing an administrator. All these measures would be thwarted if a COMI shift after the insolvency petition resulted in the courts of another Member State acquiring jurisdiction for main insolvency proceedings. See H Eidenmuller, 'Abuse of law in the context of European Insolvency Law', April 2009. *European Company and Financial Law Review*, Vol. 6, No. 1. Available at SSRN: <<http://ssrn.com/abstract=1396623>>, 17.

¹⁰⁵ *Ibid.* 17-18.

earlier, in order to open main proceedings in the destination jurisdiction, there will need to be sufficient evidence to rebut the presumption in the EIR, which as has been discussed, is often rebutted based on the “head office functions test”. Following the European Court’s judgment in *Eurofood*¹⁰⁶ there was some concern that filings based on the location of a group head office would become far more difficult however there have been a number of examples of COMI-based filings post-*Eurofood* around the European Union.

2.46 Schefenacker, Deutsche Nickel¹⁰⁷ and Hans Brochier¹⁰⁸ are examples of German companies who have tried (and in one case, failed) to move their COMI from Germany to England to take advantage of English insolvency laws. The reason driving this migration was that, as a matter of German corporate law, companies could not have their administrative headquarters in a different place from their registered office.¹⁰⁹ An attempt to shift COMI may be made in one of the following ways: by changing registered office; through migration of assets and liabilities; and through a factual relocation of COMI.¹¹⁰ The most likely way of achieving a successful COMI migration becomes apparent when discussing the above-mentioned cases.

2.47 In *Hans Brochier*, a German construction company attempted to transfer its registered address to England. Although the company was at first successful in appointing English administrators out-of-court, it

¹⁰⁶ The High Court followed *Eurofood* (n 43) in *Stanford* (n 85) and held that a company’s COMI is presumed to be at the location of its registered office, unless there are objective factors that are ascertainable to third parties that would lead them to conclude that the head office functions of the company were being carried out elsewhere. For these purposes, what is ascertainable to a third party is what is in the public domain and what a typical party would learn in the ordinary course of business with the company. See Macfarlanes (n 64) 1.

¹⁰⁷ Both unreported. On the *Schefenacker* case, see G Quenby, ‘Moving with the times’ (24 September 2007) , www.thelawyer.com (accessed 28 March 2008); A Tashiro and V Beissenhirtz, ‘German companies heading towards England for their rescue’ (2007) 4 Intl Corporate Rescue 171, 174. See on the *Deutsche Nickel* case, R Hickmott, ‘Forum shopping is dead: long live migration!’ (2007) 5 J of Intl Banking and Financial L 272.

¹⁰⁸ *Hans Brochier Holdings Ltd v Exner* (2006) EWHC 2594; [2007] BCC 127.

¹⁰⁹ A rule that has now changed: see Moore (n 98) 27; R Spedding, ‘COMI migration: history and future’, (2008) 6 CRI 183.

¹¹⁰ See Webb & Butter (n 98).

was subsequently decided by the administrators that the COMI remained in Germany and so they made an application to the English court for directions. The judge held that the company's COMI was in Germany.¹¹¹ This case demonstrates that it is important for directors to consider seriously whether the company's COMI has been relocated, and not simply assume that it will be located in the jurisdiction of the new registered office. It can be concluded that just relocating the jurisdiction of a company's incorporation is insufficient to transfer the company's COMI and satisfy the court that there has been legitimate attempt to move the company's head office functions. The company has to produce enough evidence to rebut the presumption in Article 3(1) that the company's COMI is the jurisdiction of its incorporation.¹¹²

2.48 The more likely way to achieve a successful COMI migration seems to be through a transfer of assets and liabilities. This depends on whether the transfer is valid under the laws of both the original and new jurisdictions and the new legal entity does in fact have its COMI in the new jurisdiction. This is what happened in the landmark cases of *Schefenacker* and *Deutsche Nickel*.¹¹³ It has also been demonstrated that COMI migration can be attained without the need to refer to particular domestic legislation as was illustrated by the *Damovo* restructuring.¹¹⁴

2.49 In the *Schefenacker* case, the group was held through a German parent company and ran its business through subsidiaries located in a number of jurisdictions, including England, the United States, Korea, Hungary, Australia, Germany and Slovenia. It experienced financial difficulties and the main interested parties considered potential restructuring solutions and determined that an English corporate voluntary

¹¹¹ Spedding (n 109) 184.

¹¹² Spedding (n 109) 184.

¹¹³ Only one of these cases will be discussed as an example as similar restructuring strategies were followed in both cases.

¹¹⁴ Spedding (n 109) 184. See also James Quinn, 'Damovo failure to be "first of many"', *Daily Telegraph* (London), Dec 23, 2006 at 25 available at: <http://www.telegraph.co.uk/finance/2952830/Damovo-white-flag-to-be-first-of-many.html>

arrangement (CVA) would provide the best result. Therefore the COMI was to be transferred to England so that, afterwards, main proceedings could be opened in England for the purpose of the EIR which would then be recognized throughout Europe. The transfer of COMI was achieved through a number of steps¹¹⁵ which ultimately resulted in the German company's business being transferred to an English company. In this case the successful migration of COMI from Germany to the UK was vital to the survival of the group and, arguably a legitimate attempt to act in the best interest of all stakeholders. There was a genuine shift of head office functions in contrast to *Hans Brochier*.

- 2.50 The Damovo restructuring is an example of a factual relocation of COMI.¹¹⁶ An IT company moved its COMI from Luxemburg to London prior to effecting a pre-packaged administration by (amongst other things) moving its head office functions to England, telling all suppliers, creditors and counterparties of the move, setting up bank accounts in England and holding board meetings in England. All these steps were disclosed to the English court on the application to appoint administrators and the court was willing to make the appointment, which allowed the pre-pack to proceed. This approach may be of more general application and therefore more instructive for the future regarding COMI migrations. However there are a number of legal and commercial issues that will need to be addressed. To a large extent, these issues will depend on the individual facts, however the most apparent issues that need consideration include those of directors' duties when facing insolvency, the tax regimes, and regulatory and licensing issues.¹¹⁷ This directly links to the issue of potential risks that

¹¹⁵ Moore (n 100) 26.

¹¹⁶ Where the other two methods of COMI migration are not possible (e.g. because of the domestic law of a particular jurisdiction), the alternative solution is to try to establish that the administration of interests is being conducted at another location, as opposed to the country of incorporation. One will generally have to prove that there has been a re-location in head office, central management functions and certain assets to another country. See Webb & Butter (n 95) 39.

¹¹⁷ See Moore (n 100), 27.

secured creditors should be aware of when contemplating supporting a COMI migration.

- 2.51 Overall, for bank creditors, the process involved in effecting corporate migrations is very likely to trigger banking covenants. Thus, in practice, major creditors will need to be in agreement if the migration is to succeed. The potential risks that the Lender should be aware of in relation to a COMI migration include: the costs of considering and implementing the migration which are likely to be significant,¹¹⁸ while there may be shortcomings in the insolvency regime of a given jurisdiction, such jurisdictions may have advantages that would be lost following a shift in COMI;¹¹⁹ A COMI shift that takes place on migration could constitute a shift in residency or domicile for tax purposes; and, once COMI has been shifted and insolvency proceedings have been commenced, it is important, particularly in the case of a multinational corporate group, that the insolvency proceedings are recognized as effective in all countries where the operating company, its guarantors and affiliates in the case of a group insolvency, have businesses or assets.¹²⁰
- 2.52 Furthermore, in certain countries, local law may restrict the ability of a debtor to migrate its COMI.¹²¹ The effect of secondary proceedings also needs to be considered as a COMI migration will not prevent these from opening. The effect of secondary proceedings is discussed in the

¹¹⁸ e.g. the total advisory costs in the Schefenacker restructuring exceeded 40 million euros. A company in financial difficulty may not have the time or funds available to facilitate a shift in COMI. See Webb & Butter (n 98).

¹¹⁹ In *Hans Brochier* (n 108), despite the company's failure to commence proceedings in England, under German insolvency law the insolvency practitioner received state funding to pay three months' salary for the company's 800 employees. See Webb & Butter (n 98).

¹²⁰ A prior judicial determination of COMI, such as a judgment from the relevant EU court which opened the main proceedings, would be of assistance. See Webb & Butter (n 98).

¹²¹ See Case-C210/06 *Cartesio Okato es Szolgaltato bt* [2009] 1 CMLR 50. The Advocate General's opinion stated that preventing a company from transferring its administrative centre from one member state to another amounted to a restriction on the right of freedom of establishment and movement. If the ECJ had followed the Advocate General's Opinion, the case could have had real ramifications for those EU jurisdictions which have attempted to confine the ability of a company to relocate its COMI, whether at all or prior to a restructuring. However the ECJ took the contrary view and so this issue remains a risk for companies seeking to migrate COMI between certain jurisdictions.

following section. The main concern for the Lender is the fact that the assets in that jurisdiction may effectively be carved out of the main proceedings and will be subject to the insolvency law of the secondary jurisdiction. The issue of forum shopping and predictions regarding future COMI migrations are discussed further in Chapter 3.

Secondary Insolvency Proceedings under Article 3(2), the definition of ‘establishment’ and the impact on the Lender

- 2.53 As outlined earlier, in addition to the main insolvency proceedings, Article 3(2) gives the courts of a Member State in which the debtor does not have his COMI but has an ‘establishment’ jurisdiction to open insolvency proceedings in relation to that debtor. The effect of Article 3(2), however, is not universal and is restricted to the assets of the debtor situated in the territory of the particular Member State. The definition of ‘establishment’ is clearly crucial as without the finding of an ‘establishment’, secondary proceedings cannot be commenced.
- 2.54 Article 2(h) defines ‘establishment’ as any place of operations where the debtor carries out a non-transitory economic activity with human means and goods. The effect of this is that it is insufficient for a debtor to have assets within a Member State; there must be a place of operations within the state in order for the courts of that state to have jurisdiction to open territorial proceedings. One issue that arises is whether the definition of ‘establishment’ should be extended to include services¹²² so that companies operating solely in the provision of services will fall within the ambit. Furthermore it is not clear why the test for ‘establishment’ does not include a requirement for factors to be

¹²² As per the definition in the UNCITRAL Model Law and implemented in the Cross-Border Insolvency Regulations 2006.

“ascertainable by third parties” as is the case when determining COMI.¹²³

2.55 In contrast to COMI there is little case law on the meaning of ‘establishment’ and this matter has not been considered by the ECJ. One difficulty that has been identified concerns the phrase “human means” especially as regards self-employed traders. The definition of establishment needs clarifying because, from the Lender’s perspective, it will not be clear at the stage of analysing risk assessment, whether secondary proceedings can actually be opened. In addition, whether historical factors can be taken into account by a court when assessing whether the debtor possesses an ‘establishment’ in the jurisdiction is also something that would benefit from clarification.¹²⁴

2.56 Another consideration for the Lender, not dissimilar to COMI migration, is the issue of whether it is possible for a debtor to disband or freely re-locate an establishment if, at the time of dealing with the debtor through that particular establishment, there were resulting outstanding debts and liabilities.¹²⁵ It is submitted that if it can be shown that the creditor will be “substantially prejudiced” due to the move or disbandment of the establishment, then use of an “an estoppel-like doctrine” will enable the relevant parties to apply for the opening of proceedings in the state in which the establishment formerly operated, and to seek invalidation of any acts where the debtor tried to move assets from that jurisdiction during the period preceding the disbanding of the former establishment.¹²⁶ It is important to note that the decision of the ECJ in *Staubitz-Schreiber*¹²⁷ in relation to COMI and the policy of the EIR against forum shopping demonstrates that a

¹²³ See Recital 13 of the EIR. Generally see A.7 for discussion on how the concept of an ‘establishment’ was introduced in the Phase I draft conventions. See A.12 for further developments under the Istanbul Convention and the introduction of the possibility of territorial or secondary proceedings. See A.14 for early criticism of the possibility of opening secondary proceedings.

¹²⁴ Courts in Belgium, Estonia and Sweden have reached differing conclusions on whether past business activity can give rise to an establishment.

¹²⁵ See M, F & I (n 38) 274, para 8.144.

¹²⁶ See M, F & I (n 38) 274, para 8.144.

¹²⁷ *Staubitz* (n 77).

debtor cannot discontinue an establishment after a request to open insolvency proceedings in order to escape the jurisdiction of the courts in the Member State in which the request has been filed.¹²⁸ However there is still a time frame in which the debtor can move or discontinue an establishment prior to the making of a request to open proceedings.¹²⁹

- 2.57 In addition to the concept of ‘establishment’ the ability to open secondary proceedings in Member States generally, regardless of the fact that main proceedings have already been opened in the Member State where the debtor has its COMI, may cause difficulties in practice for the Lender.¹³⁰ There is also the issue that secondary proceedings are restricted to winding-up proceedings. In particular, where main proceedings have been opened in relation to a number of group companies in one jurisdiction, the opening of secondary proceedings in relation to the group company may impact on the ability to rescue the companies within the group in a coordinated and effective manner. Accordingly it may often be in the interests of the creditors of all individual group companies that secondary proceedings are not opened. Not only will the opening of secondary proceedings make the rescue of the company concerned more difficult, it will also result in the duplication of expenses and work carried out by office holders.¹³¹

Article 16 of the EIR: Recognition of Insolvency Proceedings

- 2.58 Having discussed Article 3 and jurisdiction criteria, the requirement of recognition in all Member States is emphasized as these important

¹²⁸ See M, F & I (n 38) 274, para 8.143.

¹²⁹ This is consistent with the principle of freedom of establishment however the migration of an establishment could be problematic for creditors as discussed above.

¹³⁰ See M, F & I (n 38), 275, 8.149

¹³¹ Insolvency Law Committee Response (n 93), Question 11.

elements would not be workable in practice without the principle of mutual trust. Because the EIR operates a system of automatic recognition, any concerns that creditors might have had about the impact of Articles 3 and 4 on their assets are made all the more prominent due to the application of Article 16.

- 2.59 Once insolvency proceedings have been commenced in one Member State then the opening of insolvency proceedings and their effects are immediately recognized in all other Member States without the need for any further formalities. This rule of automatic recognition reflects the principle that these proceedings are to have universal effect over all of the debtor's assets wherever situated within the European Union (except Denmark).¹³²
- 2.60 The removal of any lapse of time between the proceedings becoming legally effective in the State of opening and their being recognized throughout the other Member States, and hence having the same authority in all of them as they have in their State of origin, reduces the risk of foreign creditors engaging in a 'race of diligence' during the period between the commencement of insolvency proceedings in the debtor's 'home' country and the moment when the liquidator can succeed, country by country, in obtaining a judicial order granting powers of enforcement over such assets as are located within each jurisdiction.¹³³
- 2.61 In *Eurofood*¹³⁴ the ECJ held that the first sentence of Article 16(1) can be more accurately interpreted as portraying the fact that the courts of other Member States are required to recognize main insolvency proceedings opened by a Member State without those courts being able to review the jurisdiction of the court of the opening state. Article 16(1) establishes a rule of priority that is based on the principle of

¹³² Although it is clear that Denmark is not a 'Member State' for the purposes of Article 16, questions have arisen concerning Denmark's obligations under the EIR: see M, F & I (n 38) 305, para 8.262.

¹³³ Fletcher (n 36) 421. It should be noted however that Article 16 does not prevent the opening of secondary proceedings.

¹³⁴ *Eurofood* (n 43).

“mutual trust.” This has facilitated the creation of a mandatory system of jurisdiction that has allowed Member State to adopt a more simple means for the recognition and enforcement of decisions within insolvency proceedings as opposed to applying their internal rules of recognition and enforcement of foreign judgments.¹³⁵ If an interested party has the opinion that COMI is located in a Member State that differs to that in which main insolvency proceedings have been opened and wants to dispute the jurisdiction adopted by the court which opened those proceedings, it can make use, before the courts of the Member State in which main proceedings were opened, of the remedies stipulated by the national law of that Member State against the opening decision.¹³⁶

- 2.62 It should be noted however that only the insolvency proceedings within the scope of the EIR benefit from the system of recognition provided. Proceedings not listed in the Annexes are not eligible for recognition under the EIR nor can they prevent the recognition of proceedings provided for in the EIR even though they were opened earlier.¹³⁷
- 2.63 Where secondary insolvency proceedings are opened, or where independent, territorial proceedings are opened under the circumstances specified in Article 3(4), these too are encompassed by the basic principle of automatic recognition stipulated in Article 16(1), which does not distinguish between main and secondary or independent territorial proceedings for this purpose. The effects of secondary and territorial proceedings are restricted to assets of the debtor located in the territory of the State of opening, but the liquidator may have to engage in some actions in other Member States during the course of his administration, especially where assets which properly comprise part of

¹³⁵ This is subject to Article 26 [See 2.77-2.87], the public policy exception, which is one of the limited exceptions as outlined in Recital 22 of the EIR: “...to that end, grounds for non-recognition should be reduced to the minimum necessary.” Also see Article 17 in relation to the ‘effects of recognition’ [See 2.69 – 2.76].

¹³⁶ See *Eurofood* (n 43), paras 39-40, 43, operative part 2.

¹³⁷ *Virgos-Schmit* (n 42), para 145.

the secondary estate are found to have been re-located.¹³⁸

- 2.64 The second paragraph of Article 16(1) confirms that the rule of recognition shall also apply where, on account of the debtor's capacity, insolvency proceedings cannot be brought against the debtor in other Member States. Therefore, the fact that a debtor is not considered to be insolvent according to the relevant test under the law of another Member State, or that he is there regarded as belonging to a category of debtor, who is excluded from the operation of insolvency law, cannot be a reason for refusal of recognition to insolvency proceedings opened in the first State.¹³⁹
- 2.65 As there is no time limit for the opening of secondary proceedings, the secured creditor faces the risks at all times that important assets may be taken over by secondary proceedings. In order to avoid this, the creditor's concern is that the liquidator in the main proceedings moves all assets to his own country as soon as possible. Despite his choice of action however, the liquidator will find it difficult to negotiate the sale of a whole enterprise, with establishments and assets in several member states as a going concern.¹⁴⁰
- 2.66 The effect of Article 16 on creditors is compounded by the definition supplied in Article 2(f), whereby 'the time of the opening of proceedings' is declared to mean 'the time at which the judgment opening proceedings becomes effective, whether it is a final judgment or not'. There are difficulties in ascertaining precisely when recognition bites in the case of insolvency proceedings that are initiated out of court under national law.¹⁴¹
- 2.67 Overall, a judgment opening proceedings does not need to be a final

¹³⁸ Fletcher (n 36) 424.

¹³⁹ For example, the laws of some states do not provide for insolvency proceedings to be brought against an individual who is not a trader; however, if such proceedings are opened in another Member State then those proceedings must be recognized regardless of the fact that it would not have been possible to have commenced those proceedings under domestic law. See M, F & I (n 38) 194, para 8.134.

¹⁴⁰ See M, F & I (n 38) 196, para 8.142.

¹⁴¹ See Virgos-Schmit (n 42), 52 & 68.

judgment (meaning one not subject to further appeal) in order to enjoy recognition provided that its effects have not been stayed by the court which granted it.¹⁴² Such judgment whether final or provisional shall have effect in the whole territory covered by the EIR as long as it is effective in the State of the opening of proceedings.¹⁴³ If a judgment opening proceedings is discharged on rehearing or on appeal¹⁴⁴ then the obligation of other Member States to recognize the judgment must come to an end. In the period after the judgment ceases to have effect,¹⁴⁵ a judgment of a court of another Member State, having jurisdiction pursuant to Article 3, may open insolvency proceedings and its judgment must be recognized by all other Member States including the state in which the earlier (but discharged) judgment was given.¹⁴⁶

2.68 One issue that is unclear however is what happens, under English law for instance, where there is a company voluntary arrangement ('CVA')¹⁴⁷; or creditors' voluntary liquidation ('CVL'). In the case of the former, a decision by meetings of a company's members and creditors to place the company into a CVA would attract automatic recognition under the EIR.¹⁴⁸ In the case of the CVL the position is complicated by the fact that Annex A to the EIR expressly states that the insolvency proceeding is 'creditors' voluntary –winding up (with confirmation by the court)'.¹⁴⁹ This suggests that court confirmation is a necessary element of the proceeding governed by the EIR and therefore it is the court confirmation that opens the proceedings.¹⁵⁰

¹⁴² Fletcher (n 36) 421.

¹⁴³ Virgos-Schmit (n 42), para 147 : The EIR is based on the principle of Community trust and the 'favor recognitionis', so that national borders are no obstacle to the efficient administration of international insolvency proceedings throughout the Community.

¹⁴⁴ For example on the grounds of lack of jurisdiction.

¹⁴⁵ for example pending a further hearing or appeal.

¹⁴⁶ See M, F & I (n 38) 196, para 8.143.

¹⁴⁷ Under IA 1986, Part I.

¹⁴⁸ A CVA comes within the phrase 'Voluntary arrangements under insolvency legislation' in Annex A even though there is no court judgment (in an English law sense) opening the proceedings.

¹⁴⁹ See Insolvency Rules 1986, r 7.62 (inserted by the Insolvency (Amendment) Rules 2002), which sets out the procedure in England for an application for confirmation. See also M, F & I (n 38), para 8.22, FN 36.

¹⁵⁰ In relation to a CVL, see n 94.

Article 17 of the EIR: Effects of Recognition

- 2.69 Article 17(1) describes the effects of automatic recognition set out in Article 16 in relation to main insolvency proceedings and Article 3(2) proceedings. ‘Automatic recognition’ means immediate recognition by virtue of the EIR without any need to resort to preliminary proceedings to declare it effective.¹⁵¹ Recognition has its effects under Article 17 ‘with no further formalities’. This means that creditors are subjected to such effects without any need to issue local proceedings or carry out any other measures. The ‘effects’ are not further defined and depend on the law of the proceedings, the *lex concursus*.¹⁵²
- 2.70 ‘The judgment’ opening Article 3(1) proceedings is to have the same effects in all the Member States as under the *lex concursus*. This means that, in practice, the judgment may have more far reaching effects on creditors than proceedings in their own Member States would have had. Moss, Fletcher & Isaacs submit that the following seem to be included within the ‘effects’ of a judgment opening proceedings: the appointing of a liquidator; the divestment of the debtor; the restriction of individual executions; the estate encompassing all of the debtor’s assets in the estate; and the important requirement that each creditor has to return what they have received following the commencement of insolvency proceedings..¹⁵³

However, it should be noted that the applicability of the *lex concursus* is subject to the various exceptions stated in Articles 5 to 15.

- 2.71 Therefore, the automatic recognition of the effects of a judgment commencing main proceedings is subject to two specific types of exceptions: where the EIR provides otherwise (for example the exceptions relating to the rights in rem of third parties (Article 5), the

¹⁵¹ Virgos-Schmit (n 42), para 152.

¹⁵² See Recital (23).

¹⁵³ See M, F & I (n 38), 306, 8.266 and Virgos-Schmit (n 42), para 154.

set-off of mutual debts (Article 6), and to retention of title (Article 7);¹⁵⁴ and where Article 3(2) proceedings have been commenced in a Member State.¹⁵⁵

- 2.72 Article 17(2) provides for the recognition of Article 3(2) proceedings and gives the Lender some protection. The second sentence deals primarily with two types of situations: the first is where the Article 3(2) proceedings have produced a stay of creditors' remedies;¹⁵⁶ and the second is where Article 3(2) proceedings are concluded by creditors agreeing to discharge the debtor, for example, by a compromise of their claims against the debtor.
- 2.73 Without the relevant consent from the creditor, Article 17(2) clarifies that a discharge will only effect the debtor's assets which are located in the Member State in which the territorial proceedings were commenced. The creditor can therefore seek the rest of his claim against the debtor's assets in other Member States.¹⁵⁷ It is not clear though whether 'consent' in this case can apply, where court approval is given, to a consent binding a minority through getting the requisite majority vote or whether 'consent' only refers to individual consents. It is argued that it would make little sense in having the consent exception unless a "locally acceptable means of majority voting so as to bind a minority could supply the necessary consent."¹⁵⁸
- 2.74 Virgos-Schmit however adopts a more cautious approach in protecting creditor rights by stating that consent means individual consent so that the restriction provided can only be relied on against creditors who have accepted it individually and not by majority vote.¹⁵⁹ Creditors' consent can therefore not be replaced by a decision of the court.

¹⁵⁴ *Ibid.*

¹⁵⁵ In addition, Article 26 might give rise to an exception where recognition of the insolvency proceeding is opposed by a Member State on the grounds of public policy. See M, F & I (n 38) 306, para 8.267.

¹⁵⁶ That stay cannot extend beyond the member state where those proceedings have been opened save in respect of creditors outside who have consented.

¹⁵⁷ See M, F & I (n 38) 307, para 8.272.

¹⁵⁸ *Ibid.* 308, para 8.273.

¹⁵⁹ Virgos-Schmit (n 42), para 157.

- 2.75 Although the liquidation of assets can be organized quite easily on a territorial basis, this is not true of the discharge of liabilities as liabilities are assignable to the capital as a whole, not to specific assets. It should be noted that the laws of Member States vary significantly with respect to the question of discharge. It has been suggested that a distinction is necessary between a discharge that results from a composition or insolvency plan¹⁶⁰ and the availability of a ‘fresh start’¹⁶¹ for debtors who are natural persons by means of a discharge of residual claims.
- 2.76 As referred to in the discussion regarding Article 16, *Eurofood* emphasizes the application of the principle of mutual recognition.¹⁶² Subject to the public policy exception, as discussed in the next section, once a decision has been made to open proceedings in one Member State, courts in other Member States must respect the decision and cannot generally question it on substantive or procedural grounds. It follows that any challenges to the first court’s assumption of jurisdiction will ordinarily have to be made in that Member State.

Article 26: Public Policy

- 2.77 The EIR is based on the principle of mutual trust and the general legal presumption that the judgment handed down in another Member State is valid. This is the reason why the only ground for opposing recognition is that the judgment handed down in another Member State is contrary to the public policy of the requested State.¹⁶³ This provision

¹⁶⁰ Under a composition or insolvency plan, all affected claims, regardless of whether or not they were lodged by their holders and whether or not they accepted the plan, may be discharged and replaced by the obligation provided by the plan. There may be a potential problem in ensuring coordination between the main and the secondary proceedings. See V & G (n 2) 180, para 337.

¹⁶¹ A ‘fresh start’ represents a distinct insolvency policy that is unrelated to the collective action problem that gives insolvency law its general shape. See V & G (n 2) 180, para 336.

¹⁶² *Eurofood* (n 43).

¹⁶³ Virgos-Schmit (n 42), para 202.

should only take effect in exceptional circumstances which is reflected in the wording ‘manifestly’ contrary to public policy.¹⁶⁴ However, the Lender needs to be aware of this exception to Article 16 as it could have an unanticipated turn of events against the Lender’s expectations.

- 2.78 In practice, case law demonstrates that a restricted approach is predominantly taken in the application of Article 26 which means that, in practice, the position of the Lender after insolvency effects have been determined, will remain relatively unaltered. However there is always the possibility that in the future, case law may interpret Article 26 less rigidly and the application of this provision will then be of greater concern to the Lender.
- 2.79 The restricted application of Article 26 is apparent in cases such as *Re Stojevic*¹⁶⁵ and in *Eurofood*.¹⁶⁶ It was held in *Re Stojevic* by the Austrian Supreme Court, confirming the decision of the Higher Regional of Vienna (Court of Appeal), that it was not possible to refuse recognition under Article 26 if the only reason for the refusal was because it was believed that the court that first opened main proceedings had taken jurisdiction without any sufficient grounds. The point was clear enough not to be referred to the ECJ for a preliminary ruling.¹⁶⁷
- 2.80 Non-recognition of insolvency proceedings should solely be means of last resort. This is because Recital 22 requires that that the grounds for non-recognition of insolvency proceedings commenced in other Member States should be kept to the minimum necessary. The only real justification for using non-recognition under Article 26 would be if was a gross violation of fundamental legal principles and, especially, procedural principles. In this case it was not ‘manifestly contrary’ to Austria’s public policy that the judgment of the High Court in England did not particularize the grounds for the basis of the English court’s

¹⁶⁴*Ibid.*, para 204. The limited scope of the public policy exception was considered by the ECJ in *Eurofood* (n 43).

¹⁶⁵ (Austrian Supreme Court, 17 March 2005), 8 Ob 135/04t.

¹⁶⁶ *Eurofood* (n 43).

¹⁶⁷ See M, F & I (n 38) 324, para 8.332.

jurisdiction¹⁶⁸ to commence the insolvency proceedings. It is argued that the Austrian Supreme Court's ruling is to be welcomed and correspond with the view of the ECJ in the Eurofood decision.¹⁶⁹

- 2.81 In *Eurofood*, both the Advocate General and the ECJ referred to the restricted scope of Article 26. The Advocate General referred to Recital 22 and stated¹⁷⁰ that it was clear that the public policy exemption was intended to be of limited scope. This is emphasised by Virgos-Schmit, which states: 'The public policy exception ought to operate in exceptional cases'.
- 2.82 The ECJ held that these exceptional cases will only occur where recognition or enforcement of a judgment delivered in another Member State is at variance to an "unacceptable degree" with the legal order of the Member State in which enforcement is sought. This will happen, for instance, where recognition or enforcement will infringe fundamental rights. Any infringement will have to constitute a manifest breach of a rule of law regarded as essential in the legal order of the Member State in which enforcement is sought or of a right recognized as being fundamental within that legal order. In particular a Member State may refuse to recognize insolvency proceedings opened in another Member State where the decision to open the insolvency proceedings 'was taken in flagrant breach of the fundamental right to be heard'.¹⁷¹ Importantly, however, the ECJ pointed out that the Irish court in that case could not hold that there was a breach of this fundamental right simply because there was no fair oral hearing, even though that might be fundamental to Irish notions of a fair hearing, if in all the circumstances¹⁷² there was a fair hearing.¹⁷³

¹⁶⁸ This was because of the lack of a written judgment giving reasons for the finding that the COMI was in England.

¹⁶⁹ See Marshall & Haywood (n 55), section 9.2.

¹⁷⁰ See n 43, para 131.

¹⁷¹ *Ibid.* para 67 of the judgment.

¹⁷² i.e. the ability to file written submissions.

¹⁷³ *Eurofood* (n 43), para 68. See also *Daisytek* (n 62), *Public Prosecutor v Segard (as Administrator for Rover France SAS)* Versailles Court of Appeal, (15 December 2005) (*MG Rover*) and *Re Muscle Tech Research and Development Inc* [2006] OJ No 3300 Ont SCJ. See M, F & I (n 38) 324, 8.333

- 2.83 This and subsequent authorities are helpful as they indicate that the Lender can, according to the present approach adopted by courts in the EU and internationally, rely to a certain extent on the predictability that the court will defer to the judicial decisions made in a foreign main proceeding as long as it is satisfied that due process protections are in place and in such cases, comity will override any reliance on public policy. On the whole it also appears that courts recognize creditor interests and the need for certainty in terms of the creditors' reliance on the COMI of the debtor and the insolvency effects rendered by the *lex concursus*.
- 2.84 It is important however to bear in mind that the approach in relation to Article 26 might become more relaxed in the future and that there have been instances where Article 26 has been applied. In *Hans Brochier*, administrators were appointed out of court in England in respect of a Germany company on the basis of an assertion by the directors that COMI was in the United Kingdom. The German court¹⁷⁴ refused to recognize the opening in the UK on the grounds COMI was in Germany, the UK opening was fraudulent and that Article 26 applied. Subsequently, the UK administrators obtained a declaration from the English court that, in light of further information from Germany, COMI was in Germany.¹⁷⁵ It followed that the opening of main proceedings had been invalid.
- 2.85 As public policy derives from national law, the concept does not have a uniform standard throughout the Community. Public policy will differ according to the individual State's fundamental principles of the law including constitutionally protected rights and freedoms. It is important to remember this although Article 26 minimizes the risk of being too broad by excluding unreasonably wide interpretations of public policy.¹⁷⁶ Furthermore public policy is interpreted as encompassing the essential procedure guarantees such as the adequate opportunity to be

¹⁷⁴ *Amtsgericht Nurnberg*, ZIP 2/2007 81.

¹⁷⁵ *Hans Brochier* (n 108).

¹⁷⁶ *Virgos-Schmit* (n 42), para 205. Also see para 208: judgments affecting personal freedom or postal secrecy from the obligation of recognition and enforcement are also excluded.

heard and the rights of participation in the proceedings.¹⁷⁷ It does not involve a general control of the correctness of the procedure followed in another Member State.¹⁷⁸

- 2.86 Moreover, the public policy exception, where capable of being invoked, need not result in the total rejection of the judgment emanating from the other Member State. It may be possible to refuse recognition or enforcement of specific portions of the judgment, while allowing other parts to enjoy effect.¹⁷⁹ The extent to which this may be possible will depend on the exact circumstances of the individual case.
- 2.87 It has been suggested by Dr Gerald Masch,¹⁸⁰ that if jurisdiction to open main proceedings has been taken on the basis of a move of COMI designed to avoid creditors then this may not be recognized in other Member States on the basis of Article 26.¹⁸¹ The writer questions whether Article 26 can be used as a means of attacking bad forum shopping¹⁸² however submits that each case would have to be assessed on an individual basis and it may be difficult to prove the reason for a move of COMI was specifically to avoid creditors. It will be interesting to see whether the application of Article 26 in future case law will gradually adopt this approach in the interests of protecting the security rights of creditors.

Article 4: Law applicable

- 2.88 The general rule given effect to by Article 4(1) is that the law applicable to insolvency proceedings is that of the state where the proceedings are commenced (the *lex concursus*). This rule applies to

¹⁷⁷ These rights have a crucial role in plans to reorganise businesses or compositions.

¹⁷⁸ Virgos-Schmit (n 42), para 206.

¹⁷⁹ *Ibid.*, para 209.

¹⁸⁰ At the European Academy of Law (ERA) on 19 September 2006.

¹⁸¹ See also See M, F & I (n 38) 325, para 8.335.

¹⁸² See paras: 2.44; 2.170; 3.7; and 3.14 for analysis of what amounts to ‘good’ and ‘bad’ forum shopping.

main and secondary proceedings.¹⁸³ It presupposes that the court has jurisdiction to open insolvency proceedings according to the EIR, which means that the rules of international jurisdiction¹⁸⁴ end up fulfilling a double function: they determine the competent jurisdiction directly and the applicable law indirectly.¹⁸⁵ Article 4(1) contains a very broad and general description which includes both the opening, conduct and closure of the insolvency proceedings as well as their effects, both procedural and substantive,¹⁸⁶ on the rights and obligations of all the concerned parties.

2.89 There are a number of reasons why Article 4(1) is important to the Lender. Firstly, in a world of sovereign states with different insolvency policies, it allows a single set of insolvency policies to be pursued. Insolvency proceedings are collective proceedings and in order for collective proceedings to function effectively it is necessary for there to be clear legal positions. It would therefore appear that the efficient conducting of cross-border insolvency proceedings depends on whether the recognition of the relevant states is not limited to just recognition of the jurisdiction in which main proceedings were commenced but also extends to the effect of any judgments given by the courts in those proceedings and the powers of the liquidators in those proceedings. This will only occur if there are harmonized rules on conflict of laws that guarantee some certainty that, in the event of insolvency, rights created or granted in insolvency proceedings will be recognized throughout the Member States.¹⁸⁷

2.90 Article 4(1) enables the Lender and other parties to readily identify their rights and obligations, and consequently to bargain “in the shadow

¹⁸³ See Recital 23 and Article 28 of the EIR. Article 28 specifically deals with the position in relation to secondary proceedings. However, since Article 4(1) is stated as a general rule it must be taken as applying to independent territorial proceedings. See also Virgos-Schmit (n 42) para 89

¹⁸⁴ Articles 3(1) and 3(2).

¹⁸⁵ See V & G (n 2) 72, para 118.

¹⁸⁶ The fact that both types of effects are subject to the same law reduces the difficulties of legal application because it eliminates problems of characterization and adjustment. See V & G (n 2) 73, 119. See also Virgos-Schmit (n 42) para 90.

¹⁸⁷ See M, F & I (n 38) 279, para 8.161.

of” a single legal system. Secondly, it facilitates the administration of the proceedings as there is one applicable forum which thereby avoids the costs associated with the application of foreign law (problems of legal adjustment, information on foreign law, etc). This argument is particularly strong in those proceedings, such as insolvency proceedings, where the procedural aspects and the substantive aspects are closely linked. Finally, it ensures, from the conflict of laws perspective, that all of the creditors of the same insolvent debtor are subject to the same proceedings and to the same legal system.¹⁸⁸

2.91 The Lender will be concerned about the specific wording of Article 4(1) and in particular the interpretation of what insolvency ‘effects’ are subject to the *lex concursus*. Under all national laws, insolvency proceedings may interfere and bring about abrupt changes in the legal position of the debtor and the creditors. These changes encompass the legal consequences and variations which the procedural and substantive rights of the debtor and the creditors must undergo in order to achieve the objectives of the insolvency proceedings, as set forth by the *lex concursus*. From this perspective, the *lex concursus* displaces, in so far as insolvency policy requires, the law governing the affected act or right itself. The Lender will need to be aware that these insolvency policy-based effects may be greater or lesser depending on the legislative policy decisions of each State especially at the initial stage of bankruptcy proofing a transaction. Generally there are systems which significantly alter the positions of the parties and there are others which respect those positions as far as possible and which are less ‘interventionist’ than others.¹⁸⁹

2.92 It is submitted that, in terms of insolvency policies, the EIR is itself neutral. It respects national diversity and admits in its Annexes, insolvency proceedings with a very different degree of “interventionism”. In accordance with Article 4, it is the task of the *lex*

¹⁸⁸ See V & G (n 2) 89-90, para 135.

¹⁸⁹ *Ibid.* 73, para 119. See also 1.119 -1.125 in relation to the principles of universalism and territorialism.

concurus to establish the degree to which the insolvency proceedings need to interfere in the rights and relationships of the parties¹⁹⁰ which are necessary for the insolvency to achieve its collective objectives.¹⁹¹

2.93 The Lender will therefore be concerned with the unanticipated effects that the intervention of the *lex concursus* might cause. It is important to note, however, that the *lex concursus* may only interfere with the law governing the act or right itself for insolvency law reasons. It determines the impact of the insolvency proceedings on those acts or rights; but it must only apply to the extent required by insolvency law policies. The *lex causae* continues to apply to other civil law consequences not connected with insolvency policies. On many occasions, the application of this criterion requires the decision as to whether or not a given effect is founded on insolvency law policies to be inferred from the ‘sense and purpose’ of the rule which establishes it. If this is the case, the *lex concursus* takes precedence over the *lex causae*; if not, then the latter continues to apply.¹⁹²

2.94 In practice, the application of domestic insolvency law under Article 4 may not be so straightforward. For instance, in some special circumstances, it could indirectly lead to the application of the law of another Member State. From the point of the Lender, it is a risk that could not have been anticipated. However, it could also be advantageous. One example of this is the case of *Collins v Aikman Europe SA*.¹⁹³ The English court had opened main proceedings in respect of a number of companies incorporated in other Member States. The English court considered the fact that promises had been made by the administrators to local creditors to the effect that local law priorities would be respected if they did not cause secondary proceedings to be

¹⁹⁰ i.e. the modifications, restrictions or redistributions.

¹⁹¹ See V & G (n 2) 73, para 119.

¹⁹² In any case the EIR establishes some safeguards against an excessive ‘interventionism’ by the *lex concursus*: (i) the exceptions in favour of a different national law expressly established in Articles 5-15;(ii) the possibility of opening territorial proceedings, which will result in a different *lex concursus* being applied;(iii) and in extreme cases, the public policy clause, Article 26. See V & G (n 2) 73, para 119.

¹⁹³ [2006] EWCH 1343 (Ch); [2006] BCC 861.

opened. This resulted in the English court directing that, according to English law principles of justice, the local law priorities to the claims of the creditors of each company should be applied in the main proceedings.¹⁹⁴ This enables the possibility of having a single main proceeding in relation to a debtor, without requiring secondary proceedings, whilst also simultaneously respecting the substantive rights which local creditors would possess in secondary proceedings under the relevant local law.¹⁹⁵ As discussed in the paragraph above, the national law applied under Article 4 should be interpreted purposively and in such a way as to give effect to the purpose of the EIR.

Article 4(2): non-exhaustive matters governed by the *lex concursus*

2.95 Article 4(2) contains a list of specific matters which are subject to the *lex concursus*. This list is not exclusive and its function is to facilitate the interpretation of the general rule in Article 4(1) and to resolve any problems of characterization or doubts which may arise with regard to its application. The analysis of Article 4(2) will focus on only a few of the matters contained in Article 4(2) as paragraphs (a) to (m) are largely self-explanatory.

Article 4(2)(a)

2.96 Article 4(2)(a) states that the *lex concursus* shall determine against which debtors insolvency proceedings may be brought on account of

¹⁹⁴ It is suggested that this decision illustrates that the English Insolvency Act is not a compulsory code which necessitates the application of English substantive law in all circumstances. See M, F & I (n 38) 280, para 8.165.

¹⁹⁵ See M, F & I (n 38) 280, para 8.165.

their capacity. It is particularly significant when considering the wide diversity between the insolvency laws of the 26 participating EU Member States concerning the types of debtors to which the different kinds of insolvency proceedings are applicable.¹⁹⁶ With regard to this issue, it is important to bear in mind Article 3(4) which permits a territorial insolvency to be opened precisely in those cases in which the law of the State where the debtor has its COMI does not permit it; and Article 16(1), whereby the fact that according to the law of the State where the recognition of the insolvency proceedings is requested the debtor, on account of his capacity, cannot be subject to insolvency proceedings is not admissible as a reason for refusing to recognize those proceedings.¹⁹⁷

Article 4(2)(e)

2.97 This covers matters such as the termination of such contracts as a result of the opening of the proceedings and for these purposes the law which would otherwise be applicable to the contract may be displaced.¹⁹⁸ The first question that comes to mind is exactly what is included within the definition of ‘current contracts’? Article 8 (contracts relating to immovable property), Article 9 (payment systems and financial markets), and Article 10 (contracts of employment) must be taken into account, as they establish exceptions to this rule. The term ‘current contracts’ has been held by the English Commercial Court to include arbitration clauses.¹⁹⁹

¹⁹⁶ Under the laws of Belgium, France, Greece, Italy, Luxembourg, Portugal, and Spain, respectively, insolvency proceedings cannot take place in relation to the debtors who are not classified as traders (*commercants*). In the case of Italy, Article 2083 of the Civil Code also excludes small-scale traders (*piccoli imprenditori*) from the operation of the bankruptcy law. See M, F & I (n 38) 58, para 4.07 & FN 11.

¹⁹⁷ See V & G (n 2) 74, para 121.

¹⁹⁸ Virgos-Schmit (n 42) para 91(e).

¹⁹⁹ *Elektrim v Vivendi* [2008] EWHC 2155 (Comm) and on appeal [2009] EWCA Civ 677.

2.98 It is submitted that the *lex concursus* governs the effects on current contracts regardless of whether such effects are invoked by the administrator (for example in order to escape some of the debtor's contractual obligations) or by the other party to the contract (for example a seller refusing to deliver goods because of anticipated non-payment). The latter effect would be more appropriately governed by the law applicable to the contract in question, but that seems to be incompatible with the wording of Article 4(2)(e).²⁰⁰

Article 4(2)(f)

2.99 The effects on individual enforcement actions, both pending and future, are always determined by the *lex concursus*,²⁰¹ including preservation measures. A stay on the normal methods of enforcement against the debtor and his assets is common to all Member States. Where such a stay on action against the debtor arises under the law of the state where main proceedings were opened, then such stay will have automatic effect across all Member States pursuant to Article 17 of the EIR so as to preclude actions against the debtor otherwise than in accordance with the terms of that stay.²⁰²

²⁰⁰ See M, F & I (n 38) 281, para 8.171.

²⁰¹ See Virgos-Schmit (n 42) paras 91 and 142. In English terminology, 'execution' refers only to a process after judgment whereas here processes before and after judgment are intended. See M, F & I (n 38) 282, para 8.174, FN 210.

²⁰² See, for example, *Merrill Lynch International Bank Ltd v Winterthur Swiss Insurance Co: Re Eurotunnel Finance Ltd* (HCJ, 30 November 2006) concerning the application of the stay under a French insolvency procedure in the United Kingdom. See M, F & I (n 38) 282, para 8.173.

- 2.100 The effects of insolvency proceedings on provisional and protective measures adopted in favour of a creditor may give rise to doubts. The most reasonable course of action would be for these proceedings to follow the same regime as enforcement actions because, although they do not lead directly to the realization of the asset, they do not ‘insulate’ it thus making it more difficult for it to be included in the insolvent estate and be administered by the liquidator which may be prejudicial to the successful conclusion of the insolvency proceedings.²⁰³
- 2.101 The exception in Article 4(2)(f) for ‘lawsuits pending’ appears to contain an implied cross-reference to Article 15 and presumably covers the same ground as Article 15. As mentioned in relation to Article 4(2)(e) arbitration proceedings have been held to be covered by the expression ‘lawsuits pending’.

Article 4(2)(m)

- 2.102 It is argued that a literal reading of the phrase ‘all the creditors’, as translated in the English version of the EIR, would lead to an absurd result. It is suggested instead that in the context it means ‘creditors as a whole’ or ‘general body of creditors’. This approach may be supported by the French and German versions which use the terms ‘ensemble’ and ‘Gesamtheit’ respectively.²⁰⁴
- 2.103 A literal reading of 4(2)(m) would require proof that the act in question was detrimental to every single creditor which is impossible to obtain. This is emphasized by the fact that the act will clearly not be detrimental to the creditor who gets the relevant benefit. It is submitted that there are also a number of situations which are intended to be covered by

²⁰³ See V & G (n 2) 77, para 121(i).

²⁰⁴ See M, F & I (n 38) 283-284, para 8.179.

the provision which do not involve every creditor other than the benefited creditor receiving a detriment.²⁰⁵

2.104 For example, if the debtor gives the Lender security in the nature of a right in rem which ranks in priority behind another secured creditor, this may well not be detrimental to the prior security holder, but it is detrimental to creditors generally. Likewise, if there are sufficient assets to pay preferential creditors in full, a voidable payment or security given to one creditor may not have a detrimental effect on preferential creditors but will again be detrimental to the general body of creditors.²⁰⁶

Exceptions to the *Lex Concorsus*

2.105 Articles 5-15 of the EIR establish a series of exceptions to the application of the *lex concursus* and there is a twofold reason for their existence. Firstly, they enable the preservation of rights or interests of the Lender which are specially protected by the laws of Member States from the uncertainties or inconsistencies in policy that may result from the application of a foreign *lex concursus*.²⁰⁷ Secondly, they respond to the need to reduce the overall complexity of the insolvency proceedings.²⁰⁸

²⁰⁵ *Ibid.*, 284, para 8.180.

²⁰⁶ *Ibid.*

²⁰⁷ See V & G (n 2) 89, para 135.

²⁰⁸ Recital 11 of the EIR acknowledges the fact that as a result of widely differing substantive law it is not practical to introduce insolvency proceedings with universal scope in the entire Community. Without exceptions to the *lex concursus* difficulties would arise, for example, in relation the widely differing laws on security interests in the Community.

- 2.106 The application solely of the *lex concursus*, without exception, may affect the legal framework for secured lending and cause instability²⁰⁹ resulting in an increase in the domestic cost of finance or extra costs in commercial dealings in other States²¹⁰. Furthermore the value of a security right may be seriously impaired if foreign proceedings intrude upon such local security rights even when the *lex situs* does not permit such a result. A simple transfer of the debtor's COMI to a different State can cause a radical change in the secured party's position.²¹¹
- 2.107 The extent to which such extensive exceptions to the controlling effect of the *lex concursus* have proved necessary under certain circumstances of diversity, even among the laws of the Member States, demonstrates the need for extreme caution when attempting to take future steps in designing a scheme of choice of law rules for application on a wider global canvas. One commentator contends that it would be “politically naïve” to assume that Sovereign States would be willing, at any time in the future, to abandon all possibility of maintaining the benefits of localized rules under which creditors may have based their expectations in dealing with a debtor, by relinquishing complete and supreme control to the provisions of some foreign insolvency law under which the debtor's global estate comes to be administered.²¹²
- 2.108 Recital 25 emphasizes the particular need for an exception in relation to rights in rem in the EIR as such rights ‘are of considerable importance for the granting of credit’ and because the laws on security interests, and in particular on the creation, validity and scope of security interests, differ widely across Member States.²¹³ Article 5 therefore provides that

²⁰⁹ There are areas of the law that function to ensure legal certainty as to the holder of a right over an asset (hence the rules regarding property registers) or to provide certainty and liquidity to their exchange (hence the rules regarding securities markets). These functions require the legal regime to be both stable and uniform without unpredictability.

²¹⁰ The application of the law under which the security right in question was created is generally less costly to inform oneself about and more difficult for the debtor to manipulate ex post than the application of his centre of main interest.

²¹¹ See V & G (n 2) 89-90, para 135.

²¹² IF Fletcher, ‘Challenge and Opportunity: the ALI/III Global Principles Project, INSOL International Academics’ Group, Cape Town Conference’, 17-18 March 2007, 9. The abandonment of the Phase I drafts is a clear indication of this.

²¹³ Recital 11.

rights in rem shall not be affected by the effects of the insolvency proceedings under this law and was clearly intended to reinforce the position of a secured creditor who needs to enforce his security against collateral located in a Member State or States other than the one in which insolvency proceedings were opened.

Article 5: Third parties' rights in rem

2.109 When it comes to relying on Article 5, the Lender needs to be clear about what is included in the definition of the term “rights in rem”. Rights in rem provide the Lender with an efficient instrument for reducing or eliminating the risk of the insolvency of the debtor and fulfils an important function by promoting the availability of low-cost credit both in personal and business financing.²¹⁴ In practice, the ‘right in rem’ “enables the secured party to have direct recourse to the collateral in the event that the debtor does not pay or perform, and especially where this occurs due to the debtor’s insolvency.”²¹⁵ For this to be achieved, it is important that, if the law of the situs of the collateral recognizes the right in rem as valid, then all relevant jurisdictions also recognize the right in rem’s enforceability and validity especially in the event of the debtor’s insolvency.²¹⁶

2.110 In a cross-border case the location of the collateral, either at the time of the opening of proceedings or at some other material time, may be in a different state from that in which insolvency proceedings are opened. Due to variations between national laws concerning real security and the impact of insolvency upon such arrangements, there is a possibility that different conclusions as to the Lender’s rights may be reached

²¹⁴See V & G (n 2) 92, para 139. See also Virgos-Schmit (n 42) para 97: rights in rem are important with regard to credit and the mobilization of wealth because they safeguard their holders against the risk of insolvency of the debtor and the interference of third parties; and allow credit to be obtained under conditions that would not be possible without this type of guarantee.

²¹⁵Fletcher (n 36) 7.087

²¹⁶See M, F & I (n 38) 60, para 4.11 which refers to the content of Recital 25 to the Regulation

under the *lex concursus* and the *lex situs*. It is submitted that this uncertainty has severe consequences in relation to the stability and costs of transactions involved in a cross-border case.²¹⁷ The Lender will be concerned with the extent to which, even if the right in rem is recognized, its enforcement or realization may be affected in some way which might cause its economic value to deteriorate.²¹⁸

2.111 In accordance with the policy followed by the draftsmen of the former Convention text of 1995, the EIR does not impose its own definition of a right in rem as this may have an impact on the classification of assets resulting in conflict with the approach followed by the law of the situs.²¹⁹ Although the interpretation of a ‘right in rem’ is generally a matter to be determined by national law, it appears, from the general scheme of the EIR, that an “unreasonably wide” definition of rights in rem should not be adopted since the effect of this would be to majorly disrupt the fundamental principle behind the EIR (that the main insolvency proceedings have universal scope). It is submitted that, in these circumstances, it is probable that ‘rights in rem’ are to be construed narrowly.²²⁰

2.112 To clarify the meaning of “rights in rem”, in the context of how Article 5 applies, three ideas are taken into account.²²¹ These ideas rule out Article 5 being any of the following: a rule which attributes new rights; a “blank cheque” rule of recognition; and a rule that confers more powers upon the holder of a right in rem than those he would have according to non-insolvency law. Article 5 is a rule of recognition of rights,²²² it only recognises authentic rights in rem,²²³ and does not

²¹⁷ See M, F & I (n 38) 60-61, para 4.11.

²¹⁸ e.g. through the application of a comprehensive stay and moratorium during a reorganization procedure. See M, F & I (n 38) 60-61, para 4.11.

²¹⁹ The intention behind this is the necessity not to impose a definition of a right in rem due to the risk of describing as rights in rem legal positions which the *lex sitae* (where the assets are located) does not consider to be rights in rem, or of not encompassing rights in rem which do not fulfill the conditions of that definition. Virgos-Schmit (n 42), para 100. See also A.11-A.22 and M, F & I (n 38) 64, para 4.17.

²²⁰ See M, F & I (n 38) 287, para 8.189.

²²¹ See V & G (n 2) 94 -100, paras 144 – 157.

²²² A right in rem is created according to the national law where the asset is located and attributes of this right are determined by that national law. It will be the *lex situs* which tells

confer more powers on the holder of a right in rem than those he would enjoy in a non-insolvency situation.²²⁴

2.113 Article 5 only protects pre-existing rights which were created before the insolvency proceedings were opened.²²⁵ Therefore the precedence enjoyed by proprietary over personal and contractual claims under general law is replicated under the regime of insolvency law, with the consequence that security rights and other rights in rem which have been created prior to the commencement of insolvency remain intact, and are permitted to accomplish their intended purpose of insulating the Lender from full exposure to risk of loss in the event of the debtor's default. Conversely creditors who have not succeeded in perfecting their right to be treated as secured under the law of the *lex situs* before the time of the opening of proceedings in another member state are subject to the effects of the *lex concursus* in accordance with the basic principle of Article 4.²²⁶ One of the issues that arises, however, is whether the Lender needs to meet the onerous requirement of perfecting or registering any security over the asset in question in the jurisdiction in which the asset is situated according to Article 2(g).²²⁷ It is argued that this would result in rigorous due diligence requirements such as the necessity of perfecting the security in accordance with both where it is

one whether or not the holder has a right in rem and the scope thereof. Only if the holder has a right in rem under the *lex sitae* applicable will his position be protected by Article 5 in the event of insolvency.

²²³ Article 5 only covers rights in rem in the strict sense of the concept. Member States are free to determine according to their own laws when a right is a right in rem however the EIR determines the limits within which Member States may have recourse to that concept for the purposes of Article 5. This is deduced from Article 5(2) and Virgos-Schmit (n 42), para 103.

²²⁴ Article 5 respects the separate right of enforcement which the holder of a right in rem may have over the asset affected but does not alter the regime of priorities which governs this right outside the insolvency. The law governing the right in rem (i.e the security interest) will determine the priorities of payment between the secured creditor and any preferential creditors; if there are liens or privileges which have precedence over the security right in non-insolvency situations, they continue to apply in normal terms. See V & G (n 2) 98 - 99, para 154.

²²⁵ Virgos-Schmit (n 42), para 96.

²²⁶ For instance, creditors who have commenced such processes as distress or execution which are incomplete at the time of the opening of insolvency. See Insolvency Act 1986, ss 130(2), 183, 184, 346 & 347. See M, F & I (n 38) 64, para 4.17.

²²⁷ Insolvency Law Committee Response (n 93) 8.

located on traditional conflict of law principles as well as on the basis of the definitions in Article 2(g).²²⁸

2.114 Overall the practical effect of Article 5(1) is that although the law of state of the opening of main proceedings may claim local assets as part of the debtor's estate in those proceedings, the rights in rem of any third parties in relation to those assets are preserved in accordance with local law.²²⁹ Therefore the holder of a security right can enforce that security over the debtor's local assets (in accordance with local law) regardless of whether or not the law governing the main insolvency proceedings permits this. However, because the local assets themselves (as opposed to the rights in rem over them) remain subject to the universal scope of the main proceedings, then any surplus remaining after the exercise of rights in rem will be subject to the law and scope of the main proceedings.²³⁰ It is submitted that protection given to rights in rem is not limited to the mere 'opening' of insolvency proceedings.²³¹ In addition, Article 5(1) does not prevent secondary proceedings being commenced in respect of local assets which may prevent the enforcement of rights in rem over local assets (according to the local law applicable to secondary proceedings).²³²

2.115 It is argued that, in theory, three solutions may be provided to the insolvency treatment of rights in rem in respect of assets belonging to the debtor, which are situated in the territory of a State other than the *lex concursus*. It is clear, however, that only one of the solutions,

²²⁸ Insolvency Law Committee Response (n 93) 8.

²²⁹ Although the *lex concursus* stipulates that all assets are part of the estate, the holder of the right in rem retains all his rights in respect of the assets in question. He can exercise the right to separate the security from the estate or to realize the asset individually to satisfy the claim. Even if in possession of the asset, the liquidator needs the consent of the holder of the right in rem before he can make a decision on the asset. See Virgos-Schmit (n 42), para 95.

²³⁰ See M, F & I (n 38) 286-287, paras 8.187-8.189

²³¹ This contention is supported by two examples. The *lex concursus* may decide that, following a bankruptcy made by the court, there is an automatic stay against all creditor actions, as well as secured creditors, which therefore brings it within the scope of Article 5(1). Secondly, the *lex concursus* may provide that, where a liquidator is devising a rescue plan to be submitted to the general body of creditors, the court may order a temporary stay of enforcement action taken by a secured creditor if the court is happy that this will not cause any undue hardship to the secured creditor. See P Smart, 'Rights in Rem, Article 5 and the EC Insolvency Regulation: An English Perspective', *Int. Insolv. Rev.*, Vol. 15: 17-55 (2006) 23.

²³² See M, F & I (n 38) 286-287, paras 8.187-8.189.

reflected in Article 5, addresses the issue by establishing a rule of non-alteration of the rights in rem of creditors or third parties in respect of those assets. Two of the solutions clearly do not suffice to address the problem Article 5 aims to address for a number of reasons. One of the solutions would be to maintain the principle of universality in its strictest terms and subject the treatment of these rights in rem in insolvency to the *lex concursus*. The difficulty that arises is that the application of the *lex concursus* may result in gaps in protection which does not fully accord with the security function that these rights are required to provide according to their national applicable law. This will occur, for example, when the *lex concursus* imposes restrictions on the enforcement of rights in rem or gives priority over the collateral to the claims of another party which do not exist in the *lex situs*. The second solution would be to let the *lex sitae* which governs the right in rem also determine the treatment thereof in the event of the insolvency of the debtor. This means that the *lex situs* would determine not only the creation of the right in rem and general validity but also its effectiveness in the case of the opening of insolvency proceedings. The problem is that this alternative may have a greater impact on the administrative costs of the proceedings. This is because of the complexity arising from the fact that the effects of the same insolvency proceedings would be governed by different national laws of the countries where the debtor's assets are located.²³³

2.116 Article 5(1) does not apply where the assets are situated in a state that is not a Member State under the EIR. In such cases the *lex concursus*, including its rules of private international law, will primarily determine the rights of any parties which fall under the jurisdiction of the *lex concursus*. According to standard conflict of laws principles, the *lex situs* may be consulted to determine the validity of the security interest as at the time of its creation and also for assessing the effects of the insolvency proceedings on the rights of the secured party.²³⁴ The rights

²³³ See V & G (n 2) 92-93, para141.

²³⁴ See Chapter One regarding the *lex situs* determining the validity of the security interest.

of any parties that are not so subject to the authority of the *lex concursus* will in practice be determined by the extent to which the *lex situs* is prepared to recognize and give effect to the foreign insolvency proceedings. If the rights of the Lender are held to prevail over the claims of the liquidator appointed in the foreign proceedings, the Lender may be able to retain the full extent of the security rights previously bargained for unless it proves necessary to participate in the insolvency process in respect of any unsecured balance of claim. In these circumstances the duty to account for the assets or collateral obtained through enforcement of security will arise in accordance with the principle of ‘hotch pot’.²³⁵

2.117 The relevant time at which the location of an asset is to be determined according to the terms of Article 5(1) is the opening of insolvency proceedings. One of the problems that arises is if an asset is movable in nature and its location has changed between the time at which the right in rem was created and the time when proceedings are opened. This means that the Lender may not be fully secured if the asset happens to be located at the relevant time in a jurisdiction whose law does not give protection to the security interest in question. Conversely the relocation of a movable asset will be a cause for concern for unsecured parties if the asset has been removed from the territory over which the *lex concursus* is applicable with the consequence that the rights of the secured creditor may be less susceptible to impeachment than they would otherwise have been. However Article 5(4) ensures that the actions for avoidance of antecedent transactions that form part of the *lex concursus* are still applicable.²³⁶

2.118 Overall, the Lender when taking security over movable property on the basis that the law of its current *situs* gives satisfactory protection in the event of the debtor’s insolvency, must consider the possibility that the asset may be moved to another Member State, or to some non-Member State, and thereby become subject to a different legal regime at the

²³⁵ Article 20 of the EIR. Also See M, F & I (n 38) 63, para 4.16.

²³⁶ See M, F & I (n 38) 62, para 4.15.

relevant time. To minimize the consequent risks of such relocation the Lender will have to, if possible, structure the terms of the transaction in such a way and place restrictions on certain asset classes insofar as practicable.²³⁷ However it should be noted how widely the terms of Article 5(1) are drawn in relation to the types of assets to which it can have application. All types of property are capable of being affected including commercially important items like book debts and other receivables and assets that are of a future character at the time the security interest is created but which have come into existence by the time the insolvency proceedings are opened.²³⁸

2.119 However in the case of an intangible asset,²³⁹ there may also be difficulties in determining the *lex situs* of the assets for the purposes of determining whether or not it is located in the Member State in which the insolvency proceedings have been commenced²⁴⁰ or whether the asset is located in another Member State. The EIR does not set out which court should determine this issue but Article 2(g) gives limited assistance in this respect by defining where certain assets are located for the purposes of Article 5.

2.120 A cursory glance at the wording of Article 5(1) reveals a number of relevant points. Of particular relevance in the English law context, the expression ‘both specific assets and collections of indefinite assets as a whole which change from time to time’²⁴¹ makes it clear that the floating charge is included as a right in rem. Once the Lender complies with all perfection requirements in accordance with the applicable law, the security interest is brought into being and may be described as “present security”.²⁴²

²³⁷ *Ibid.*

²³⁸ M, F & I (n 38) para 4.13.

²³⁹ e.g. interest in a bank account or a contractual claim.

²⁴⁰ In which case Article 5 would not apply to the security interests.

²⁴¹ This particular wording was not contained in the text of the 1995 Convention, but the issue is addressed in Virgos-Schmit (n 42), para 104 which states “security rights such as the ‘floating charge’ recognized in United Kingdom and Irish law can, therefore, be characterized as a right in rem for the purposes of the Convention”.

²⁴² Article 5’s wording assumes that there are assets at the time of the opening of proceedings. The contrast between existing and future assets may create problems. It is argued that:

2.121 Under a floating charge, the security right is attached, in the first instance, to a shifting fund of assets, even though it is only in the end that it crystallizes and fastens on specific assets. No new security interest is created by crystallization. One view is that the nature of a floating charge leaves no room for arguing that there is only a right in rem upon crystallization (although it is likely that a properly drafted floating charge will have crystallized before the opening of insolvency proceedings).²⁴³ In contrast, it has been argued that the position of whether a floating charge can be recognized as a right in rem before crystallization has occurred remains doubtful until there is a preliminary ruling of the European Court of Justice under Article 267 of the Treaty on the Functioning of the European Union.²⁴⁴ The writer favours Smart's view as there is little doubt that the holder of a floating charge has an equitable interest in the assets within the scope of the charge from the moment when the assets fall within the terms of the charge.²⁴⁵ A purposive reading of Article 5 suggests that the inclusion

“in principle, present property is considered to include potential property (property not yet in existence but growing out of property which is in existence). This concept of potential property applies to both tangibles (growing crops on a piece of land) and intangibles (the right to receive sums payable in the future under existing contracts).”

This distinction emphasizes important thing about this distinction that the grant of security over the potential property will be considered as a present assignment of existing property. For further detail on this see V & G (n 2)101, para 157.

²⁴³ Smart argues that the reference in Article 5(1) to collections of indefinite assets changing ‘from time to time’ (wording specifically introduced with a floating charge in mind) would make little sense if a right in rem only arose upon crystallization. The right in rem must exist at the time relevant insolvency proceedings are opened as rights coming into existence only after the opening of insolvency proceedings will not fall within Article 5(1) and will be governed by the general rule of Article 4. See Smart (n 231) 21.

²⁴⁴ (Formerly Article 234 of the European Union Treaty) Buetter submits that it is difficult to see how a floating charge can, before crystallization, be a right in rem according to the criteria set out in Virgos-Schmit (n 42) para 103 which describes the features of a right thus: ‘it has a direct immediate relationship with the asset it covers; ... its creation involves an absolute alienation to the acquirer of the right, which enables the holder to resist the alienation of the asset to which it relates to a third party; and to resist individual enforcement by third parties’. A floating charge does not have these properties before crystallization occurs and it is difficult to accept that it creates a ‘direct and immediate relationship’ with the asset it covers. It is of the essence of a floating charge that it does not, of itself, prevent the alienation of those assets to third parties. See Michael Buetter, ‘Cross-Border Insolvency under English and German Law’, (2002), Oxford University Comparative Law Forum: <<http://ouclf.iuscomp.org/articles/buetter.shtml>>, 41-42.

²⁴⁵ See RC Nolan, ‘Property in a Fund’, (2004) (120) LQR 108. Nolan defines a floating charge as a charge over a fund of assets, in a sense that the chargee has an immediate security interest in identified assets owned by the charger and in addition will almost invariably have

of the wording “collections of indefinite assets as a whole which change from time to time” was specifically included to protect the floating charge.

2.122 There are a few issues regarding Article 5 that need further clarification. One question relates to the word “affect”. One analysis is that a stay on the enforcement of security does not “affect”, or derogate from the underlying security interest, it just postpones the right of enforcement for a certain period of time. Although there is no case law on this issue yet, it would be reasonable to presume that Article 5 will protect security over assets in another Member State from any moratorium which may arise following insolvency proceedings but until this issue has been decided by the courts, the position remains uncertain.²⁴⁶

2.123 The question also arises as to whether a liquidator can simply ‘pay off’ the Lender, thereby gaining control of the charged asset. Can it be argued that this action would ‘affect’ the right in rem and run contrary to Article 5(1)? In certain jurisdictions the domestic insolvency legislation may provide the liquidator with the power to pay an equivalent amount representing the fair market value of the asset that is subject to the right in rem.²⁴⁷ Wessels submits that a literal reading of Article 5 allows the Lender to maximize his rights, but one could argue that the equivalent payment provision does not materially ‘affect’ the rights in rem of the holder.²⁴⁸ Virgos-Schmit states that if the value of security exceeds the value of the claim guaranteed by the right in rem then the creditor will be obliged to surrender to the estate any surplus of the proceeds of sale. The liquidator can also decide on the immediate payment of the claim guaranteed (without affecting the economic value

security in identifiable future assets if and when acquired by the charger. He refers to the case of *Evans v Rival Granite Quarries Ltd* [1910] 2 KB979 at 999 and the well known dictum of Buckley LJ.

²⁴⁶ G Stewart & J Marshall, Overview of the EIR, Allen & Overy LLP, para 77. Sweet & Maxwell, (September 2006)

²⁴⁷ e.g. in the Netherlands the liquidator has a ‘lossingsrecht’, a power to release. See M, F & I (n 38) 288, para 8.193.

²⁴⁸ See M, F & I (n 38) 288, para 8.193.

of the right or its immediate realizability) and avoid the loss in value that certain assets could suffer when they are realized separately.²⁴⁹ It is submitted that it is not clear whether the liquidator can decide to make a payment in all situations or only those where the value of the security exceeds the debt owed to the Lender.²⁵⁰

2.124 There is a crucial distinction that needs to be drawn between the fully-secured creditor²⁵¹ and the under-secured creditor.²⁵² In the case of the former, the creditor's rights in rem will not be 'affected' where the liquidator proposes to pay the creditor off in full and at once however the situation may be quite different where the creditor is under-secured. Immediately paying the secured creditor the current value of the collateral (the current value of the charged property) which is less than the debt may affect his rights in rem. Depending upon the particular rights given under the charge, Article 5 may tie the hands of the liquidator when dealing with an under-secured creditor who is unwilling to accept immediate payment of the current value of the collateral.²⁵³

2.125 One of the key considerations for the Lender is whether the protection granted by Article 5 extends to the secured debt as well as the security interest per se. The commencement of insolvency proceedings in a number of Member States can subsequently result in a compromise or discharge of claims (including secured claims) depending on whether a sufficient majority of creditors vote in favour of the compromise.²⁵⁴ If, for example, the Lender's claim is reduced (by 10% or even 99%) as a result of a main insolvency proceeding, the question arises as to whether the Lender can rely on Article 5 to enforce its security over assets in another Member State in respect of the full amount of its

²⁴⁹ Virgos-Schmit (n 42), para 99.

²⁵⁰ Smart (n 231) 26.

²⁵¹ As an example, if the secured creditor is owed £100,000 and the charged property is estimated at least that amount.

²⁵² As an example, if the debt is £100,000 but the current value of the collateral is at best estimate only £85,000.

²⁵³ Smart (n 231) 26-27.

²⁵⁴ Insolvency Law Committee Response (n 93), Question 17.

(original) secured claim or whether the security interest would only stand as security for the reduced claim.²⁵⁵

2.126 Article 25 of the EIR provides that compositions approved by the court commencing main insolvency proceedings are to be recognized in all other Member States without further formalities. The question is whether Article 5 provides an exception to such recognition where secured assets are located in a Member State other than the State of opening. There is no case law yet on this issue and one view²⁵⁶ is that it would be a major inroad into the Lender's rights if Article 5 failed to protect the secured debt as well as the Lender's rights to enforce its security in respect of that debt. This important aspect of Article 5 is not clarified however the writer agrees that it would make little sense if Article 25 could be utilized to render an effect that erodes the protection given by Article 5.

2.127 This contrasts with the observation made by commentators²⁵⁷ regarding the extent to which Article 5 safeguards holders of rights in rem. An alternative view is that, when compared with the national laws concerned, Article 5 may give a stronger level of protection against the insolvency of a debtor than that which national laws demand. In this sense the rule may "overprotect" the Lender. The EIR does not impose insolvency limits on the right in rem even though both the *lex concursus* and *lex sitae* do. The justification behind this 'over protection' relates to the need for simplification of the administration of insolvency proceedings.

2.128 Article 5 refers to "rights in rem of creditors or third parties in respect of ...assets ...belonging to the debtor." The issue arises of how the phrase 'belonging to' should be interpreted. Does Article 5 include assets of which the debtor has 'economic ownership' and which (for the purposes of insolvency law) are regarded as belonging to his estate or

²⁵⁵ As compromised through the main insolvency proceeding.

²⁵⁶ Stewart & Marshall (n 246) 82.

²⁵⁷ See V & G (n 2) 105, para 164.

does it solely refer to rights in assets of which the debtor is a legal owner?²⁵⁸

2.129 Veder submits that the importance of the issue depends on the applicability of Article 5 to forms of security ownership where, according to the applicable national property law, the debtor has an ‘economic interest’ in the asset but is not the legal owner. Examples of the latter are financial lease contracts and transfer of ownership by way of security. A broad interpretation of Article 5 is necessary so it is understood to include any proprietary right in assets, regardless of the question of whether or not they form part of the debtor’s estate under the *lex concursus*. Therefore the special regime created in Article 5, for proprietary rights with respect to assets ‘belonging to’ the debtor, is not limited to situations where the debtor is the legal owner of the asset. Consistent with the policy considerations of Article 5, ownership that serves as security for credit extended by the creditor, is also protected under Article 5.²⁵⁹ Therefore the implication is that title-based quasi-security is also protected by Article 5 with the exception of the seller’s rights based on a reservation of title.²⁶⁰

2.130 Overall, some commentators refer to Article 5 as a rule of ‘relative immunity’, as it does not prevent the opening of secondary proceedings in the State where the asset is located provided that the debtor has an establishment there.²⁶¹ In such a case, the liquidator in the main proceedings can request the opening of secondary proceedings. If the law applicable to these proceedings enables the said rights to be affected then the liquidator of the main proceedings can take advantage of this possibility.²⁶² If the debtor does not have an establishment in the

²⁵⁸ Veder (n 31) 337.

²⁵⁹ *Ibid.* 337.

²⁶⁰ See Article 7 of the EIR.

²⁶¹ See V & G (n 2) 93, para 142.

²⁶² Virgos-Schmit (n 42), para 98.

State where the assets are situated, then Article 5 operates as a rule of absolute immunity.²⁶³

2.131 Article 5(2) provides a list of types of rights that are normally considered by national laws as rights in rem. This list is drawn up with two main considerations. The first, that a right which exists only after insolvency proceedings have been opened, but not before, is not a right in rem for the purposes of Article 5 (which protect pre-existing rights). The second, that a right in rem has two characteristics:

(a) its direct and immediate relationship with the asset it covers which is not dependent on the asset belonging to a person's estate or to the relationship between the holder of the right in rem and another person.

(a) The right absolutely belongs to the holder. This means that the holder can enforce the right in rem against anyone who breaches or harms his right without his consent (e.g. such rights are typically protected by actions to recover); that the right can resist the transfer of ownership of the asset to a third party (it has the restrictions characteristic of the protection of the bona fide purchaser); and that the right can thus resist individual enforcement by third parties and in collective insolvency proceedings (by its separation or individual satisfaction).²⁶⁴

2.132 Virgos-Schmit²⁶⁵ specifically states that security rights such as the 'floating charge' can be characterized as a right in rem for the purposes of the Convention and hence the EIR. Article 5(1) also includes rights characterized under national law as rights in rem over intangible assets or over rights also included provided that that location of the assets is non-fraudulent.

²⁶³ This relates to the observation earlier regarding the possible "overprotection" to the holders of rights in rem.

²⁶⁴ Virgos-Schmit (n 42), para103.

²⁶⁵ *Ibid.* para104.

- 2.133 The general rules governing actions for voidness, voidability or unenforceability (Articles 4(2)(m) and Article 13) apply where the establishment of a right in rem in favour of a particular creditor could be an act detrimental to all the creditors.²⁶⁶
- 2.134 Article 5(3), directly and independently of national law, considers as a right in rem any right entered in a public register and enforceable against third parties, allowing a right in rem to be obtained. The rationale of Article 5 imposes certain limits to the national qualification of a right in rem. One needs to note that Article 5 represents an important exception regarding the application of the *lex concursus* and the universal effect of the main proceedings. It is also important to remember that secondary proceedings are only possible if the debtor has an establishment in that Member State. The mere presence of assets is not enough in order to open such proceedings.²⁶⁷
- 2.135 Article 5, as intended, does not give an unreasonably wide interpretation of the national concept of a right in rem. For instance they do not include rights simply reinforced by a right to claim preferential payment, as is the case for a certain number of privileges

Article 6: Set off

- 2.136 Article 6 states that the opening of insolvency proceedings shall not affect the right of creditors to demand the set off of their claim against the claims of the debtor, where such set off is permitted by the law applicable to the insolvent debtor's claim. The availability of set off is important from the Lender's perspective as it reduces transaction costs and communication expenses especially in situations where there are loans and deposits in multiple accounts with the same bank.

²⁶⁶ *Ibid*, para 106.

²⁶⁷ *Ibid*, para 102.

- 2.137 Basically, Article 6 provides that the opening of insolvency proceedings does not affect a creditor's rights of set-off where they are permitted under the law applicable to the debtor's claim.²⁶⁸ Therefore such rights remain effective regardless of whether or not the law of the insolvency proceedings permits set-off in those proceedings.²⁶⁹ This is a very significant exception to the general rule set out in Article 4(2)(d).²⁷⁰
- 2.138 When determining whether set off is available the first step for the Lender, in relation to calculating the consequences of the other party's insolvency in a security transaction, must determine which Member State will potentially become the forum for main bankruptcy proceedings, or for any secondary proceedings involving the other party as the insolvent debtor.²⁷¹
- 2.139 Article 6 is therefore fully consistent with interpretative guidance supplied by Recital 26 of the EIR²⁷² which states "if a set-off is not permitted under the law of the opening State, a creditor should nevertheless be entitled to the set-off if it is possible under the law applicable to the claim of the insolvent debtor. In this way, set-off will acquire a kind of guarantee function based on the legal provisions on which the Lender concerned can rely at the time when the claim arises".
- 2.140 By including two claims which offset each other, the question arises whether the right to set off should stem from: the cumulative application of laws applicable to the two claims; or the law applicable to the debtor's claim ('passive' claim in the set-off) against which the

²⁶⁸ Also see Virgos-Schmit (n 42), para 107.

²⁶⁹ One should however note that Article 6(2) allows Article 4(2)(m) to apply with regard to cases where an exception is provided under Article 6(1). Consequently, the avoidance rules of the *lex concursus* still apply to any challenges regarding the validity or enforceability of any claim to which the principles of set-off may otherwise apply under Article 6(1). See M, F & I (n 38) 66, para 4.26.

²⁷⁰ See Virgos-Schmit (n 42), para 109: If the *lex concursus* does not allow for set-off (e.g. since it requires both claims to be liquidated, matured and payable to a certain date), then Article 6 constitutes an exception to the general application of the law in that respect, by permitting the set-off according to the conditions established for insolvency set-off by the law applicable to the insolvent debtor's claim.

²⁷¹ See M, F & I (n 38) 66, para 4.23.

²⁷² This is closely modelled upon statements contained in Virgos-Schmit (n 42), para 109.

creditor intends to set off his counter-claim against the debtor ('active' claim in the set-off). The EIR prefers the second interpretation.²⁷³

- 2.141 By following this approach whereby the policy of the *lex concursus* is displaced by that of the law of the passive claim, the authors of the EIR were applying the doctrine which scholars of the modern era seem to consider the better rule of decision for international cases. The "traditional approach", as favoured by a number of commentators formerly, necessitated the cumulative application of both the laws governing the active and the passive claim respectively, denying set-off unless both laws agreed in allowing it to operate.²⁷⁴
- 2.142 Conversely, modern analysis, on the other hand, has placed a larger emphasis on the need to protect legitimate and reasonable expectations, and therefore on the need for a stable rule that allows the Lender to rely upon the provisions of a single system of law whose provisions are applicable in the context of his incurring an obligation towards the party who is subsequently the subject of insolvency proceedings. Modern scholars appear to agree that such stability and predictability is best achieved by the through the application of the rule contained in the law applicable to the passive claim.²⁷⁵
- 2.143 The combined effect of Article 4(2)(d) and Article 6 is that a creditor may be able to take advantage of the rights of set-off whether this is permitted under the law of the *lex concursus* (pursuant to Article 4(2)(d)) or whether this is permitted under the law applicable to the debtor's claim (pursuant to Article 6). It is significant that both the contract law and insolvency law which has to permit rights of set-off is the law applicable to the debtor's claim and not the creditor's claim.²⁷⁶

²⁷³ Virgos-Schmit (n 42), para 108. Article 6(1) provides that the creditor shall not be deprived of the right to demand the set-off of his claims against the debtor "where such a set-off is permitted by the law applicable to the insolvent debtor's claim". This phrase is intended to denote 'the law applicable to the claim where the insolvent debtor is the creditor in relation to the other party'. See M, F & I (n 38) 57, para 4.24.

²⁷⁴ Fletcher (n 212) 13.

²⁷⁵ This is the approach that would be followed today under English rules of private international law. See Fletcher (n 212) 13.

²⁷⁶ Virgos-Schmit (n 42), para 108 & See M, F & I (n 38) 289, paras 8.199-8.200.

2.144 The laws of Member States vary contrastingly over the operation of set-off in the event of a debtor's insolvency. In the United Kingdom, set-off is regarded as a mandatory process which has to be applied, as a matter of public policy, in both individual and corporate insolvencies.²⁷⁷ However in most civil law systems, the superseding view is that insolvency set-off constitutes a violation of *pari passu* distribution and that, as a matter of public policy, it must be restricted to very limited circumstances. Consequently, in a cross-border insolvency, the outcome for any creditor who is also a debtor to the estate can be significantly influenced by how the issue of the applicable law is resolved, if the competing laws happen to portray varying schools of opinion regarding set-off.²⁷⁸ The necessity for clear and uniformly applicable choice of law rules²⁷⁹ is emphasized in cases concerning major commercial operations where large sums of money are involved. In the assessment of risk, the ability to determine the applicable law and fully investigate its provisions regarding set-off is especially important.²⁸⁰

2.145 One of the issues that arises is how Article 6(1) relates to Article 6(2). Article 6(1) stipulates that the opening of insolvency proceedings shall not affect the rights of creditors to set-off and Article 6(2) creates a carve out for actions in relation to voidness, voidability or unenforceability. Set-off is mandatory in the UK if the necessary requirements are satisfied. However, in many of the civil law systems, insolvency laws do not allow set-off because it is construed as an improper preference of a particular creditor which is contrary to the avoidance provisions. The question arises whether Article 6(2) should be interpreted in this way, or does it just signify that the liquidator in

²⁷⁷ See *Stein v Blake* [1996] AC 243 ; *Secretary of State for Trade and Industry v Frid* [2004] 2 AC 506 (HL).

²⁷⁸ *Re Bank of Credit and Commerce International SA (No 10)* [1997] Ch 213 illustrates this problem.

²⁷⁹ Fletcher contends that the need for this is emphasized by the fact that, despite the enormous efforts expended in negotiating and drafting the EIR, the definitional deficit has proved to be the source of troublesome and costly uncertainty in the EIR's operation. Obvious examples regard the precise meaning of "time of the opening of proceedings" of "centre of main interests" an "establishment". See Fletcher (n 212) 8.

²⁸⁰ See M, F & I (n 38) 55-56, para 4.22.

the insolvency proceedings can challenge the entering into of the transaction which gives rise to the right of set-off but not the exercise of the set-off right itself?²⁸¹

2.146 One issue that needs to be considered is the difference between contractual and equitable rights of set-off and the insolvency mandatory set off scheme contained in Rule 4.90 Insolvency Rules 1986 SI 1986/1925. The effect of Rule 4.90, operating in the UK, is that a valid set-off is treated as a notional payment at the date of the liquidation. Administration set-off has been introduced by the Enterprise Act 2002 and is governed by Insolvency Rule 2.85.²⁸²

2.147 It would be to the Lender's advantage if it can be established that the law applicable to the debtor's claim against him is Rule 4.90. However Article 6 makes it both possible and important for the Lender, if he is likely to benefit from a set-off, to try and ensure that the debtor's claim against him is governed by a law which permits the widest possible rights of set-off. For instance, if an English lender lends money to a borrower who has his COMI in France, in a French main insolvency proceeding there would be significantly narrower rights of set-off than in English law. If the parties are in a position to choose the law by which the transactions are governed they may see it as expedient to ensure that a clear, express choice²⁸³ is made in favour of the law of the country whose rule concerning set-off is most suited to their requirements. For instance, it would be in the English lender's best interests to insist that any dealing which may give rise to claim against him by the debtor be governed by English law. In this case the creditor can, due to Article 6, rely on the wider rights of set-off permitted by English law.²⁸⁴

²⁸¹ Insolvency Law Committee Response (n 93), Question 16.

²⁸² For operation of r 2.85 see *Re Kaupthing Singer v Friedland* (in administration) [2010] EWCA Civ 518; [2010] WLR (D) 119.

²⁸³ Rome I, Article 3 gives effect to such an act of choice.

²⁸⁴ See M, F & I (n 38) 290, para 8.205.

- 2.148 Generally, in identifying the national law that applies to the debtor's claim the normal rules of private international law apply including, in particular, Rome I.²⁸⁵ The possibility of contractual obligations is accepted by the express provision in Article 2 of Rome I which declares that "any law specified by this Regulation shall be applied whether or not it is the law of a Member State". Furthermore Article 3 of Rome I gives effect to such a choice, which can be made with respect to the whole or to a particular part of the contract.²⁸⁶ As Rome I is directly applicable in all Member States,²⁸⁷ the literal and natural meaning of the expression "the law applicable to the insolvent debtor's claim" in Article 6(1) of the EIR is that it means any law capable of being identified as the applicable law of the obligation in question according to the choice of law now standardized among EU Member States by Rome I.²⁸⁸
- 2.149 Contractual set-off implies an agreement subject to its own applicable law. The same rationale on which Article 5 is based explains that in the event of a contractual set-off agreement covering different claims between two parties, the law of the Member State applicable to that agreement will continue to govern the set-off claims covered by the agreement and incurred prior to the opening of insolvency proceedings.²⁸⁹
- 2.150 The application of Rome I has been discussed in Chapter One.²⁹⁰ Although confined in its application to those states which are members of the European Union, it is based upon the principle that the governing law of any contract to which its provisions apply may be that of some third state, rather than being limited to the laws of the Member States

²⁸⁵ See 1.27 – 1.43.

²⁸⁶ See M, F & I (n 38) 57, Para 4.25.

²⁸⁷ Due to the fact that new Member States have joined the European Union since 1980, the EU has included the requirement to sign up to the Rome Convention in negotiations regarding the terms of entry with existing Members of the EU and future candidates for membership. See Fletcher (n 212) 1.

²⁸⁸ On the question of jurisdiction to adjudicate on a debtor's claim, including the determination of the law applicable to the claim see M, F & I (n 38) 289-290, para 8.201.

²⁸⁹ Virgos-Schmit (n 42), para 110.

²⁹⁰ See 1.27 – 1.43.

themselves. Most importantly, Article 6 does not include any reference to the ‘member states’, or their respective laws, in creating the exception in favour of the rule of set-off that is operated by ‘the law applicable to the insolvent debtor’s claim’. Consequently, in this situation, the law of some third state could form the basis for allowing the Lender to have the benefit of set-off which would otherwise be excluded under the regime of the *lex concursus*. It is argued that this omission of any limiting words from the drafting of Article 6 as finally enacted should be construed as an indication that this provision is intended to allow a wider spectrum of laws to be applicable in order to respect parties’ legitimate expectations as to the availability of set-off arising under their previously concluded, contractual agreements.²⁹¹

2.151 When it comes to the interpretation of Article 6 it becomes apparent that the text is not especially clear. Questions arise such as: does the ‘law applicable’ refer to the applicable law of a Member State?²⁹² and is the reference to ‘law’ the general (civil or common) law of one Member State or does ‘law’ also encompass that Member State’s insolvency law?²⁹³ It is argued that through ‘forum shopping’, the engineering of financial transactions could raise the possibilities for set-off, despite this being contrary to the rationale of the EIR.²⁹⁴ This emphasizes the need to avoid ‘incentives for the parties to transfer assets or judicial proceedings from one member state to another, seeking to obtain a more favourable legal position’ in order to allow the proper functioning of the internal market.²⁹⁵

²⁹¹ See M, F & I (n 38) 57, para 4.25 & 66-67, paras 4.24-4.25.

²⁹² This seems the most likely interpretation.

²⁹³ Justice Timo Esko argues (and the writer agrees) that ‘law applicable’ does include the Member State’s insolvency law. When the EIR refers to the ‘law’ of a Member State, it is natural that ‘law’ includes all the rules applicable in an insolvency situation. See M, F & I (n 38) 290, para 8.203.

²⁹⁴ See Recital 4.

²⁹⁵ The example put forward by Wessels in M, F & I (n 38) 290, para 8.202 focuses on the distinction between Dutch ‘general civil law’, for instance, and Dutch insolvency law when it comes to the application of set-off. Under the former a creditor cannot set off a claim which has not yet matured, since the payability of the claim is a necessary condition; under the latter maturity is not a precondition. Authors who support the view that ‘law’ applies to both ordinary civil and insolvency law believe that the creditor can indeed set off. However, whether or not set off can apply, depends greatly on the circumstances. For instance in France,

- 2.152 Generally it is considered that Article 6 covers only rights to set-off arising in relation to mutual claims incurred prior to the opening of the main insolvency proceedings. Pursuant to Article 4(2)(d) the right to set-off should be determined in accordance with the law of the relevant insolvency proceedings in relation to claims incurred after the opening of proceedings. However Article 9 of the EIR provides for a specific case of set-off, between the parties to a payment or settlement system or to a financial market, to be governed solely by the law of the Member State applicable to the system or market concerned.²⁹⁶
- 2.153 In formulating a rule for application in proceedings opened anywhere globally, what may require further deliberation, is whether the reference to the law applicable to the insolvent debtor's claim, instead of the law governing the obligation under which the insolvent debtor has the role of debtor towards the other party, is the appropriate rule in principle, or whether it should be possible to invoke set-off if such a right is available under the law applicable to either claim, or (more restrictively) only if such a right can be shown to be available under the law or laws applicable to both claims (assuming neither claim to be governed by the *lex concursus*).²⁹⁷
- 2.154 Another issue for consideration is whether international set-off should be available merely on proof that such entitlement arises under one or other of the laws by which the mutual cross-obligations are governed, or whether there should be an additional requirement that the party invoking set-off must demonstrate that such a right has formed part of the legitimate expectations arising in the context of the relationship between the creditor and the insolvent debtor, so as to have been part of

by applying the 'double standard' of both French civil law and insolvency law, the creditor is not able to set off his claim, as French insolvency law provides quite stringent conditions. However, the application of French civil law alone would provide the creditor with a right to set-off as general French law has considerably wider criteria for set-off.

²⁹⁶ See M, F & I (n 38) 290-291, para 8.205.

²⁹⁷ Unless the *lex concursus* itself permits set-off, in which case the need to invoke the exception would not arise. See Fletcher (n 212) 13.

the calculation of risk during the process of becoming a creditor on the terms agreed.²⁹⁸

2.155 Overall, it is argued that the rule supplied by Article 6 is in harmony with modern views of the appropriate way in which to resolve the issues of set-off in international cases, and reflects the practice that would be followed in many jurisdictions (including England) even where the EIR is not applicable to the case in question.²⁹⁹ However in devising a rule that would be accepted by a wider international community beyond the frontiers of the European Union or which may form a beneficial amendment to the EIR it is important to analyze the questions raised in Chapter Three.³⁰⁰

Article 13: Detrimental acts

2.156 The aim of Article 13 is to uphold legitimate expectations of creditors or third parties of the validity of the act in accordance to the normally applicable national law, against interference from a different *lex concursus*.³⁰¹ Regarding the protection of legitimate interests, the operation of Article 13 is justified in relation to acts carried out prior to the opening of insolvency proceedings, and threatened by either the retroactive nature of the insolvency proceedings opened in another country or actions to set aside previous acts of the debtor brought by the liquidator in those proceedings.³⁰² The Lender's reliance on the validity of the national law that is applicable in non-insolvency situations is no

²⁹⁸ It should be noted that, generally, under cross-border insolvency law, all creditors can participate on equal footing. Any rule which provides an exception to the *pari passu* principle needs strong justification and should be prevented from applying as an "arbitrary device" without a consideration of the context under which parties have had dealings with the debtor. See Fletcher (n 212) 13.

²⁹⁹ See Fletcher (n 212) 14.

³⁰⁰ See Chapter Three generally and 3.49- 3.52 in relation to Article 6.

³⁰¹ Virgos-Schmit (n 42), para 138. Note, for instance, that an English lender will be expecting 'English' security to be governed by lender friendly avoidance provisions such as ss 238-239 of the IA.

³⁰² Virgos-Schmit (n 42), para 138.

longer justified after the proceedings have been opened in a Member State. All unauthorized disposals by the debtor will be ineffective as he no longer has the power to dispose of the assets and such effect is recognized in all Member States. Article 13 does not protect against such an effect of the insolvency proceedings and it is not applicable to disposals occurring after the opening of insolvency proceedings.³⁰³

- 2.157 It is argued that Article 13 does not clarify the preliminary question as to which system of conflict of rules should be used in respect of the detrimental act. The following could apply or have an effect: the conflict-of-laws system of the court hearing the matter; the rules of Community or international law; as well as domestic rules of international private law applicable to the same matter.³⁰⁴ Therefore, the person who benefited from an act detrimental to all creditors is first required to prove that, pursuant to the conflict-of-laws system of the court called upon to adjudicate the case, the act to be set aside is governed by the law of a Member State other than the *lex concursus*. As, in most cases, such act will be governed by a contract (subject to the applicable *lex contractus*).
- 2.158 Secondly, the person benefiting from the detrimental act is required to give evidence to fulfill the condition under the second indent of Article 13 that ‘that law does not allow any means of challenging that act in the relevant case’. The definition of what is meant precisely by a ‘detrimental act’ and ‘any means’ is left unclear. By ‘any means’ it appears that the beneficiary of the detrimental act must show that the act is not capable of being challenged in light of any provisions of either insolvency law or the national law applicable to the act or (contract). Generally Article 13 only requires that the act is capable of being challenged and no evidence is required for the act to be set aside, voided or annulled. The view taken by most Italian commentators³⁰⁵ is to construe ‘any means’ in a broader sense so that the beneficiary will

³⁰³ *Ibid.* para 138.

³⁰⁴ M Frigessi Di Rattalma, ‘Avoidance actions under Article 13 EC Regulation: An Italian View’, *European Company Law* 6, no I (2009): 27-33.

³⁰⁵ See Rattalma (n 304) and other Italian authors therein cited.

have to show that the act is unaffected by any flaws which may make it not only unenforceable against all the creditors but void or voidable as well. ‘In the relevant case’ means that the act should not be capable of being challenged after taking into account all the concrete circumstances of the case. It is not sufficient to determine whether it can be challenged in the abstract.³⁰⁶ It is also questioned what the wording “subject to” means in the context of Article 13. For example, is the giving of security “subject to” English law if English law is the governing law of the security document? In addition, is a payment made under a contract at a time when there are not enough assets to pay all creditors “subject” to the law governing the contract under which the payment was made, or does it depend on the location of the recipient?³⁰⁷

2.159 Finally, the issue arises about the real scope of the burden of allegation and proof provided for by Article 13. For instance, the defence allowed by Article 13 is usually relied upon by the defendant in an avoidance action. It would clearly be contrary to the purpose of Article 13 if the defendant claimed he had discharged the burden of proof placed on him by Article 13 by merely objecting and showing that, based on the applicable *lex contractus*, there were no flaws, defects or other grounds for avoidance in an act *corresponding* to the one alleged by the plaintiff seeking avoidance on the basis of the *lex concursus*. It can be inferred from the wording of the provision, that quite a stringent burden of allegation and proof is placed on the person pleading exemption from avoidance actions under Article 13. Therefore, the defendant will, in order for his defence under Article 13 to be validly submitted, allege all the facts relevant to the act the avoidance of which is sought, and he will then have to prove that the law system of the applicable *lex contractus* allows no means of challenging that act.³⁰⁸

³⁰⁶ Virgos-Schmit (n 42), para 137.

³⁰⁷ Insolvency Law Committee Response (n 93), Question 16.

³⁰⁸ See Rattalma (n 304), 6.1.

2.160 Article 13 clearly leaves open and unresolved several relevant issues. One other criticism is that Article 13 could lead to the undesirable result that the parties to a contract detrimental to the general body of creditors, may succeed in protecting it from being challenged by introducing into it a choice-of-law clause in favour of a legal system not permitting the challenge. The law thus chosen must be the law of a Member State but need not have any natural connection with the contract in question.³⁰⁹

SUMMARY

How successful has the EIR been in addressing ‘insolvency effects’?

2.161 At the inception of a security transaction, the Lender’s main concern is ensuring the lending transaction and underlying security interest are valid and enforceable in the event of insolvency. ‘Insolvency effects’, as discussed in Chapter One and this Chapter, can be greater or lesser depending on the legislative policy decisions of each State. The concepts of universalism and territorialism have been shown to have a considerable influence on insolvency policies and which systems are more ‘interventionist’ than others. Therefore the ‘modified

³⁰⁹ No such connection is required by Rome I.

universalism' approach as adopted by the EIR is of considerable importance to the Lender.

2.162 This Chapter has focused on the most important provisions of the EIR in relation to evaluating how far the Lender's security rights are protected from the 'insolvency effects' where the laws of unanticipated jurisdictions come into play. As discussed, this involves focusing mostly on the carve out provisions provided to the applicable law under Article 4 which are articles: 5;6;13; and 16.

2.163 In summary the following points can be made. The Lender can rely on Article 5 in relation to protection of rights in rem which is particularly significant in countering the unpredictability in taking security over movable property. Although there has been some controversy, in the writer's opinion, the Lender can safely assume that Article 5 will protect the Lender's secured debt as well as the Lender's rights to enforce his security in respect of that debt. The application of Article 6 under the EIR gives the Lender a right of set off and is successful in the sense that it is straightforward and reflects the practice that would be followed in many jurisdictions even where the EIR is not applicable. Article 13 requires further clarification before the Lender can fully rely on the effects of the provision however no major amendment is required. The effects of Article 16 acts as an important and fundamental safeguard for the Lender, in relation to predictability and risk assessment, as the principle of automatic recognition reflects the principle that, without further formalities, insolvency proceedings commenced in one Member State will have universal effect, encompassing all of the debtor's assets wherever situated within the European Union (except Denmark).

2.164 Given the vital role played by the concept of COMI within the EIR, it has come under considerable scrutiny and criticism by practitioners and scholars. However, there have been hardly any proposals as to alternative definitions that would be workable in practice. In addition, in light of the alternative unworkable concepts that were used in the

Phase 1 and Phase II drafts, it seems likely that if any other definition was proposed it would also be met with widespread criticism. It is clear overall that reform is required in relation to group insolvencies. Chapter Three explores further the Lender's concerns regarding COMI and to what extent reform is required.

How far has the EIR progressed since the Phase I drafts? Is the EIR's enactment a success story?

- 2.165 In order to determine how successful the EIR has been in addressing the concerns of the Lender it is important to note how far the EIR has progressed beyond the earlier draft Conventions. It can be concluded that the EIR's drafters 'learned' from the unworkable proposals of the past and, in particular, the failings of the Phase I and II drafts of the Bankruptcy Convention.³¹⁰ It can be argued that the production of the 1970 draft Convention was a precursor to the production of a 'simplified and rationalist system of bankruptcy' for the EU³¹¹ and, based on this original proposal, revisions resulting in the incorporation of numerous modifications and refinements in detail and some transformations on matters of principle have eventually lead to text that has been successfully adopted by Member States.
- 2.166 The essential difference of the EIR, which ultimately accounts for the success story of its enactment as supranational EC/EU law by Member States, is the fact that, although it is an instrument of directly applicable EU law, it does not interfere with certain international concepts in the domestic insolvency law of Member States itself. This is a huge leap from the unrealistic approach of the Phase I drafts in superimposing a unitary set of mandatory jurisdictional rules and their adherence in

³¹⁰ See generally A.1-A.11.

³¹¹ See I F Fletcher, 'The Proposed Community Convention in Bankruptcy and Related Matters', Final Chapter in K. Lipstein, *Harmonization of Private International Law by the EEC*, (1977) Chameleon/ Institute of Advanced Legal Studies: London, 135.

following a strict universalist approach.³¹² The EIR therefore abandons the arguably futile aim of seeking overall harmonization of laws and focuses on a more predictable framework for coordinating cross-border insolvencies which, broadly speaking, seeks to respect Lender's rights. The modified universality approach is argued as representing work-in-progress towards getting states to understand the effectiveness of reducing the costs and formalities inherent in international insolvency and inducing acceptance of partial harmonization of the rules of procedure.³¹³

2.167 The Istanbul Convention's main failing was its choice of adopting indirect jurisdiction and not imposing any mandatory jurisdictional rules. It, however, introduced the proposal that main proceedings could be supplemented by any secondary proceedings in which the debtor has an 'establishment'.³¹⁴ The EIR's refinement of this concept,³¹⁵ including removal of any possibility of opt-out provisions,³¹⁶ is a clear example of how the EIR gives proper consideration to the expectations of the Lender, for example, if he has had dealings with the debtor outside the context of the latter's forum of bankruptcy. A further example of prioritizing the Lender's rights is how the EIR, following the policy adopted by the draftsmen of the former Convention text of 1995, has deliberately refrained from imposing its own definition of a right in rem which could result in assets having to be classified in a way which is in conflict with the approach followed by the law of the situs.

³¹² See A.5 – A.7 in relation to the extreme universalist approach envisaged by the Phase 1 draft conventions. See A.8 for criticism of this approach. See A.10 outlining the unsuccessful attempt in the Phase 1 drafts to apply the twin principles of unity and universality of bankruptcy.

³¹³ See A.11 on how the Istanbul Convention adopted a more flexible approach to the universalist theory. See A.14 as to why it was not an ambitious enough model. See A.16 regarding how 'modified universalism' better protects the interests of secured creditors. See also A.19 – A.20.

³¹⁴ European Convention on Certain International Aspects of Bankruptcy, June 5, 1990, Europ. T.S No. 136 (hereinafter Istanbul Convention), Art 17.

³¹⁵ Note that, through the refining process that resulted in the EU Convention, (amendments passed down to the EIR), all categories of creditors, not only local creditors, were allowed to participate in secondary proceedings and be paid from the estate.

³¹⁶ Opt-out provisions were first envisaged in the EU Convention. It was concluded that some issues were better covered by conflict of law principles and therefore excluded from the application of the EU Convention. See A.16.

- 2.168 One can argue against unrealistic expectations of the EIR's success being measured by whether it governs all the possibilities that might occur within a single insolvency and that infinite scenarios can be conceived in relation to the specifics of each cross-border insolvency. That is arguably why the ECJ has been given a wide power of discretion in providing guidance through instructive case law. If one follows the journey from the 1970 draft Convention to the European Convention, approximately 40 years' worth of cumulative effort by legislators, and then notes the refinements perceived in the EIR, it is difficult to not to conclude that the eventual enactment of the EIR represents a success story. The textual evolution apparent within the EIR clearly reflects a better understanding of the Lender's concerns than was ever conceived in any of the previous drafts.
- 2.169 There have been a number of issues identified which require reform and these are discussed in more detail in Chapter Three. The lack of provisions within the EIR in dealing with group insolvencies is identified as a major concern. However it can be argued that the EIR is far from a failure because it does not address this issue. The problem regarding group insolvencies has been magnified since the time of the EU Convention³¹⁷ and the enactment of the EIR because of the growth of large multinational corporate groups. The Convention purposely did not have specific rules on parent-subsidiary relationships. The reasoning behind this was the fact that it was perceived that Member States of the EU have widely divergent views on the legal consequences of parent-subsidiary relationships.³¹⁸
- 2.170 Rather than requiring a major overhaul, in terms of amendments, the EIR requires modernization which is why Article 46 has been built into the text, arguably because it was expected that, the legislation needed to be adapted with the changing times in order for it to be practically applied in the future. Furthermore, in relation to forum shopping, in

³¹⁷ See generally A.15 – A.22

³¹⁸ See M Balz, 'The European Convention on Insolvency Proceedings', 1996, 70 Am. Bankr L.J 485, 503-504 for further detail.

light of recent cases, it can be argued there is no major concern where creditors have been the initiators of forum shopping as those creditors “in the money” consented to the COMI migration before proceedings were opened.³¹⁹ It is argued that a “more efficient insolvency procedure” refers to the situation where creditors are in favour of the company’s migration into another jurisdiction, and more significantly, if they actually instigate the re-location.³²⁰ The Lender’s main concern is where there has been or there is the possibility of “bad” forum shopping and this is possibly an area that needs to be addressed. This means concentrating on situations such as where the debtor re-locates abroad without getting the consent of the majority of the shareholders. Conversely, even when certain major creditors (such as large banks like the Lender) do give their consent in support of a migration, there may be a number of dissenting junior creditors.³²¹ Chapter Three addresses amendment of the EIR and puts forward some tentative proposals regarding reform.

³¹⁹ This was the case in the Schefenacker restructuring: see G Tett and I Simensen, ‘Schefenacker considers move to London’, *Financial Times* (London 16th October 2006); I Simensen, ‘Schefenacker restructuring holds up mirror to cross-border differences’, *Financial Times* (London 11 October 2007).

³²⁰ Especially for institutional lenders who regularly conduct large restructurings, this can be perceived as a recognized advantage of pre-insolvency migration. See WG Ringe, ‘Forum shopping under the EU Insolvency Regulation’, University of Oxford, Legal Research Paper series, Paper No 33/2008, August 2008, electronic copy: <<http://ssrn.com/abstract+1209822>> 19. The important factor is whether the COMI migration is in the interests of efficiency and helps in maximizing the full potential of net assets available to satisfy creditors’ claims. It is argued that, if it does, the COMI migration cannot be regarded as abusive. See Eidenmuller (n 100) 13.

³²¹ e.g. unsecured, junior and typically involuntary creditors. See Ringe (n 320).

CHAPTER THREE

REFORM OF THE EIR

Introduction

- 3.1 There are several issues that need to be explored further in this last chapter before we can conclude on the many questions that have been raised in the first two chapters. These factors all relate to the main focus of this thesis which is to consider, from the Lender's perspective, what legal concerns are faced in relation to the potential effects of insolvency proceedings on cross border security and the best way the Lender can address these anticipated risks to get the maximum realization of his security. The issue of insolvency effects and how these can be mitigated by the Lender leads to the pertinent question of how efficient the EIR is in ensuring that there is minimal erosion of the Lender's realized security by different insolvency laws which favour other creditors. If the EIR falls short in addressing this fundamental concern then are there any steps the Lender can take to minimize risk?
- 3.2 In order to review how successful the EIR has been in addressing the concerns of secured creditors it will be helpful to consider the issues identified in the Insolvency Service's Evaluation Questionnaire (the Questionnaire) which focus on the problematic areas of the EIR over which there has been much controversy. The European Commission is required to report on the EIR by 1 June 2012 and, if necessary, to produce proposals for its amendment.¹ To this end, the Commission intends to launch a study of the EIR this year and the Insolvency Service are currently carrying out their own evaluation so as to be in a

¹ See Article 46 of the EIR.

position to inform and influence the Commission's Report. The aim of the Questionnaire is therefore to gather information on the experiences of individuals working with the EIR in practice to assess whether or not it meets its objectives.²

(1) Making jurisdiction 'stick'

The use of COMI covenants

- 3.3 Chapter Two raises the concerns the Lender potentially faces in relation to the uncertainty of the location of COMI; the lack of a comprehensive definition; and the prospect of COMI migration.³ An important factor to consider is whether the use of banking covenants exerts some measure of control over the Lender's risk factor and how far, in practice, these covenants protect the Lender's position. The Lender is faced with difficulties as risks and remedies may vary in a different Member State and the location of the debtor's COMI may impact both on his ability to enforce and the effectiveness of his security.
- 3.4 One of the questions raised in the Questionnaire specifically relates to whether the lack of a comprehensive definition of COMI is a problem and, if so, in what way and how the difficulties can be overcome. Indirectly this leads us to the question of whether the lack of a proper definition for COMI may not be such a problematic issue in ascertaining COMI if COMI covenants can be successfully used. It was seen in the previous chapter that the lack of a proper definition of

² The Insolvency Service, 'Evaluation of Council Regulation (EC) No 1346/2000 of 29 May 2000 on Insolvency Proceedings – Evaluation Questionnaire', www.insolvency.gov.uk (The Questionnaire) 2.

³ *Ibid.* Question 4 : 'Does any uncertainty as to the location of a debtor's COMI or the fact that the debtor can change this COMI at some future date (i.e. after the debt has been incurred) cause difficulties for creditors or other parties such as directors, employees or regulatory authorities in assessing the risks of entering into business transactions?'

COMI may cause problems for the Lender. This is especially in relation to the initial assessing of risk factors as, in the absence of further clarification from the ECJ, there may be a lack of consistency in determining jurisdiction across the EU. Depending on where the assets are located, there is a continuing risk that local Member State courts may consider different objective factors and give them different weightings in terms of importance. Uncertainty as to the location of the debtor's COMI, whether it is largely because of the lack of proper COMI definition or not, means that different creditors or interested parties may perceive the COMI to be in a number of different Member States. This raises the question of what approach the courts will take in the situation where competing creditors consider a debtors' COMI to be in different Member States.

3.5 In addition to the uncertainty in determining a debtor's COMI when a transaction is entered into, it was seen in Chapter Two that it is possible that the COMI may move after the security transaction has been completed. The issue of forum shopping is further explored later in the chapter. Nevertheless certainty and predictability of the insolvency regime applicable if the debtor goes into financial difficulty is very important to the Lender. It has already been discussed in Chapter One that, when conducting a risk assessment, the Lender will seek to identify the jurisdictions in which insolvency proceedings might occur in order to assess the effects of the insolvency laws of those jurisdictions upon the transaction in question. It is common for syndicated loan agreements to contain clauses with which the debtor represents that its COMI is in a particular Member State.⁴ However, to more effectively protect his position, it is common for the Lender to obtain covenants that the debtor will not take any steps that would

⁴ An example of a clause in a loan document is as follows:

“For the purposes of ‘the Council of the European Union Regulation No. 1346/2000 on Insolvency Proceedings’, [the debtor’s] centre of main interest is situated in England and it has no ‘establishment’ in any other jurisdiction.”

See H. Eidenmuller, ‘Abuse of law in the context of European Insolvency Law’, April 2009. *European Company and Financial Law Review*, Vol. 6, No. 1, 11.

cause the COMI to change or seek the consent of the Lender with respect to a planned COMI shift. Failing to get the Lender's approval for a proposed COMI migration would result in an acceleration of the underlying payment obligation.⁵ In practice, however, it is uncertain whether COMI covenants will provide the ultimate solution in protecting the Lender's position. Will COMI covenants ultimately deter debtors that are determined to effectuate a COMI shift in order to benefit at the expense of their creditors?

- 3.6 Although some degree of control can perhaps be established by using covenants, it is argued that it does not seem probable that, if jurisdiction existed, the courts of that country would refuse to accept that jurisdiction on the sole grounds that the factors bringing the debtor company within its jurisdiction had involved a breach of banking covenants.⁶ Furthermore if COMI was moved in breach of a COMI covenant, the issue arises of what remedy the Lender would have in this instance and whether it would be enough of a compensation. The breach of a covenant from the debtor would only give rise to a claim in damages. This may be of limited use if the debtor is in financial difficulty. In this instance the Lender can only hope that the court will take into account COMI covenants when considering what is ascertainable to third parties on COMI. In terms of assessing risks however, this means relying a great deal on the discretion of the court. Conversely, COMI covenants might be useful as evidence of 'ascertainability' and, coupled with an event of default triggered by any step to move COMI, they may be useful in some cases.

⁵ Although this thesis is concerned mainly with safeguarding the Lender's interests it needs to be noted that, for trade creditors, it is normally uneconomical to seek and draft detailed covenants to obtain an enhanced level of protection. For them, retention of title clauses are a much more common and sensible means of self-help. See Eidenmuller (n 4) 11.

⁶ See IF Fletcher & H Anderson, 'The Insolvency Issues' in Michael Bridge & Robert Stevens (eds), *Cross Border Security and Insolvency* (Oxford University Press, Oxford 2001) 263.

(2) Moving jurisdiction

Forum Shopping – COMI Migration

3.7 One of the questions put forward in the Questionnaire is:

‘Is there evidence of debtors relocating their COMI from one Member State to another in order to frustrate creditor claims or to benefit from insolvency laws more advantageous to them?’

In Chapter Two the issue of ‘good’ versus ‘bad’ forum shopping was introduced.⁷ It was discussed that the latter is generally where a particular stakeholder selects a jurisdiction based on self interest in order to escape creditors, whereas the former is where a jurisdiction is selected with the best interests of all stakeholders in mind.

3.8 Whilst there may be little evidence that debtors are relocating their COMI from one Member State with the sole intent of frustrating creditor claims,⁸ cases such as *Schefenacker*, *Deutsche Nickel* and *Hans Brochier* involved debtors moving their COMI to take advantage of another Member State’s insolvency regime in pursuit of more favorable restructuring laws. It should be noted that in cases such as these large scale reorganizations that will be involved in effecting a corporate migration, secured creditors are hardly taken by surprise. In practice, due to the number of banking covenants focusing on COMI, major creditors will need to be on board if the migration is to succeed.

⁷ See 2.46, 2.172, 3.7 & 3.14.

⁸ A debtor apparently has the right to move his COMI, even in the case where he is trying to remove himself from the Member State where he has incurred the debt and where his creditors are located. See *Shierson v Vlieland-Boddy* [2005] EWCA Civ 974, [2005] 1 WLR 3966. See also *Official Receiver v Eichler* [2007] BPIR 1636, HCJ.

- 3.9 In terms of what the future holds for COMI migrations it should be noted that UK schemes of arrangement⁹ are increasingly being used as a mechanism for restructuring, and enable a restructuring plan to be forced through where a minority of creditors oppose it. Cases such as *IMO Car Wash*¹⁰ and *Wind Hellas*¹¹ show how senior secured creditors have been able to exploit COMI mobility to their advantage.¹²
- 3.10 The English High Court recently delivered judgment in the IMO case in which the High Court considered whether to sanction three related schemes of arrangement for restructuring indebtedness proposed by the IMO Car Wash group to the senior lenders of the relevant group companies. Four legal principles that relate to junior and senior secured lenders were emphasized by Mann J: firstly, a company is able to choose the creditors with whom it wants to enter into an arrangement and this does not need to include those creditors whose rights remain unaffected by the scheme;¹³ secondly, the company is not required to consult any class of unaffected creditors prior to entering into the scheme based on one of the following reasons:(i) because their rights remain intact (ii) because they do not have an economic interest in the

⁹ A scheme is a statutory procedure which permits a company to propose an arrangement to its shareholders or creditors (or any class of them). Provided that the scheme is approved by the requisite majorities of shareholders and creditors and subsequently approved by the court, it is binding on 100% of those shareholders and creditors (or any class of them) who were entitled to vote, irrespective of whether or how they voted. So a scheme can be used for any transaction where a company is concerned to bind creditors and shareholders by an arrangement. For more detail, see: “The scheme: a most convenient and modern arrangement”, www.practicallaw.com/5-380-7686. The question arises as to how far a scheme will be recognized in other jurisdictions as it is not an ‘insolvency proceeding’ for the purposes of the EIR. There may however be a way forward by sheltering behind an administration and then relying on Article 25(1) auto recognition of judicially approved compositions.

¹⁰ *Re Bluebrook Ltd* [2009] EWHC 2114 (Ch), [2010] 1 BCLC 338.

¹¹ *Re Hellas Telecommunications (Luxembourg) II SCA* [2009] EWHC 3199 (Ch).

¹² R Watts & C Newell, “Firms flock to ‘bankruptcy brothel’ UK”, *The Sunday Times*, (London, March 7, 2010: <<http://www.timesonline.co.uk/tol/news/politics/article7052729.ece>>

¹³ This is based on the following case law: *Perusahaan Perseroan (Persero) PT Perusahaan Penerbangan Garuda Indonesia* [2001] All ER (D) 53 (Oct) and *Re British & Commonwealth Holdings plc* (1992) 1 WLR672. See Ashurst London, “IMO Car wash restructuring approved; analysis of the “Rollover Scheme & Pre-pack” (September 2009) <www.ashurst.com> , See also C Scott-Priestley, ‘IMO Car Wash: A Washout for Junior Creditors?’ (2009), Squire, Sanders & Dempsey LLP, <www.ssd.com>

company;¹⁴ the court can determine whether a certain class of creditors really has an economic interest in the company and distinguish this from a situation where this is only based on theory prior to taking the appropriate action;¹⁵ and junior lenders can object as creditors on grounds of unfairness if the schemes unfairly prejudice them in ways other than altering their strict rights.

3.11 This case is a useful demonstration of how the court's approach is likely to affect junior creditors when schemes of arrangement are used as a mechanism for restructuring. Enabling such a restructuring plan to be forced through, which could serve as an effective threat to dissenting creditors, may well involve a manipulation of COMI to the senior creditors' advantage.¹⁶ Practically, this case illustrates the significance of the provisions in an inter-creditor agreement in enabling senior lenders, when they are enforcing their security, to release the claims of junior lenders. The junior lenders have a limited course of action if it is clear: that the senior lenders have wide reaching powers under the agreement; the restructuring can be implemented through an enforcement sale; and the value will reduce the senior debt. It is therefore argued that junior lenders who grant wide inter-creditor release rights in favour of senior lenders "contract away their place at

¹⁴ See *Tea Corporation Limited* (1904) 1 CH12.

¹⁵ The mere fact that there is a possibility of establishing a negotiating position and extracting a benefit from the deal is not the same as having a real economic interest. Furthermore the question of which creditors have a genuine economic interest in the distressed company is determined by the present market value of the company, tested on a going-concern basis. If the value is less than the senior debt, a restructuring excluding junior lenders will merely implement the subordination provisions envisaged in the loan documents. See *Scott-Priestley* (n 13).

¹⁶ *Wind Hellas* (n 11). In this case: the head office was moved to Luxembourg to the UK a week before investors were informed that the company was considering restructuring its debt. Hence there was a strategic move to shift COMI in order to take advantage of the UK's insolvency regime. See also *Sunday Times* (n 12), the chief executive of SPQR, one of the creditors, was quoted as saying:

"Any business can set up a tiny office in London and cheat their creditors out of debts of hundreds of millions of pounds.....this is entirely legal under UK laws – and signed off by High Court judges".

the negotiating table if the value of the business falls below the quantum of the senior debt.”¹⁷

- 3.12 The *Wind Hellas* restructuring was based on a pre-packaged administration sale in England. However, as in the above-mentioned case, the court focused on the fact that the sale of the company’s assets¹⁸ required the consent of senior creditors who, in accordance with an inter-creditor deed, had been allocated priority over different classes of creditor. Lewison J, in his judgment, referred to the fact, that based on the evidence before the court, the senior creditors made it clear that the only bid they were willing sanction was the bid made by the company ‘Weather’ which was part of the same group. Therefore there was no alternative for the administrators other than to proceed with the pre-pack sale to Weather.¹⁹
- 3.13 Leaving aside the issues relating to the distinction between junior and senior creditors, if a COMI migration is desired then, as discussed in Chapter Two, certain steps need to be taken. The creditors will need to ensure that enough is done within the migration process so that COMI can really be established in the new location especially if the company’s registered office remains in the original jurisdiction. To be successful, any movement of COMI must have sufficient substance to be credible and must also satisfy the requirements of Recital 13 that the COMI be the place where the debtor conducts the administration of his interests on a ‘regular basis’ and is therefore ascertainable by third parties. An ‘element of permanence’ is required and courts have a duty to scrutinize carefully situations where it appeared the move had been made with impending insolvency in mind.²⁰ It should be noted from *Wind Hellas*, per Lewison J, that the purpose of COMI is to enable creditors in particular to know where the company is and where it may

¹⁷ See Ashurst (n 13).

¹⁸ The shares in the operating company.

¹⁹ This was despite the fact that complaints were made by junior lenders regarding the fact that Weather, the successful bidder, was given an advantage over other bidders and there had been an abuse in the process. See *Wind Hellas* (n 11).

²⁰ See *Re Ci4net.com Inc* [2005] BCC 277 and *Shierson* (n 8).

deal with the company. The most important feature raised in the evidence in this case was the fact that all the negotiations between the company and its creditors took place in London.²¹

3.14 It is submitted overall that perhaps Recital 4²² of the EIR needs to be reviewed in light of what is considered bad forum shopping. It is argued, and the writer agrees, that the ability to move COMI is consistent with the principle of freedom of establishment within the EU.²³ It therefore follows from this that, if COMI is moved with a view to benefiting creditors and not prejudicing them, there is nothing wrong with COMI migration in order to take advantage of more favourable restructuring laws existing in a particular Member State.²⁴ In fact recent case law shows this is a more progressive way of following the guidance under the EIR for the benefit of secured creditors. However this type of forum shopping should be distinguished, for example, from the situation where a debtor seeks to move its COMI outside the EU in order to avoid the commencement of insolvency proceedings in any Member State and to prejudice creditors in the EU. In such a case there is no question of freedom of establishment within the EU and there is a strain in applying the principle that COMI falls to be assessed as at the date of the opening of proceedings against preventing abuse of the EIR by debtors. Where it can be shown that the steps to move COMI outside the EU are plainly abusive and for the purpose of avoiding insolvency proceedings under the EIR, it would clearly be in the creditors best interests if such steps were ignored.²⁵ From case law

²¹ *Wind Hellas* (n 11), per Lewison J, para 5. Note that the company took a number of other steps to achieve a successful COMI migration: a new head office was opened in London, at which board meetings were held and from which correspondence was sent out; notices of change of address were sent to trustees and agents; the company was registered at Companies House etc. See, 'Financial restructuring of Wind Hellas', Financial Briefing (December 2009), Slaughter and May: <<http://www.slaughterandmay.com>>

²² It is necessary for the proper functioning of the internal market to avoid incentives for the parties to transfer assets or judicial proceedings from one Member State to another, seeking to obtain a more favourable legal position (forum shopping).

²³ The ability to move COMI is consistent with the principle of freedom of establishment under what is now Article 49 of the Treaty on the Functioning of the EU (TFEU).

²⁴ G Moss, I Fletcher and S Isaacs, *The EC Regulation on Insolvency Proceedings, A Commentary and Annotated Guide*, (Oxford, 2nd ed, 2009), 8.102.

²⁵ See *Hans Brochier Holdings Ltd v Exner* [2007] BCC 12. See also M, F & I (n 24), 8.106, 8.336 and FN 18.

such as *Wind Hellas* and *IMO Car Wash* it is not so clear cut when trying to distinguish between what is in the best interests of secured creditors as a whole as some restructuring solutions may weigh more in the favour of senior lenders over junior ones.

3.15 However, in relation to creditors as a whole, it is argued that the EIR does contain creditor protection measures in the face of forum shopping.²⁶ On the one hand, every creditor is free to oppose the opening decision of the insolvency proceedings in the alleged COMI state. A more difficult option would be for the creditor to attempt to file for insolvency in the Member State where he or she believes the real COMI is located.²⁷ In the event that a COMI migration takes place which results in detrimental consequences for creditors, the most significant remedy will be the possibility of opening ‘secondary proceedings’ as provided by Article 3(2) of the EIR. Creditors situated in a Member State other than the COMI Member State will get insolvency protection through secondary proceedings being opened in their state allowing the operation of local rules and separate treatment from the main proceedings. Drawing these issues together, there appears no reason why forum shopping should not be permitted. If a cross-border migration is supported or initiated by creditors expecting a more efficient restructuring for themselves then this can be seen as a strong indicator that the migration will entail beneficial effects. In the case where the creditors do not support the COMI migration, in addition to safeguards provided under domestic law²⁸ depending on the Member State, the EIR provides certain creditor protection safeguards. The question then arises as to whether these safeguards are adequate in

²⁶ See W Ringe, ‘Forum shopping under the EU Insolvency Regulation’, University of Oxford, Legal Research Paper series, Paper No 33/2008, August 2008, electronic copy: <<http://ssrn.com/abstract+1209822>>20-22.

²⁷ This solution has become more difficult since (C-341/04) *Re Eurofood IFSC Ltd* (2006) ECR I-3813, [2006] BCC 639 ECJ and the ECJ emphasising the principle of mutual trust.

²⁸ UNCITRAL 30th Session, 12-30 May 1997: Official Records of the General Assembly of the United Nations, 52nd Session, Supplement No 17 (A152/17), Part II, paras 12- 225. Legislative Guide on Insolvency Law, 2004 . See e.g. sections 13, 14, 21 and 22. The UK implemented the Model Law by enacting the Cross-Border Insolvency Regulations 2006. Thereby, creditor protection is also ensured in cross-border insolvency cases which do not relate to other EU Member States. See Ringe (n 26) 21.

ensuring protection against ‘bad forum shopping’ or whether reform is needed.²⁹

- 3.16 Directly linked to the issue of COMI shifting is the fact that the EIR does not recognize the commercial reality of multinational corporate groups and hence there is no degree of co-operation between proceedings across groups. The effect of the lack of special provisions within the EIR in dealing with group companies is discussed further in the following section. However, for as long as the concept of COMI depends on a debtor’s factual circumstances, and there remains a misalignment between the commercial reality of corporate groups and the strict legal requirement to recognize single legal entities on insolvency, forum shopping by COMI migration is likely to occur.³⁰ Although criticized for its lack of certainty and artificiality, the flexibility provided by COMI migration arguably offers the best solution available to debtors or debtor groups and secured creditors wishing to take advantage of the insolvency regime of a particular jurisdiction. It has been established that in many cases COMI migration and a resultant restructuring has led to a higher return for creditors.

²⁹ See Ringe (n 26) 22.

³⁰ Note that there have been developments which have the potential to aid COMI migration in future restructurings. See the European Directive on Cross-Border Mergers of Limited Liability Companies (Directive 2005/56/EC of 26 October 2005) which has been largely implemented across the EU and enables two limited liability companies incorporated in different member states of the EU to merge and the remaining entity may have its COMI in either member state. See <www.practicallaw.com/0-201-4689>. The main reservation is whether the registration and formal requirements are too time consuming and costly in a restructuring environment. See Robert Spedding, ‘COMI migration: history and future’, (2008) 6 CRI 183.

Possible reform of Articles 3 & 4 in relation to the obscurity of the COMI approach

3.17 As has been discussed in the previous Chapter, the current unpredictability of a criterion that is of such importance has been the topic of much scholarly debate. In light of this, what could be the alternative to the present system? Two ways are suggested to amend the current law so that it will supposedly fit into the route of compatibility with the freedom of establishment as interpreted by the ECJ and shed some clarity regarding the definition of COMI.³¹ However the writer is not convinced that these options will be workable as alternatives.

3.18 The first approach would be to eradicate the possibility of a rebuttable presumption and alternatively connect both jurisdiction and the applicable law to the relevant Member State of incorporation. Following from this, Article 3(1) of the EIR could be amended as follows:

“ The courts of the Member State within which the centre of a debtor’s main interests is situated shall have the jurisdiction to open insolvency proceedings. In the case of a company or legal person, the place of the registered office shall constitute the centre of its main interests.”

Article 4 of the EIR would remain unaltered however, by amending Article 3, it is argued that the Lender would be put in the advantageous position of having both a predictable jurisdiction venue and applicable law.³² However, as emphasized in the *Eurofood* case, with this suggested reform there would be no distinction in the case of a ‘letterbox company’ and genuinely ascertaining where the debtor’s centre of main interests is really located.

³¹ See Ringe (n 26) 27-29.

³² *Ibid.* 27.

3.19 The second and less heavy-handed alternative could be to reform the choice-of-law rule in Article 4 of the EIR so that the applicable law would be the one of the Member State of the origin, whereas the jurisdiction clause in Article 3 would remain the same. Therefore, Article 4 could be amended as follows:

“Save as otherwise provided in this Regulation, the law applicable to insolvency proceedings and their effects shall be that of the Member State within the territory of which the debtor’s registered office is situated, hereafter referred to as the ‘State of the opening of proceedings.’”

This solution will arguably have the same benefits as the first option in relation to reform, however, insolvency proceedings could be opened in the Member State where the debtor has its COMI, subsequently taking into consideration the convenience of such a jurisdiction venue for most creditors which have dealings with a letterbox company in the host Member State. However this solution may result in practical problems if the particular situation necessitates courts of the host Member State applying the insolvency law of the state of origin and taking such steps such as winding up the debtor company.³³

3.20 In relation to the proposals above, the question arises whether the significant disadvantages outweigh the general advantages over the current system in the protection of the Lender’s rights. The writer does not agree that pursuing these suggestions for reform will create a genuinely reliable system of cross-border insolvency in the Community, giving the Lender a predictable answer as to which insolvency regime applies when the company becomes insolvent. For instance, the first option may require the Lender to pursue his claim in a Member State different from his own. Furthermore if he decides to file for insolvency, he will have to familiarize himself in relation to the laws of a different Member State which includes incurring expenses

³³ *Ibid.* 28.

such as travel costs and choosing another legal representative.³⁴ In the case of option two, as discussed earlier, the situation may arise necessitating the application of foreign insolvency law by Member States which will create difficulties especially when it comes to winding up companies. The implications of the suggested reform options on forum shopping may be to reduce the likelihood of COMI migration on the basis that the registered office is not freely transferable. If a company were to forum shop under the proposed regime, it would need to take on the onerous task of registering in a new Member State.³⁵ However, in relation to finding a more efficient solution for dealing with the insolvency of corporate groups, currently a more problematic issue for the Lender than the impact of COMI migration,³⁶ no solution is provided. Firmly linking the COMI with the ‘registered office’ leads to the consequence that no common insolvency procedure for corporate groups can be established. It needs to be noted that, rather than focusing predominantly on countering possible forum shopping, in recitals 2, 8, 16, 19 and 20 of the EIR, the efficient and effective administration of cross-border insolvencies is emphasized.

³⁴ It is noted however that there is the option of opening secondary proceedings under Article 3(3) of the EIR where an ‘establishment’ exists. Ringe (n 26) 28.

³⁵ Currently, the cross-border move of the registered office is only available via the European Company (SE) Regulation (Article 8 provides for the cross-border transfer of the registered office) or indirectly via a cross-border merger (see Merger Directive (n 30)). See Ringe (n 26) 30.

³⁶ In order for the COMI migration to succeed it is more than likely that the Lender will have consented. There are also the additional safeguards available of taking COMI covenants.

Is the lack of special provisions dealing with group companies detrimental to the Lender?³⁷ If so, in what way and how might this be addressed?

- 3.21 As discussed in Chapter Two, the EIR does not provide adequate guidance in dealing with the insolvency of affiliated companies. Furthermore Virgos Schmit³⁸ clearly refrains from developing a clear approach in relation to the COMI of group companies. It has been established earlier that the lack of an explicit solution to the particular case of group companies within the EIR poses a threat to the protection of the Lender's rights. The difficulty that arises is that different creditors involved with the group may have different interests and expectations regarding the location in which any given group member's insolvency will be handled.
- 3.22 For instance, creditors of a certain subsidiary may wish that the company will be managed separately, while the creditors of other related companies may expect all proceedings to be conducted jointly due to their impression that they have been dealing with the entire group. In terms of finding a solution as to how this issue might be reformed it has been argued that applying the simplified rule of treating each company separately without a prior consideration of the group context may result in considerable unfairness towards the majority of the group's creditors.³⁹ Furthermore splitting up the business sale process within a group could cause a significant loss of value to the assets of the group as whole or create an obstacle to an easily coordinated continuation of the business while a reorganization takes place. It is also important to consider the fact that one set of insolvency

³⁷ This is adapted from Question 20 of the Questionnaire (n 2): 'Is the lack of special provisions dealing with group companies detrimental to the efficiency and effectiveness of cross border insolvency proceedings and, if so, in what way might this be addressed'.

³⁸ Para 76.

³⁹ IR. Mevorach, 'Centralizing insolvencies of pan-European corporate groups: a creditor's dream or nightmare?' J.B.L (August 2006), 468-486.

officeholders appointed on behalf of the consolidated group is more likely to promote efficiency and effectiveness⁴⁰ as it could save time and costs and make the administration of the insolvency or reorganization proceedings more efficient.

- 3.23 Chapter Two discusses the arguments surrounding the effectiveness of the “Head Office functions Test” and mentions the impact of *Re Stanford International Bank*⁴¹ in relation to the future use of that test, especially in light of the recent Court of Appeal’s decision.⁴² It is argued that, in light of the recent Court of Appeal decision, it will be considerably more difficult to adopt the group COMI approach in the United Kingdom than was common practice before.⁴³
- 3.24 As discussed in Chapter Two⁴⁴ it is apparent that the most prominent decision of the ECJ concerning the issue of group companies is that relating to the *Eurofood* case. This decision has raised the evidential bar that has to be overcome to show that a subsidiary has its COMI in the same place as its parent company. The question is left open regarding what level of parental control will be sufficient to rebut the registered office presumption and to lead third parties to conclude (based on objective and ascertainable factors) that the subsidiary has its COMI in the same jurisdiction as its parent’s. It is clear however that the ECJ decision has not prevented courts, in particular circumstances, from concluding that all subsidiaries within a group have their respective COMIs in the same place. The Eurotunnel case was referred to earlier where the French court was prepared to place companies with their registered offices in Member States other than France into *sauvegarde* proceedings based on the control exercised by the French

⁴⁰ This is in accordance with Recital 8 of the EIR which focuses on improving the efficiency and effectiveness of insolvency proceedings.

⁴¹ *Re, Stanford International Bank Ltd (In Receivership)*, Re [2009] EWHC 1441 (Ch), [2009] B.P.I.R. 1157.

⁴² *Stanford International Bank Ltd (In Receivership)*, Re [2010] EWCA Civ 137.

⁴³ See NWA Tollenaar, ‘Dealing with the insolvency of multi-national groups under the European Insolvency Regulation’, *Insolv. Int.* 2010, 23(5), 65-73.

⁴⁴ See 2.17 – 2.24 and *Eurofood* (n 27).

parent company.⁴⁵ In this case the court laid emphasis on case law which suggests that courts of Member States would take a “pragmatic approach” to groups of companies, taking into account the fact that all their functions could be consolidated into a “single headquarters function.”⁴⁶ Similar conclusions regarding COMI’s location at the head office were reached in the following cases: *Lennox Holdings PLC*,⁴⁷ *Re Crisscross Telecommunications Group*,⁴⁸ *Re Collins & Aikman*,⁴⁹ *Re MG Rover*,⁵⁰ *Re Daisytek-ISA Ltd*,⁵¹ *Re MPOTEC GmbH*,⁵² and *Re Energotech Sarl*.⁵³

3.25 However, in *Stanford Bank*, Lewison J conducted a detailed analysis of the rationale of the *Eurofood* decision, and of its implications for other decisions of English courts concerning the same or related issues, and concluded that the “head office functions test”, as a purely factual test of the whereabouts of the COMI, was incomplete in view of the emphasis placed by the ECJ⁵⁴ on the elements of transparency, objectivity and ascertainability by third parties.⁵⁵ Lewison J referred to the view regarding COMI expressed by Chadwick J in *Shierson v Vlieland Boddy*.⁵⁶

⁴⁵ RG 07/05764, jurista No. 2007/346870 and RG 07/05752, jurista No. 2007/354294, Tribunal de commerce de Paris. 15 January 2007; Bull. July 2007 p. 459; Court of Appeal of Paris; 3rd court, Section B, 29 November 2007.

⁴⁶ See M, F & I (n 24), 8.89.

⁴⁷ [2009] B.C.C 155, Chancery Division, 20 June 2000. However note that in *Stanford Bank* (n 41), when reformulating the test to be applied, Lewison J conceded that he had followed the wrong course in this earlier decision.

⁴⁸ (20 May 2003), Rimer J.

⁴⁹ [2005] EWCH 1754 (Ch); [2006] BCC 606.

⁵⁰ [2005] EWHC 874, Ch. The question arises, however, as to whether the English court would have been able to reach the decisions it did in *MG Rover* and *Collins & Aikman* if these cases had been heard after the ECJ’ decision in *Eurofood* (n 27).

⁵¹ 2003 WL 21353254; [2003] BCC 562 ; [2004] BPIR 30.

⁵² [2006] BCC 681, Tribunal de Commerce de Nanterre.

⁵³ Tribunal de Grande Instance de Lure, 29 March 2006.

⁵⁴ See also view of Advocate General, Francis Jacobs, in is separate non-binding at paras 118-124.

⁵⁵ Note that, in also considering the link between UNCITRAL Model Law and the EIR, Lewison J considered it reasonable to infer that the intention of the framers of the Model Law was that COMI in the Model Law would bear the same meaning as in the EC Regulation.

⁵⁶ [2005] EWCA Civ 974, [2005] 1 WLR 3966.

“ As Chadwick LJ says, one of the important features is the perception of the objective observer. One important purpose of COMI is that it provides certainty and foreseeability for creditors of the company at the time that they enter into a transaction. It would impose a quite unrealistic burden on them if every transaction had to be preceded by a set of inquiries before contract to establish where the underlying reality differed from the apparent facts”.⁵⁷

3.26 On this issue the court concluded that: the presumption that COMI coincides with the location of the company’s registered office was a true presumption; and the burden lies upon the party seeking to rebut it with connecting factors that were objectively ascertainable by third parties. It is submitted that the Court of Appeal’s decision in *Re Stanford* may provide a welcome opportunity for a “precedent-forming pronouncement, post-*Eurofood*, regarding the test for overcoming the presumption that the COMI of a corporate debtor is at the place of its registered office.”⁵⁸ In any case, what is clear, is that it would be helpful if the proposed amendments to the EIR included clarification of how to treat group insolvencies.

3.27 It has been suggested that one way forward is to use a clearly defined centralized approach to deal with insolvencies within multinational corporate groups (MCGs). This would involve placing MCGs under insolvency in a single location, de facto subject to a single supervision and single insolvency regime.⁵⁹ Under the EIR, as discussed, this is only achievable when all companies involved have their COMI in the same state. Otherwise, if related companies have their COMI in different countries, then, under the EIR it is impossible to control their insolvencies from a single location and the proceedings are then handled separately. It is argued that, in addition to many other reasons,⁶⁰ centralization would dispose of the need to have a patchwork

⁵⁷ See the judgment at [62].

⁵⁸ See I F Fletcher, ‘Rival foreign proceedings compete for recognition under the Cross-Border Insolvency Regulations’, *Insolv. Int.* 2010, 23(2), 26-28.

⁵⁹ See Mevorach (n 39) 468.

⁶⁰ *Ibid.* 468.

of various cases in different countries, thus resulting in better returns to the creditor. However, overall the main concern is the issue of fairness to creditors.

- 3.28 The following questions therefore arise: does a centralized approach fulfill the Lender's expectations in relation to jurisdiction and does it accord with his legitimate interests regarding the situation of insolvency proceedings; can it successfully address creditor's forum shopping; and does it facilitate the Lender's involvement in the process and give him sufficient representation?⁶¹ The issue of centralization needs consideration in light of these questions in order to evaluate the way forward in reforming the lack of rules in relation to cross-border insolvencies of affiliated companies.
- 3.29 When discussing the Lender's expectations it is important to consider the scenario where the creditors are related to a certain company but not to a group of companies. In this case they may have expectations of asserting their rights in relation to that company whether or not there are any other connections to other companies within the group structure. It would clearly not be fair to these creditors if their rights were prejudiced because of "group considerations". Clearly a centralized approach will be unsuccessful in this situation as it will conflict with creditor expectations and may not conform with their views relating to which forum should oversee the process. As raised earlier however there are cases where treating the insolvent subsidiary separately from the group context will actually discord with creditors' expectations. This applies where creditors may have dealt with the subsidiary as if it was the entire group or were given the impression that the whole weight of the group is behind the specific subsidiary they were dealing with. Whilst the currently used "segregated" approach in dealing with affiliated companies may not be entirely successful it is

⁶¹ *Ibid.* 469

clear that using only a centralized approach is not the way forward either.⁶²

- 3.30 The centralized approach should also be evaluated in relation to the possibility of creditor forum shopping. Creditors will be motivated to choose a particular forum over another if insolvency encompasses the entire group or one of its companies. This is because national laws may vary in their dealings with group issues in the onset of insolvency proceedings. Rather than focusing on what is in the best interests of the group as a whole, some local creditors may want certain subsidiaries to fall within the ambit of the local insolvency regime.⁶³ Local creditors may be able to cause problems by initiating secondary proceedings where there is an establishment unless some sort of compromise is reached with them as in the case of *Collins & Aikman*.⁶⁴ They will be able to engage in forum manipulation because the local insolvency laws might better suit their aims regarding the debtor and increase their ability to apply close control over the insolvency.
- 3.31 The issue to consider is whether using a centralized approach might provide a solution to minimizing this type of manipulation. It is argued that the strength of using a centralized approach is that it may “disregard ‘pure’ formalities that may obscure the ‘real’ state of affairs of the group at stake.”⁶⁵ Therefore, in order to truly overcome creditors’ forum shopping, the way forward will be to designate the place to which the group as a whole has the strongest connection as the COMI of the MCG. By putting in place a system that strives to reflect the state of affairs prior to the onset of insolvency proceedings and using a broader evaluation of the MCG, it is submitted that creditors’ manipulation will be drained of its essence.⁶⁶ However it has been discussed earlier that simply replacing a segregated approach in dealing

⁶² Mevorach (n 39) 470

⁶³ *Ibid.* 473.

⁶⁴ *Collins* (n 49).

⁶⁵ For example where the group was fragmented into separate entities yet all operated a single business directed and managed from a single location. See Mevorach (n 39) 473.

⁶⁶ *Ibid.* 473.

with companies with a centralized approach will not necessarily be in the best interests of all the creditors involved.

3.32 One of the potential flaws in using a centralized system is apparent when analyzing creditor rights of involvement and adequate representation in the group context. Here a centralized approach may have the effect of neglecting some creditors and therefore compromising their involvement and representation rights. The appointee or appointees, if handling the whole proceedings together, may be representing different interests and may be more concerned with a certain party's needs and expectations while forsaking those of other perhaps more 'remote' creditors.⁶⁷ Therefore dealing with the proceedings of each entity on an individual basis and in accordance with local law is most likely to ensure the involvement of creditors in the process of the subsidiary, to which they directly relate, in the most easiest and accessible way. Conversely, it should be noted that insolvency occurring within a MCG may be relevant not only to members directly under the proceedings but also to other affiliates which may be located in other states. A centralized approach may be beneficial in a situation such as this where the financial situation of one member may influence another and there may be mutual claims or questions of group liability. In this type of case it will be paramount that the wishes and views of creditors of affiliated companies will be heard. A centralized approach that gives authority to a certain court to look at the group insolvency as a whole may ensure that the Lender is given an opportunity to present his views and that they will be taken into account.⁶⁸

3.33 It is apparent that a decision regarding the location of proceedings should take into account the expectations and views of the group's creditors as a whole and not only a specific subset of them. Therefore a "one size fits all" approach, whereby proceedings relating to group

⁶⁷ *Ibid.* 473-474

⁶⁸ Mevorach (n 39) 469

companies are dealt with at one location or otherwise always conducted in separate proceedings with no link between the proceedings, will prevent the overall facilitation of protecting creditors' rights.⁶⁹ It is argued that a more flexible methodology is required whereby the creditors expecting to have a unified process for the entire MCG are accommodated as well as the case where creditors are dealing with a specific subsidiary as a separate entity.⁷⁰ However, in practice, amending the EIR to accomplish this flexibility might be difficult.

- 3.34 One suggestion would be to identify the COMI for the entire integrated MCG rather than for a single debtor, i.e. via the concept of centralization, however by using a flexible methodology with some exceptions. An adaptable methodology can be applied in both the following situations: where all the subsidiary companies should be located at the MCG's COMI; and where some subsidiaries are actually "locally separated". Where there are cases involving local proceedings of independent subsidiaries, the supervisory role over the whole process should be allocated to the place where main decisions are made. However the extent of control asserted over the other companies' processes will depend on the specific circumstances of the case.⁷¹
- 3.35 Recital 19 of the EIR can be used as a tool to facilitate the application of a flexible methodology in complex cases by allowing the opening of secondary proceedings in complex cases. This would apply, for instance, in cases where the debtor shares a number of functionalities with a wholly owned subsidiary such as financial and commercial administration and a common IT platform.⁷²
- 3.36 There are obvious benefits in assigning COMI to the state from which the business is actually controlled and managed rather than a "façade of headquarters."⁷³ The main issue is how to diminish the problem of

⁶⁹ *Ibid.* 472.

⁷⁰ Mevorach (n 39) 477.

⁷¹ *Ibid.* 478

⁷² M, F & I (n 24), 8.91.

⁷³ Mevorach (n 39) 477.

creditors' difficulties in ascertaining these headquarters and how to set up rules for the transparent representation of a company's COMI and its relationship with the rest of the group.

- 3.37 One method would be to ensure that the company's documentation contains a specific reference in relation to whether the company belongs to part of a group structure and, if it does, then where the COMI of the MCG is situated.⁷⁴ Each affiliate that the MCG is comprised of should state the same information on its business documentation. Annually, the company's auditors will be requested to verify the accuracy of the representations on the business documents and report whether the details correspond to the way the business is actually functioning. These representations can, in addition, be included in: transaction documents; and statements and prohibitions in relation to COMI migration or the relocation of the company within the MCG. It is argued that this will ensure maximum creditor protection and diminish and potential gaps between the "impression" and "reality" of the companies' operations and their impact on jurisdiction matters.⁷⁵
- 3.38 Overall, in relation to responses to the Questionnaire, it has been acknowledged that there is a lack of special provisions dealing with group companies which is detrimental to the efficiency and effectiveness of cross border insolvency proceedings.⁷⁶ However the Insolvency Law Committee of the City of London Law Society, for instance, did not put forward any proposals as to how this issue could be resolved and neither have there been any other radical propositions for a way forward. It is specifically stated that, whilst this has been the subject of extensive debate in domestic law for a number of years, it is not an easy issue to resolve. In light of emerging case law in relation

⁷⁴ See Mevorach (n 39) 477. Note however the earlier mentioned caveats in relying on COMI representations and covenants in 3.3– 3.7.

⁷⁵ *Ibid.* 477.

⁷⁶ See 'Evaluation of Council Regulation (EC) No 1346/2000 of 29 May 2000 on Insolvency Proceedings', Response form for Evaluation Questionnaire completed by The Insolvency Law Committee of the City of London Law Society: <<http://www.citysolicitors.org.uk/Default.aspx?sID=920&IID=0>> accessed April 2010, Question 20..

to group insolvencies national courts may come under pressure to find that the COMI of a number of group insolvencies are in the same place. However, the application of Article 16 and the recognition principle may result in conflicts over COMI between Member States and potentially result in a race to the court. In light of this, it is argued that “any attempt to incorporate a concept of ‘group’ into the EIR would need to be afforded significant further consideration.”⁷⁷

3.39 A flexible methodology of centralization will only work if the necessary tools and protective measures are put into place. These measures will enable creditors to be sufficiently represented in the process so there is a better chance of finding solution which accords with the specific facts and realities of the situation.⁷⁸ In practice it may be difficult to put into place any legislation or rules that will solve all the outstanding problems identified in relation to group insolvencies. For instance, the possibility of debtors strategically manipulating the location of the group’s headquarters still needs to be dealt with as well as the debtor’s ability to use successive filings⁷⁹ to choose a preferable jurisdiction for the MCG in anticipated distress. It is argued that, in order to avoid manipulations of the MCG’s centre being taken at the “eve of insolvency,” a model that operates worldwide should seek for “the real centre of control” for an identifiable period of time prior to the onset of insolvency proceedings. If there is more than one possible location then the chosen venue should be “where the place of control was residing longer.”⁸⁰ It remains to be seen whether this approach could meet with any success especially in light of effective creditor representation and forum shopping. What is certain however is that, if this approach is vulnerable to manipulation, then the Lender’s

⁷⁷ *Ibid.*

⁷⁸ See Mevorach (n 39) 480.

⁷⁹ Namely, manipulating the order in which group members file insolvency petitions, by filing initially by one or more members of the group followed later by filings of other members, postponing for instance the filing of the controlling entity to a larger stage, making it difficult to then transfer the process to the centre of the group. See LM LoPucki, “Cooperation in International Bankruptcy: A Post-Universalist Approach” (1999), 84 *Cornell Law Review*: 696 at p. 722-723, See also Mevorach (n 39) 474.

⁸⁰ See Mevorach (n 39) 479.

expectations will not be met and the identified centre will probably not reflect their views with regard to the MCG's operation.

Countering insolvency effects (Articles 5-15)

- 3.40 The Questionnaire raises the issue whether the exceptions to the general rule that the law applicable to the proceedings is that of the State of the opening of proceedings (Articles 5-15) “adequately protects expectations and certainty of transactions?⁸¹” “Are these exceptions appropriate; do they work; and are they sufficiently clear?⁸²”

Article 5

- 3.41 It has been established that, even if the Lender conducts a thorough pre-bankruptcy risk assessment, there is no assurance that he will be right in predicting which forum will end up governing the insolvency proceedings. The issue therefore arises of whether the exceptions provided to the *lex concursus* by the EIR effectively enable the preservation of rights or interests of secured creditors and protect them from the uncertainties or inconsistencies in policy that may result from the application of a foreign *lex concursus*. This issue is specifically raised by the Insolvency Service in the Questionnaire.
- 3.42 As discussed in Chapter Two, when it comes to relying on Article 5, creditors need to be clear about what is included in the definition of the term “rights in rem” however this is not adequately provided for in the EIR however Articles 5(1) and 5(2) do provide some indicative

⁸¹ For example, do they strike the right balance between the need to protect secured creditors and the general principle that the applicable law should be that of the State of opening? As adapted from Question 16, ‘The Questionnaire’ (n 2).

⁸² As adapted from Question 17 of the Questionnaire (n 2).

parameters. When considering how or whether to expand on a definition within the EIR, paragraph 100 of the Virgos-Schmit needs to be considered. This expressly provides that there is a risk in having a rigid definition of what encompasses ‘rights in rem’. This is because the EIR might start describing as rights in rem legal positions which the law of the State where the assets are located does not consider to be rights in rem, or of not encompassing rights in rem which do not fulfill the conditions of that definition. The EIR does not take on the impossible task of harmonizing all the national laws of EU countries and therefore imposing a strict definition of ‘rights in rem’ may be more confusing than helpful. There is also the danger of providing an unreasonably wide interpretation of the national concept of a right in rem. The writer concludes that it is sufficient that Article 5(2) of the EIR provides some guidance in facilitating the application of the EIR by providing a list of types of rights that are normally considered by national laws as rights in rem.

- 3.43 The Lender needs to be sure that, in the onset of insolvency, the laws of every concerned jurisdiction will fully accept that the right in rem is valid and enforceable and its enforcement or realization will not be affected in any way that decreases its economic value. One of the issues that needs to be explored further is whether it is “necessary for the Lender to perfect or register any security over the asset in question in the jurisdiction in which the asset is deemed to be located for the purposes of Article 2(g).” It is argued that this will result in a “dual due diligence requirement with the need to perfect the security according to both where it is situated on traditional conflict of laws principles and on the basis of definitions in Article 2(g).”⁸³ This may run contrary to the principles of improving the efficiency and effectiveness of insolvency proceedings on which the EIR is based.⁸⁴ Furthermore there is then scope for the Lender not being able to register or perfect his security interest because all the possibly onerous formalities concerned with the

⁸³ Insolvency Law Committee Response (n 76), Question 16.

⁸⁴ Recital 8.

procedure may not be able to be met in order for the recognition of a valid security interest in the applicable forum under Article 2(g).

- 3.44 One of the issues of concern for the Lender in relation to certainty of transactions and protected expectations is the issue of movable assets. When taking security over movable property, the Lender will be concerned that the asset may be moved to another Member State, or some non-Member State and therefore become subject to a different legal regime at the relevant time. Although actions for voidness, voidability or unenforceability are not precluded by virtue of Article 5(4), the issue of timing will be important for the Lender. A movable asset can change location between the time the creditor's security right was created and the time when proceedings are opened. A secured creditor will be placed in a vulnerable position if the asset is relocated to a jurisdiction which does not recognize the security interest at the time proceedings are opened. Conversely, if the Member State where the asset has been moved to strengthens the position of the secured creditor by maximizing his rights, then the unsecured creditors will be disadvantaged.⁸⁵
- 3.45 As discussed above, in terms of perfecting the security, this would have been carried out in the place where the asset was previously located and the Lender will have to ensure that security over the asset in the new location doesn't fall short of any formal requirements. The Lender will need to find a way of placing restrictions on certain assets and structuring transactions to try and eliminate this risk. This might be difficult considering the wide inclusion of Article 5(1) to encompass assets such as those that are of a future character at the time the security interest is created.⁸⁶
- 3.46 Can the position of the Lender in relation to assets which are situated or move to a state that is not a Member State under the EIR be improved in any way? The Lender's rights in this instance are of course

⁸⁵ Insolvency Law Committee Response (n 76), Question 16.

⁸⁶ See 3.3 – 3.7 for discussion on effectiveness of COMI covenants.

dependant by the extent to which the *lex situs* is prepared to recognize and give effect to the foreign insolvency proceedings. A situation could arise where the rights of the Lender are not recognized by the *lex situs* as prevailing over the claims of the liquidator and the Lender will have no choice but to participate in the insolvency process as an unsecured creditor. However, unless there is a word-wide instrument in place recognized globally in terms of what amounts to a right in rem, this situation is difficult to avoid.

- 3.47 Trying to enforce security rights over intangible assets is another area where the Lender may be faced with difficulties in interpreting Article 5. It is argued that in these cases it may be difficult to establish the location of an asset to fulfill the requirements of the Article 5 exception. For example, in the case of bank accounts, some commentators have suggested that the account is situated at the place “where the bank has its own COMI rather than the place of the branch holding the account.”⁸⁷ It would therefore be useful to get more clarification under the EIR.
- 3.48 One of the key considerations for the Lender, as discussed in more detail in Chapter Two,⁸⁸ is whether Article 5 “protects the secured debt as well as the security interest itself.”⁸⁹ Further clarification is required in the situation where a Lender’s claim is reduced as a result of main proceedings regarding whether the Lender can apply Article 5 to enforce its security over assets in another Member State in respect of the entire value of its original secured claim.⁹⁰ It would be completely contrary to creditor expectations if the Lender’s protection was limited to the amount in the reduced claim as compromised in the main insolvency proceeding. The writer takes the view that Article 5 does not erode the underlying claim, however the point needs some sort of

⁸⁷ Insolvency Law Committee Response (n 76) 8 (Q 16).

⁸⁸ See 2.127 – 2.128

⁸⁹ Insolvency Law Committee Response (n 76) 8 (Q 17).

⁹⁰ *Ibid.*

affirmation under the EIR especially as there is no instructive case law yet.

Article 6

- 3.49 As discussed in Chapter Two, although set-off is not strictly security as a matter of English property and commercial law, it is important to the Lender because not only is it treated as a mandatory process which must be applied in the United Kingdom, the Lender's rights of set off remains effective regardless of whether or not set-off is permitted under the law of the opening state.
- 3.50 However the relationship between Article 6(1) and 6(2) needs to be defined more clearly in order to be more consistent with the interpretative guidance supplied by Recital 26. Does Article 6 really accomplish the effect of bestowing the Lender with a guarantee function based on the legal provisions on which the Lender concerned can rely when a claim arises? As argued in Chapter Two, clarification is required as to whether Article 6(2) means that the liquidator in the insolvency proceedings can challenge the entering into of the transaction which gives rise to the right of set-off, and not the exercise of the set-off right itself.⁹¹
- 3.51 Another issue requiring clarification is the carve out provision in Article 20 in relation to Articles 5 and 7 but not Article 6. Perhaps the exclusion of Article 6 was an oversight and this issue needs to be amended within the EIR.

⁹¹ Insolvency Law Committee Response (n 76) Question 17.

Article 13

- 3.52 The earlier textual analysis in Chapter Two outlines how the aim of Article 13 is to uphold legitimate expectations of creditors. Avoidance rules of the Member State in which proceedings are opened shall not apply if the person who benefited can show that the ‘detrimental’ act is subject to the law of another Member State and that law does not allow any means of challenging that act in the relevant case.
- 3.53 It is argued that some aspects of Article 13 are unclear and require further clarification before the Lender can fully rely on the effects of such a provision. For instance, the meaning of the phrase ‘subject to’ as discussed earlier. The members of the Insolvency Law Committee also submit that the provision is not sufficiently clear as to whether, once the applicable law has been established, the insolvency law of that jurisdiction needs to be considered even in the situation where no insolvency proceedings have been commenced there. It is queried whether a transaction governed by English law, which is capable of being challenged by a liquidator or administrator, can be challenged if insolvency proceedings have not been commenced in the UK. If it can be challenged then what “hardening period” should be used?⁹²
- 3.54 The problem is the wording “that law does not allow any means of challenging that act in the relevant case”. On the face of it office holder actions, e.g. under 238, 239, 245, can only be commenced if there is an English administration or liquidation as a matter of English law. Therefore, if the applicable law is English law, there is an argument that the transaction cannot be challenged “in the relevant case” unless there is an English liquidation or administration based on an establishment under Article 2. If we assume that this argument would not be accepted and so the question becomes, (assuming a hypothetical liquidation or administration in England and Wales): ‘would the transaction be

⁹²*Ibid.*, Q. 17, pg 11.

vulnerable “in the relevant case” under 238, 239, 245?’ the question that follows is how relevant time is computed?’ Would one also have to hypothesize that the English liquidation or administration commenced on the same day as the foreign main proceeding and count back 6 months, 12 months or 2 years depending? Based on the current state of Article 13, one could argue that if these issues arose in a case and their resolution would be outcome determinative there would probably have to be a reference to the ECJ for a definitive interpretation.

CONCLUSION

3.55 It was concluded, in Chapter Two, that the enactment of the EIR has proved beneficial from the Lender’s perspective, in relation to generally protecting his security interests, and one can argue that, in light of the previous attempts within the history of the evolution of the EIR and how far it has advanced,⁹³ the EIR is in fact a success story. However, in light of the upcoming review of the EIR, several issues arise in relation to the amendment of certain sections. Chapters Two and Three illuminate which areas of the EIR are in need of direct legislative attention. However it has been discussed how, in some of these areas within the existing framework, the Lender can take steps to mitigate risk and take advantage of practical methods that have been commercially devised to counter the risks of ‘insolvency effects’. For instance, it can be argued that the Lender can presently safeguard his security interest by exploiting COMI, (through COMI migration and forum shopping), to achieve global restructuring. Furthermore, legal practitioners seem to have found a way of dealing with group

⁹³ See A.10, A.14, and A.16 -A.21.

companies, through uniformity and consistency, by arranging an effective COMI migration for all the companies to one location.

3.56 Overall, the most important issue that has been raised for reform relates to the concept of COMI which was conceived in the Phase I draft Conventions⁹⁴ and has, since then, been amended and supplemented by a barrage of case law. However, despite, the ‘learning process’ that the EIR has undergone, issues in relation to COMI are still subject to a great deal of criticism by scholars and practitioners alike. Three main issues arise in relation to the reform of COMI in the EIR: does it require greater definition; in relation to COMI migration and the possibility for the Lender to take advantage of more favourable restructuring regimes, should more aggressive rules be inserted to address the perceived risks to junior creditors of COMI migration; and, in light of the recent *Stanford Bank* case⁹⁵ and criticism of the ‘Head office functions test’, is a new concept of Group COMI required?

3.57 The writer submits that a more restrictive interpretation of COMI will have a negative impact on the flexibility of courts to apply the provisions of the EIR on a case by case basis in light of factors derived from the content of the EIR as interpreted by the ECJ. The intentional lack of definition of COMI therefore leaves some scope for judicial discretion and encourages common sense to be exercised. In relation to protecting junior creditors, it is argued that by just ranking as creditors lower down the chain, they entered into a security transaction well aware of the risks of being subordinate to a greater claim by more senior creditors and hence protection of the Lender’s rights is a more fundamental concern. The difficult issues that arise in relation to group insolvencies has been discussed in this Chapter and it has become apparent that the EIR does need to provide more guidance as to how to deal with MEGs that become insolvent. In relation to Articles 5 to 15 which operate as ‘carve out’ provisions to the applicable law, the crucial question is whether, in their present format, they do in practice

⁹⁴ See A.7.

⁹⁵ n 41 & n 42.

help in mitigating against potential ‘insolvency effects’. It has been suggested that, other than minor adjustment of wording in order to provide more clarity, these provisions work quite well in practice and are not in need of any major reform. It will be helpful to consider the overall responses of practitioners in relation to the Questionnaire, based on the cases they have been involved in which have necessitated a practical application of the EIR.

- 3.58 It remains to be seen what will be proposed in the Report of the European Commission that has to be submitted by 1st June 2012. In the meantime, however, the Lender will benefit by continuing to make use of COMI covenants in security transactions and by taking advantage of ‘good forum shopping’ and making use of more favorable restructuring regimes if this is a solution to providing maximum return on his investment. It will be interesting to note what further measures are developed by secured creditors and practitioners to take advantage of or circumvent the provisions of the EIR once it has been amended.

APPENDIX I

HISTORY OF THE EIR: EVOLUTION OF THE TEXT

The Phase I Draft Conventions (1960 -1980)

- A.1 The need for a Convention among certain European member states to coordinate the conduct of their insolvency proceedings was foreseen by the Treaty establishing the European Economic Community (EEC) 1957. Article 220 of that Treaty provided, *inter alia*, that Member States should enter into negotiations with a view to securing for the benefit of their nationals the simplification of the formalities governing the reciprocal recognition of judgments of courts or tribunals and of arbitration awards. This provided the UK with the incentive to begin negotiations with other Member States concerning a draft EEC Bankruptcy Convention.¹ The Brussels Convention on Jurisdiction and the Enforcement of Judgements in Civil and Commercial Matters was signed by the original six Member States² of the Communities on 27 September 1968 and entered into force between them on 1 February 1973. However the Brussels Convention,³ by Article 1(2),⁴ specifically excluded judgments relating to ‘bankruptcy, winding-up, arrangements, compositions or similar proceedings’ thus leaving a large gap that needed to be addressed.
- A.2 Over the period from 1960 to 1996 the Bankruptcy Convention project featured on the agenda of the institutions of the European Community/European Union, particularly the Commission and the Council. During those years, work advanced in various stages of irregular duration, interspersed by periods of

¹ E Comm Doc 3.327/ 1/ XIV/70- F, dated 16 February 1970 (the 1970 draft Convention). The English version of the text of the Preliminary Draft Convention was published as Appendix 10 to the Report of the Bankruptcy Convention Advisory Committee, in August 1976 (Cmnd 6602).

² The original six members of the European Communities (including the Coal and Steel and Atomic Energy Communities, as well as the Economic Community) were Belgium, France, (West) Germany, Italy, Luxembourg, and the Netherlands.

³ As discussed in Chapter One the Brussels Convention has largely been superseded by the Brussels Regulation (Brussels I) which came into force on March 1 2002.

⁴ See now Brussels I, Art 1(2)(b).

almost total dormancy.⁵ Moss, Fletcher and Isaacs suggest that the period when the majority of reform took place can generally be divided into two main phases, of which the first can be further divided into two parts. The preliminary part of Phase 1 took place in the years before February 1970. During that time a group of experts,⁶ the members of which were selected from the original six Member States,⁷ was convened as a Working Party by the European Commission⁸. From 1963 the Working Party began meeting under the Chairmanship of M. Jean Noel, Counsellor at the French Cour de Cassation to prepare a Preliminary Draft Convention on Bankruptcy (the 1970 Convention). This draft was published on 16 February 1970, together with a Report prepared by M. Noel and M. Jacques Lemontey (the NL Report).⁹

A.3 The draftsmen prepared what was seen as an ‘ambitious scheme’,¹⁰ the main objects of which were:

“to channel bankruptcy jurisdiction within the European Communities to a single and appropriate national court; to secure that the liquidator appointed by that court had virtually exclusive authority to administer the insolvent estate, wherever situated in within the Communities; to simplify the tasks of the liquidator by achieving some harmonization as to the effects of the bankruptcy order, and by authorizing him, apart from the harmonized rules, to apply the rules of his own winding up code, including those relating to his powers as a liquidator, both when dealing with the recovery of the bankrupt’s estate and

⁵ G Moss, I Fletcher and S Isaacs, *The EC Regulation on Insolvency Proceedings, A Commentary and Annotated Guide*, (Oxford, 2nd ed, 2009) (M, F & I) 2, para 1.03.

⁶ The Committee of Experts was originally formed in July 1960 and proceeded with the drafting of what was to become the Brussels Convention. It was however decided that insolvency and related matters were a special subject that required separate treatment and this led to the setting up of a Working Party to consider the matter separately. Their aim was to develop a Bankruptcy Convention which would complement the Brussels Convention and thereby accomplish the task of ‘simplification of formalities governing the reciprocal recognition and enforcement of judgments’ mentioned in the fourth indent of Article 220. See M, F & I (n 5) 7, para 1.10.

⁷ When discussing the draft Conventions the Member States which agreed to be bound by the terms of the Conventions shall be referred to as the ‘Contracting States’ to avoid confusion.

⁸ M, F & I (n 5), 2, para 1.03.

⁹ The gap left by the exclusion of insolvency proceedings from the scope of the Brussels Convention was to be filled by the 1970 Convention (n 1) which, according to the NL Report, would apply to ‘any proceedings which being founded, according to different legislations, on the condition of cessation of payments, insolvency or undermining of the debtor’s credit, imply an intervention of the judicial authority, not only suspending individual proceedings, but achieving forced and collective realizations of assets, or simply, control of a debtor’s business’. See Cmnd 6602 (n 1) 2, paras 7, 8 & 24.

¹⁰ See Cmnd 6602 (n 1) Chapter 9, para 408.

when pronouncing upon claims made against it; and to assist the foreign creditor in presenting his claim to such liquidator with the least complication and expense, including the avoidance or reduction of the legal costs of prosecuting his claim.”¹¹

A.4 The second part of Phase I followed the accession of the first three additional Member States from 1 January 1973.¹² Work was resumed on the basis of text of the 1970 Convention, with a view to its being adopted by all nine members. Many alterations were made to the original text during the last stage of Phase I. This was partly due to critical comments widely published after 1970, and also in response to specific concerns raised by new participants in the negotiations.¹³ For instance, following the UK’s accession to the EEC, an advisory committee was appointed in 1973 under the chairmanship of Mr Kenneth Cork¹⁴ to “consider the terms of the 1970 Convention and to advise the UK Department of Trade upon the effect of implementation of the Convention in its then present terms and to recommend such modifications as were considered necessary and practicable.”¹⁵ The essential features of the 1970 Convention were subsequently carried through into the Convention submitted to the Council in April 1980 for further study and potential adoption. The failure to promote the adoption of the 1980 Draft marked the end of Phase I which was followed by several years of inactivity and uncertainty.

A.5 Both draft Conventions in Phase I followed the radical approach of superimposing a unitary set of rules of direct jurisdiction in place of the variety of nationally-evolved rules previously applied by the individual Contracting States.¹⁶ There are two contrasting methods of dealing with jurisdiction in

¹¹ *Ibid*

¹² Denmark, the Republic of Ireland, and the UK together joined the European Communities. Norway, which had also negotiated terms of accession, did not take up membership following a negative outcome of its national referendum held for that purpose. See M, F & I(n 2) 3, para 1.03 and FN 5

¹³ M, F & I (n 5) 3, para 1.03.

¹⁴ Referred to hereafter as Cork’s advisory committee.

¹⁵ The resulting report was a substantial document extending to some 180 pages stressing that a comprehensive review of insolvency was required, not only in order to participate in negotiations with other EEC Member States, but also because the state of the law demanded this. It should be noted that prior to this there seemed to have been no overall national study by a widely based national committee, consulting with important professional organisations and involving different professional, business and financial bodies to study the draft convention: see M Hunter, ‘The Draft EEC Bankruptcy Convention a Further Examination’, *International and Comparative Law Quarterly*, (April 1976, Vol 25), 312.

¹⁶ See 1970 Convention (n 1) and 1980 Convention, E Comm Doc III/D/72/80 Title II (Arts 3-16).

international treaties. Jurisdiction can be dealt with directly or indirectly. In a system of direct jurisdiction, the method by which jurisdiction is allocated amongst states does not allow for any other State to claim jurisdiction in relation to a case where an alternate State has authority to act judicially. This system generates mandatory rules of jurisdiction for all cases falling within its scope. In a system of indirect jurisdiction, only specific conditions are agreed by the parties in relation to the recognition of each other's decisions. This type of system will generally contain rules of recognition and enforcement, for instance, without imposing a mandatory set of jurisdictional rules.¹⁷

- A.6 The important feature of the 'Uniform Law' was that, in order to incorporate its provisions, a Contracting State might have to amend its existing national law if required or, if it declined to take this course of action, to make reservations expressly refusing to incorporate the provisions. To comply with such an obligation, it was essential firstly to ensure an accurate and 'authentic' translation into English of the obligations and statutes referred to in the Phase I drafts.¹⁸ However this was clearly not the case as the advisory committees struggled with various translations. Furthermore it can be argued that a law could hardly be regarded as "uniform" when it was subject to extensive reservations from Contracting States.¹⁹
- A.7 To apply in conjunction with the application of Uniform Law, the Phase 1 drafts proposed three levels of jurisdictional criteria connecting the debtor to the territory of the State in which proceedings could be opened:

¹⁷ See M Balz, 'The European Convention on Insolvency Proceedings', 1996, 70 Am. Bankr L.J 485, 493 & FN 32; See also I F Fletcher, 'The European Union Convention on Insolvency Proceedings: An overview and comment, with U.S Interest in mind', 23 Brook. J.Int'l L. 25 1997-1998, 28-29.

¹⁸ Hunter M, 'The Draft Bankruptcy Convention of the European Economic Communities', 21 Int'l & Comp. L.Q 682, 1972, 696.

¹⁹ The draftsmen admitted that, although the ideal course would have been to draft a uniform bankruptcy law for the whole of the Community (i.e. one comparable to the Federal Bankruptcy Code of the United States of America), this was politically an unattainable objective at that time. Instead a number of uniform provisions were produced as set out in the Annexes to the draft Conventions. The question arises as to how anyone could perceive that the radical approach of getting different countries to agree to be governed by uniform substantive insolvency law could ever be a realistic attainable objective? See Hunter 1972 (n 17) 694, 696.

“Firstly, the courts where the debtor’s ‘centre of administration’ was situated were declared to have ‘exclusive jurisdiction’ to declare the debtor bankrupt.²⁰ The second was intended to apply to situations where the debtor’s centre of administration was not located in any of the Contracting States. In that case, the courts of any Contracting State in which the debtor had an establishment were awarded jurisdiction to declare the debtor bankrupt”.²¹

Unlike the EIR, there was just one set of proceedings allowed which was the only proceedings rather than ‘main’ proceedings and there was no possibility of opening ‘secondary proceedings’ where there was an establishment. There was also no definition of ‘establishment’ in the 1970 text. Proceedings opened according to the primary and secondary rules of jurisdiction would constitute the only proceedings allowed to take place through the Contracting states, and would have automatic effect in relation to the debtor’s property anywhere within those states. The third took effect where neither the centre of administration nor any establishment was situated in a Contracting State and allowed the courts of any Contracting State, whose law so permitted, to declare the debtor bankrupt.²² Such bankruptcies were given “the full advantages of recognition and enforcement throughout the Community” in the 1970 Convention but not in the 1980 draft which was modified so as to exclude such bankruptcies from falling within the scope of the Convention.²³

A.8 Overall, the 1970 Convention can be viewed as a precursor to the production of a ‘simplified and rationalist system of bankruptcy’ for the Community.²⁴ However, because of reasons that will become apparent in the later discussion of the important provisions of the draft texts, the realization of this hope is much doubted.²⁵ Despite having been weakened considerably, the 1980 Convention remained unpopular with all the Member States for varying reasons. As will be

²⁰ See Art 3(1) of both the 1970 (n 1) and 1980 Conventions (n 16)(the wording is identical).

²¹ See Art 4(1) of both the 1970 (n 1) and 1980 Conventions (n 16) (the wording is identical). See M, F & I (n 5) 8, para 1.14.

²² See M, F & I (n 5) 8, para 1.14.

²³ See Art 5 in the respective versions of the 1970 (n 1) and 1980 (n 16) draft Conventions. See M, F & I (n 5) 8, para 1.14.

²⁴ See I F Fletcher, ‘The Proposed Community Convention in Bankruptcy and Related Matters’, Final Chapter in K. Lipstein, *Harmonization of Private International Law by the EEC*, (1977) Chameleon/Institute of Advanced Legal Studies: London, 135.

²⁵ P Omar, ‘Genesis of the European Initiative in Insolvency Law’, (2003) 12 *International Insolvency Review*, p 147-170, 152.

discussed, criticism focused mainly around concerns that it would be unworkable for one forum to administer one centralized insolvency estate, given the enormous range of differences in countries' insolvency laws.²⁶ It was criticized by some as being an "over ambitious model"²⁷ and unacceptable for most European countries because it required an "overly rigid centralisation".²⁸ Furthermore other complaints included a fear that it discriminated against those outside the community.²⁹

A.9 The 1980 Convention was abandoned in 1985 and negotiations were resumed in 1989 in a different form known as the European Union Convention on Insolvency Proceedings. However prior to this, the Council of Europe³⁰ convened and began to draft the European Convention on Certain International Aspects of Bankruptcy. It eventually proposed a multilateral treaty named the European Convention on Certain International Aspects of Bankruptcy³¹ also known as the Istanbul Convention.

A.10 The unsuccessful attempt in the Phase I drafts to apply the twin principles of unity and universality of bankruptcy emphasized the shortcomings of the jurisdictional rules in these conventions. In terms of how 'interventionist' these early drafts were, there is some contention as to the degree to which the principles of unity and universality had genuinely been assimilated into the substance of the provisions to which the Contracting States would be committing themselves.³² Moss, Fletcher and Isaacs submit that, early in their

²⁶ Balz (n 16) 492.

²⁷ See IF Fletcher, 'International Insolvency: A Case for Study and Treatment', 27 Int'l Law (1993) 429, 437.

²⁸ Burton, L A, 'Toward an International Bankruptcy Policy in Europe: Four Decades in Search of a Treaty', 5 Ann. Surv. Int'l & Comp. L 205 1999, p. 212.

²⁹ *Ibid.*

³⁰ The Council of Europe founded on May 5 1949 aimed to promote cooperation between the European countries. In 1990 the twenty members were: Belgium, Cyprus, Denmark, Finland, France, Germany, Greece, Holy See, Ireland, Italy, Liechtenstein, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Turkey, United Kingdom and Switzerland. The Council of Europe is an intergovernmental organization that was formed to promote cooperation between the European countries and should not be confused with the Council of Ministers or the European Council, which are organs of the European Union.

³¹ European Convention on Certain International Aspects of Bankruptcy, June 5, 1990, Europ. T.S No. 136 (hereinafter Istanbul Convention).

³² See Art 2 of both the 1970 draft Convention (n 1) & 1980 draft Convention (n 16), which bear the heading: Unity of the Bankruptcy, and Art 33 of the 1970 draft Convention (n 1) and Art 34 of the 1980 draft Convention (n 16), both headed Universality of the Bankruptcy. See also M, F & I (n 5) 10, para 1.16.

discussions, the negotiators had ascertained that the domestic laws of the original six Member States which were currently in place drastically varied regarding specific issues such as the way they dealt with security and the rights of preferential creditors. This led them to conclude how futile it would be in the foreseeable future to try and harmonize substantive laws.³³ Under ‘direct’ Conventions such as the Phase I drafts, all interested parties have to rely almost completely on the integrity of the legal process at the point where jurisdiction is first exercised. This places fundamental importance on the rules for allocation of jurisdiction being intrinsically sound and sensible. There is only limited possibility to rectify any misapplication or misuse of the Conventions’ provisions and so their meaning and effects needed to be as clear and unambiguous as possible, in the interests of enabling creditors to understand their legal position and arrange their affairs with adequate certainty. The balance between achieving this goal and applying a radical full universality/unitarian approach was clearly not met by any of the Phase I drafts.

Phase II: The Istanbul Convention, the Convention on Insolvency Proceedings (1995) and progression to the adoption of the EIR

A.11 The Istanbul Convention rejected the unitarian approach that had been so heavily criticised in the earlier 1970 Convention and instead adopted a flexible approach to the universalist theory.³⁴ Further, the Istanbul Convention relied on ‘indirect jurisdiction’. Thus although it contained rules for recognizing and enforcing judgments, it did not impose any mandatory jurisdictional rules,³⁵ thereby creating further potential for disagreements.

³³ See M, F & I (n 5), 10-11, 1.16. See also, e.g. the view expressed by Mr A E Anton who regarded the Conventions as “Revolutionary”. See 1970 Convention (n 1) 106, para 4. Note that the position adopted by Anton is reflected in the work of modern territorialists such as Lopucki. See L LoPucki, (1999), “Cooperation in International Bankruptcy: A Post-Universalist Approach”, (1999) 84 Cornell Law Review: 696, See also J Pottow, ‘Procedural Incrementalism: A Model for International Bankruptcy’, (2005) Virginia Journal of International Law, 45 for more detail as to why more commentators, such as Pottow, saw problems in giving universal effect, at the normative level, to one country’s insolvency law.

³⁴ Anne Nielson, ‘The Cross-Border Insolvency Concordat: Principles to Facilitate the Resolution of International Insolvencies, 70 AM. BANKR. L.J., 533, 1996, 540, FN 57.

³⁵ Istanbul Convention (n 31), Art 4; Fletcher (n 15).

A.12 It was proposed that one main insolvency proceeding would be opened in a centralized administrative forum in the country that was the “centre of...[the insolvent debtor’s] main interests”.³⁶ The Istanbul Convention provided for the mutual recognition of only certain powers of the liquidator rather than the full effect of the mutual recognition of foreign proceedings. Basically the Convention refrained from also exporting the effects of a main bankruptcy proceeding to other jurisdictions.³⁷ Secondary bankruptcies could be opened in other Member States where the debtor had substantial assets which would serve to pay secured and priority creditors, local employees, local tax authorities, and creditors whose claims arose from the local operations of the debtor.³⁸ The adoption of secondary proceedings was aimed at protecting the interests of secured and priority creditors and of employees and other local creditors of foreign establishments of the insolvent debtor, whilst turning over any excess proceeds obtained from the secondary estate to the main estate. This illustrates how the principle of unity was abandoned in the Istanbul Convention and the principle of universality reduced in scope which was also emphasized by the complex system of reservations allowing Contracting States to choose to participate in the entire Convention, for the recognition of foreign liquidators’ powers only, or for secondary bankruptcies.³⁹

A.13 The similarities between the Phase I drafts and the Istanbul Convention included the division between primary and secondary jurisdiction criteria with use of the ‘centre of administration’⁴⁰ and the ‘centre of main interests’⁴¹ to justify primary assumption of jurisdiction. However there were important differences in the latter’s definitions in relation to COMI that were used to develop this concept further. With the Phase I drafts however, the second tier jurisdiction or secondary proceedings were only intended to apply where the debtor’s centre of administration was not located in any of the contracting states and, in this case,

³⁶ Istanbul Convention (n 31), Art 4(1).

³⁷ essentially the powers to collect assets from all Member States and to sue and be sued in such States. In any Contracting State the liquidator could take provisional and protective measures legally possible under the laws of that State. See Istanbul Convention (n 30), Art 8.

³⁸ Istanbul Convention (n 31), Art 21.

³⁹ Balz (n 16) 493- 494.

⁴⁰ in the Phase I drafts.

⁴¹ In the Istanbul Convention (n 31).

the courts of any contracting state in which the debtor had an ‘establishment’ were awarded jurisdiction to declare the debtor bankrupt.⁴² Under the Istanbul Convention it was provided that the main proceeding need not be the only authorized forum; it could be supplemented by secondary proceedings in any other country in which the debtor had an ‘establishment’.⁴³ Creditors such as those holding priority and secured claims would be allowed to file their claims in a secondary proceeding in their own country, instead of in the main proceeding.⁴⁴ The secondary proceedings would therefore be administered under local law thus resolving problems arising from issues such as the validity of security interests.⁴⁵ It was proposed that from the assets subject to the secondary proceedings, claims filed in the secondary proceeding would be paid first. The balance of the assets remaining would then be forwarded to the main proceeding where the other creditors could file their claims and be paid.⁴⁶

- A.14 The general view was that the fact that the Istanbul Convention sought to provide countries with some freedom to apply their own domestic insolvency law in the secondary proceedings was unfair and contrary to the aim of insolvency proceedings which was to facilitate, the administration of the debtor’s assets in one forum and equal distribution to all creditors under a uniform set of laws.⁴⁷ This is interesting because the Istanbul Convention did not have the choice of law rules and carve outs in what is Articles 4 to 15 of the EIR. By allowing countries to opt-out of the universality provisions of the Istanbul Convention and by using indirect jurisdiction provisions, its drafters weakened it.⁴⁸ The Istanbul Convention did not fully uphold a universalist position due to the fact that it allowed autonomy in the application of diverse national rules.⁴⁹ Some commentators argue that, unlike the earlier ‘overambitious’ Phase I drafts, this Convention was not ambitious enough or

⁴² See Art 4(1) of both the 1970 draft Convention (n 1) and 1980 draft Convention (n 16) versions (the wording is identical). In the Phase I drafts once one country had jurisdiction over the insolvency, no other country could conduct any insolvency proceedings on its own.

⁴³ Istanbul Convention (n 31), Art 17.

⁴⁴ *Ibid.*, Arts 11, 21.

⁴⁵ *Ibid.*, Arts 19-22.

⁴⁶ *Ibid.*, Arts 22, 31.

⁴⁷ Burton (n 28) 215.

⁴⁸ *Ibid.* 216.

⁴⁹ See Fletcher (n 27), 439.

strongly universalist because of its extensive opt out provisions.⁵⁰ In contrast to the Phase I drafts, which were too strong, the Istanbul Convention was too weak.

- A.15 When it became apparent evident that the majority of EEC countries would not ratify the Istanbul Convention, the EEC Council of Ministers established a Working Group on Bankruptcy in late 1989. In 1995 this working group produced the European Union Convention on Insolvency Proceedings (EU Convention).⁵¹ It ultimately lapsed as well, albeit for different reasons than those that toppled the Phase I drafts and the Istanbul Convention. However the objectives of this attempt at harmonization were, among other things, to:

“retain the principle of universality to the extent practicable; create a unitary system (without reservations) binding on all Member States; adapt the system of secondary proceedings so as to make it compatible with maximum universality; allocate jurisdiction directly (rather than indirectly as did the Istanbul Convention) among Member States, both for main and secondary bankruptcies; harmonize certain conflict rules that bear on the administration of bankruptcies; take proper account of the introduction of rehabilitation (or reorganization) proceedings into the laws of some Member States; and create a more efficient and closely-knit system of legal cooperation within the emerging internal market than the Istanbul Convention.”⁵²

- A.16 The EU Convention attempted to harmonize laws by choosing a modified universalist theory, amalgamating a “framework of member state cooperation” with a recognition of the “unique aspects of member states’ laws”.⁵³ It has been submitted that these provisions in the EU Convention are reminiscent of the best parts of the Phase I drafts. The universalist treatment was calculated as the most effective method of fulfilling the main aim of insolvency proceedings which is to ensure the consolidation of all assets in one forum therefore maximizing the

⁵⁰ Burton (n 28) 216.

⁵¹ European Union Convention on Insolvency Proceedings (EU Convention) opened for signature, Nov 23, 1995, 35 I.L.M 1223 (1996). Many consider this Convention as a continuation or revitalization of the earlier EEC Draft Convention. See Fletcher (n 27) 439.

⁵² Balz (n 16) 495.

⁵³ EU moves toward the creation of a European Convention, EUROWATCH, April 15, 1996. See Burton (n 28) 218 & FN 69.

potential for equal treatment of all creditors.⁵⁴ However the drafters of the EU Convention wisely concluded that some issues were better covered by conflict of laws principles and these were excluded in the Convention. These included the validity of security interests⁵⁵ and issues regarding sales of property under a reservation of title,⁵⁶ both of which were to be determined by the laws of the *situs* of the property. The EU Convention took a similar approach to the Istanbul Convention in relation to allowing secondary proceedings in order to liquidate some assets locally. The reasoning behind allowing the opening of secondary proceedings was to facilitate resolution of the rights of secured creditors and practical problems that were likely to arise due to liquidating assets from a distance.⁵⁷

A.17 Unlike the Phase I drafts, the provisions for main and secondary proceedings inherent in both Conventions sought to eliminate some of the problems anticipated in the pure universalist approach. It has been argued that the key distinction to be considered is the treatment of secured creditors as opposed to unsecured creditors. In relation to secured creditors and their expectations regarding assets situated locally, it is reasonable that rights in assets pledged as collateral should be determined locally, at the *situs* of the collateral, when the validity of the secured interest is governed by local law. Unsecured creditors, however, have no claim to the debtor's assets and should therefore not be concerned with where those assets are liquidated. The author therefore agrees that applying a universal law to unsecured creditors is reasonable when considering the ultimate aim of providing equal treatment for such creditors.⁵⁸

A.18 The term “centre of...[the insolvent debtor's] main interests” originally taken from the Istanbul Convention was also adopted in the EU Convention and it is curious how it was conceptualized. In both Conventions the concept of COMI was not defined and it appeared to be an entirely artificial term without precedent in any one State's national laws.⁵⁹ Although, logically, there could only be one

⁵⁴ Burton (n 28) 220.

⁵⁵ EU Convention (n 51), Art 5.

⁵⁶ *Ibid.*, Art 6.

⁵⁷ *Ibid.*, Art 3(2).

⁵⁸ Burton (n 28) 221.

⁵⁹ Balz (n 16) 504.

centre of main interests, both Conventions did not address the scenario where two or more States claimed to have the centre of the debtor's main interests. The ambiguity of this central concept is a problem that continues in the existing Regulation and there are similar criticisms in relation to the increased opportunities of forum shopping and disputes over jurisdiction. One notable defect in the Istanbul Convention (in contrast to the EU Convention and the EIR) which did not help interpretive difficulties was the absence of a court within the Council of Europe hierarchy for deciding matters other than human rights.⁶⁰ Therefore there would have been no means of uniformity and any ambiguities in the Istanbul Convention would be subject to varying and conflicting national interpretations.⁶¹

A.19 Overall, most importantly, the EU Convention did not allow countries to 'opt out' of any part of the Convention. As discussed earlier, this was a fundamental problem with the Istanbul Convention and the drafters of the EU Convention were keen to move further away from the 'unity theory' that had been adopted in the earlier Phase I drafts and the Istanbul Convention. The drafters believed that fairness was best achieved by plural, but properly coordinated, administrations".⁶² Thus the EU Convention far exceeded the Istanbul Convention in its promotion of universality.⁶³ Furthermore the EU Convention relied on direct jurisdiction⁶⁴ with the more likely result of achieving a truly international system⁶⁵ and, as opposed to the Istanbul Convention, it had a forum to interpret its provisions. The ECJ was authorized by the EU Convention to interpret its provisions with binding effect on all signatories⁶⁶ and to give advisory opinions at the request of national courts.⁶⁷

A.20 The progression from the Phase I drafts to the EIR that is in force today demonstrates the gradual recognition that the concept of universality is not

⁶⁰ See Fletcher (n 27) 438-439.

⁶¹ Burton (n 28) 215.

⁶² Fletcher (n 27) 440.

⁶³ *Ibid.*

⁶⁴ The major similarity in the operation of Article 3 between the Phase I drafts and the Istanbul Convention which would lead to their ultimate downfall was, as discussed earlier, that all drafts only operated through indirect jurisdiction.

⁶⁵ Burton (n 28) 222.

⁶⁶ EU Convention (n 50), Arts 43-46.

⁶⁷ *Ibid.*, Art 44.

exclusively dependent upon that of unity. There can be other methods of achieving the goal of implementing the universal administration and resolution of the global affairs of an insolvent debtor without really requiring all rights and interests, as well as all proceedings, to be subordinated to the dominance of a single forum and its system of law.⁶⁸ By giving an element of discretion to the courts of other interested countries and including the possibility of opening secondary bankruptcy proceedings, or some type of ancillary proceedings,⁶⁹ proper consideration is given to the expectations of secured creditors who may have had dealings with the debtor outside the context of the latter's forum of bankruptcy. It is argued that the final position may be one of universality, though it is obtained by a cumulative method that cannot be described as 'unitary'.⁷⁰

A.21 Although the EU Convention seemed to have resolved most of the troublesome issues that had plagued past attempts to reach an insolvency convention, it could not be made effective at its deadline date of 23 May 1996.⁷¹ It was not until 1999 that the then-defunct EU Insolvency Convention revived in the form of the EIR which included most of the main provisions of the EU Convention with no real amendments apart from drafting adjustments. The EIR was subsequently adopted on May 2000 and entered into force on 31 May 2002.⁷²

A.22 The terms of the EIR do not seem to differ greatly from the body of the EU Convention. There seems to have been a conscious effort at preserving the numerical order of the articles in the main body of the text. Subject to the

⁶⁸ See Nielson (n 34) 534 (espousing a "modified universality theory" resulting in a central administrative forum in one country with secondary proceedings in other countries). See also Fletcher, I F, 'The European Union Convention on Insolvency: Choice of Law Provisions', (1998) 33 *Tex. Int'l L. J.* 119, 122.

⁶⁹ as well as invoking the rules of recognition and enforcement of foreign judgments

⁷⁰ See Fletcher (n 68) 122.

⁷¹ This is because it was mandatory that the EU Convention could not enter into force until it had been ratified, accepted or approved by all the Member States of the European Union on the date on which the Convention was closed for signature. This failed to happen and as the EU Convention itself contained no provision for extending the deadline date, under its own terms it could not become law if it were not signed by all 15 Member States by that date. The United Kingdom refused to sign in retaliation over a completely different matter with regard to the ban on British beef arising from concerns over transmission of "mad cow's disease" to humans and sovereignty issues regarding Gibraltar. Twelve of the fifteen Member States signed in November 1995. The Netherlands signed in March 1996 and Ireland in April 1996 bringing the total to 14 Member States.

⁷² Block-Lieb S & Halliday T (2007), "Incrementalisms in Global Lawmaking", Fordham University School of Law: <<http://ssrn.com/abstract=964425>>, 30.

necessary updates due to the expansion in membership of the European Community and by improvements to domestic insolvency laws, any commentary on the earlier text could be applied to the EIR. For this reason, this textual commentary in relation to the Convention has been combined with that of the EIR. Furthermore the Virgos and Schmit Report (1995)⁷³ which accompanied the Convention is referred to as an explanatory report when interpreting the EIR.

⁷³ The Report on the Convention on Insolvency Proceedings, prepared by Professor M Virgos and ME Schmit (hereafter referred to as 'Virgos-Schmit'), was circulated as EU Council Doc 6500/96, DRS 8 (CFC), bearing the date 3 May 1996. It was unpublished, and remains unapproved by the Council, which means it does not have the status of travaux préparatoires, either in relation to the Convention or those provisions of the EIR which are directly derived from the Convention. It is nevertheless a valuable aid to understanding the intended meaning of those provisions. See *M, F & I (n 5)* para 1.06, FN 11 and (C-341/04) *Re Eurofoods IFSC Ltd* (2006) ECR I-3813, [2006] BCC 639 ECJ [511].

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