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*Conflicts of Law Issues in Cross-Border Workouts in the Perspective of the EU
Regulation on Insolvency Proceedings:*

Dr. Manfred Balz, Deutsch Telekom, Germany

Conflicts of Law Issues in Cross-Border Workouts in the Perspective of the EU Regulation on Insolvency Proceedings¹

by Manfred Balz²

Preliminary remarks

It has become trivial to observe that informal workouts take place in the shadow of formal proceedings. Procedural and substantive rights participants would have in a formal proceeding channel and structure their behavior in informal processes. When, as is quite frequently the case, an informal workout eventually fails, it is important to save as many features and results of informal discussions for subsequent formal proceedings (as in the case of “prepackaged plans of reorganization”), in order to avoid renewed negotiations and a loss of time. Parties will therefore be well advised to bear the framework for formal proceedings continuously in mind when they embark upon a workout. And this they actually do.

In the case of cross-border workout needs, the very existence of rules for cross-border insolvencies facilitates and accelerates negotiations. Any rule is better than no rule insofar as it creates legal certainty. But, obviously, good, or efficient, rules are best. I shall explain in the way of an outline how the existence of a European Union document on cross-border aspects of insolvency proceedings (the “Regulation”) facilitates and impacts workouts. I shall then discuss how a similar set of rules could be created in a region with a lesser degree of economic and legal integration than the European Union.

Content of the EU Regulation

The Regulation does essentially four things, namely

- (a) Allocate jurisdiction to open and conduct insolvency proceedings among states (Article 3) and distinguish jurisdiction, based on the situs of the “centre of the debtor’s main interests” for full-fledged (“main”) insolvency proceedings that include extraterritorial assets, from jurisdiction for “secondary” proceedings, based on the mere presence of an “establishment” of the debtor, which include only assets situated in the respective opening state.³ Main proceedings may be liquidation or rehabilitation proceedings, secondary proceedings can only be liquidation (or unitary) proceedings (but they may under certain circumstances be ended by a composition or the like).
- (b) Harmonize certain rules on insolvency related conflicts of laws in critical areas, such as, *i.a.*, security interests, set-off, payment and settlement systems, and financial markets operations, employment relationships, and prejudicial transactions and avoidance actions (Articles 4 -

¹ Council Regulation (EC) N° 1346/2000 of 29 May 2000 on insolvency proceedings, O.J. L 30/06/2000, pp. 1-13, http://europa.eu.int/eur-lex/en/lif/dat/2000/en_300R1346.html

² General Counsel, Deutsche Telekom AG, Bonn, Germany (Manfred.Balz@Telekom.de). The author participates in this conference in his personal capacity only. He helped draft the German Insolvency Reform Act of 5 October 1994, and he served 1989 -1996 as Permanent Chairman of the EU Council Committee on Bankruptcy, drafting and negotiating the 1995 European Convention on Insolvency Proceedings which has now been enacted as a Council Regulation (see fn. 1). He assisted the Legal Department of the IMF in the preparation of a publication on Orderly and Effective Insolvency Procedures (1999), <http://www.imf.org/external/pubs/ft/orderly.htm>, and he served as a member of the World Bank Task Force on Insolvency and Creditor Rights in the framework of the World Bank Insolvency Initiative.

³ Such a system has sometimes been termed a system of “modified universality”.

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- (c) Guarantee equal access and treatment of domestic and foreign creditors (Articles 39 - 42)
- (d) Provide for the mutual recognition of proceedings opened by the internationally competent jurisdiction(s) (Articles 16 - 26) and establish a minimum standard of coordination between main and any secondary insolvency proceedings.

Impact on the legal framework for informal workouts

How do these elements of a transnational insolvency framework influence informal workouts? I shall give only a few examples.

Jurisdiction governing legitimate expectations of parties in the workout process

Resolving the jurisdictional conflict for bankruptcies will determine also which jurisdiction should be governing key aspects of the workout process. Negotiations will be conducted in, and under the perspective of, the jurisdiction which could open main proceedings, *i.e.*, in the case of companies generally the place of the registered office (*siege social*), and before the foil of a hypothetical main insolvency proceeding in that jurisdiction.

If the debtor owns an establishment in one or more other jurisdictions which could be the objects of territorial secondary proceedings under Article 3 (2), the rights of creditors in these proceedings will also need to be taken into account. A creditor may, *e.g.*, have a priority claim in one insolvency jurisdiction, and only a general unsecured claim in another, or his claim may be admissible (allowable) in one jurisdiction and inadmissible in another. Determining the overall amount which a creditor may expect in an insolvency setting additionally requires application of some sort of “hotchpot” rule (Article 20(2)) whereby a creditor who received a partial payment in one proceeding will share in distributions made in another proceeding only when creditors of the same ranking or category have obtained, in such other proceeding, an equivalent dividend (*i.e.*, percentage of their claims).

Domestic versus foreign creditors

Resolving the bankruptcy conflict between domestic and foreign creditors in favor of equality likewise impacts informal workouts: All creditors, domestic as well as foreign, will be involved on an equal footing, provided their claims are of identical seniority.

While discrimination among creditors based on nationality is banned by the Regulation, it admits of some special rights for “local” creditors, based on domicile, habitual residence or, in the case of companies, the place of the registered office.

Absent a main proceeding, if the debtor has an establishment in a state other than the state where it has the centre of its main interests, local creditors there or creditors with claims arising from the operations of the establishment might trigger an isolated secondary insolvency proceeding (Article 3 (4)) to which then, however, all creditors would have access, under the terms, of course, of the applicable local insolvency law. The threat of such a secondary proceeding may prompt other creditors to accord a certain preference to such local or “establishment” creditors in order to stop them from causing a liquidation of foreign situated assets.

Varying economic value of security interests

Practically all legal systems recognize that the law of the *situs* (*lex rei situs*) governs the creation, the content, and the enforcement of security interests such as liens and mortgages; the Regulation implicitly recognizes this rule. It had to take account also, however, of the fact that insolvency regimes vary greatly with respect to interferences of bankruptcy law with security interests. Some

leave secured creditors entirely unaffected, others subject them to the stay of individual creditor action and accord secured creditors a mere priority claim, at times even junior to administrative claims. The Regulation (Article 5) limits the reach of the law of the main insolvency proceeding to collateral situated in the jurisdiction governing the insolvency proceedings. Collateral situated outside this jurisdiction will not be affected by the bankruptcy (subject, of course, to a possible secondary insolvency proceeding there). Creditors with collateral inside and outside the main jurisdiction may be expected to have different negotiating power and possibly strike a different bargain in an eventual workout.

Varying economic content of set-off rights

Many legal systems in Europe hold that the right of a creditor to set-off its claim against a counterclaim of the debtor should be governed by the law which governs the counterclaim. The Regulation implicitly recognizes this rule. But it must needs take account of the fact that insolvency laws interfere with the general law of set-off in manifold ways. The Regulation recognizes such interference when the law of the insolvency forum coincides with the law governing set-off. If the law of another jurisdiction governs set-off, the latter will not be affected (at least not restrictively) by the insolvency proceedings (Articles 4(2)(d) and 6 (1)). Creditors who have, or expect to have, a right to set-off may be in different positions depending on whether the same legal system or two different systems govern the insolvency proceeding and the right to set-off, and this may impact their stance in negotiations.

Evaluation

Europe to this day probably has the greatest conceivable diversity not only of insolvency laws but also of insolvency philosophies. There is not even a European consensus on the relative merits of rehabilitation and liquidation in general theory, and on the proper mix of them in insolvency reality. In the minutest technical details of insolvency law design, utter diversity will be encountered.

In this environment, a conflicts of law approach to cross-border insolvency and the informal management of financial crises appears natural. It aims at defining the proper scope of insolvency policies in relation to the policies of other laws, and at establishing a system of mutual respect of each other's different policies. Clearly, harmonizing conflicts rules is more promising and faster than harmonizing substantive laws. We submit such a piecemeal, modest, and realistic (some might say minimalist) approach might be useful for regions other than Europe also.

What the Regulation did not do is

- (a) Introduce a unitary substantive insolvency regime for the EU which would create a unitary framework for out-of-court workouts,
- (b) Attribute unmitigated universality to the bankruptcy proceedings opened by one, the main, forum, which would offer a simpler framework for workouts,
- (c) Give overriding priority to rehabilitation attempts in the main jurisdiction even when the debtor conducted substantial business via an establishment in other jurisdictions, and – obviously –
- (d) Attempt to establish a framework for the rehabilitation not only of legal entities but of complex groups of companies.

All of these were not even considered to be desirable when the text of the Regulation, and formerly of the identical Convention, were developed and negotiated.

Implementation of a minimalist approach

The Regulation, as a piece of EU legislation, is self-executing. It was preceded by a literally identical EU Convention which did not obtain the requisite number of ratifications because of a minor territorial conflict between two Member States.

It would be wrong, however, to assume that the key elements of the Regulation with its salutary effects on informal workouts require a supranational legislature or an international treaty.

Most elements of what became the Regulation were applied unilaterally and without the requirement of reciprocity, e.g., by Germany well before the EU resumed work on an insolvency document. The Insolvency Bill introduced by the German Government proposed to accept practically the full text of the then draft EU Convention on a purely unilateral basis⁴.

For countries wishing to increase legal certainty for informal workouts, a common understanding of the following minimum elements of a cross-border insolvency system should primarily be sought, and could be promoted by appropriate unilateral legislation:

- Basis for jurisdiction to open main (universal) proceedings reaching out to foreign situated assets,
- Access of both domestic and foreign creditors,
- Certain uniform conflict rules on key issues, such as security interests, set-off and netting, avoidance, etc.,
- Conditions for the recognition of foreign main proceedings, or, at least, of certain powers of a foreign administrator.

Such a common understanding may be achieved by gradual consensus building among governments, academic circles, business associations, and the general public, and assisted by existing documents such as the Regulation or the UNCITRAL Model Law.

⁴ Sections 379-399 of the Bill, Bundestags-Drucksache 12/2443