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EU INSOLVENCY REGULATION AND ITS IMPACT ON EUROPEAN BUSINESS

BOB WESSELS *

“... After all our complaints of the frequency of bankruptcies, the unhappy men who fall into this misfortune make but a very small part of the whole number engaged in trade, and all other sorts of business; not much more perhaps than one in a thousand. Bankruptcy is perhaps the greatest and most humiliating calamity which can befall an innocent man. The greater part of men, therefore, are sufficiently careful to avoid it. Some, indeed, do not avoid it; as some do not avoid the gallows.” These are the words of Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*.¹ In those days regulation of insolvency was rare too and sometimes contained criminal sanctions. Only a few bilateral treaties (within what now is the Netherlands and in Italy) existed. Nowadays however, the number of one in a thousand has become obsolete. In Europe in 2002, in the (then) fifteen member states, filings for insolvency amounted to a quarter of a million for individuals. In addition, around 150,000 businesses went into insolvency. The numbers have gone up dramatically as has the volume of legislation with regard to international or cross-border insolvency law.

In 2000 the EU Insolvency Regulation No. 1346/2000 was created, which entered into force on 31 May 2002. For several financial institutions, falling outside the scope of the Regulation, Directive 2001/17 and Directive 2001/24 were issued in 2001 on the reorganization and winding-up of insurance undertakings and of credit institutions. Where a Regulation is a European Community law measure binding fully the EU member states (except for Denmark, which opted out), both directives have to go through a legislative implementation process in each individual EEA

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¹ 1779; part. II.3.29.

(European Economic Area) member state. The implementation date for Directive 2001/24 is 20 April 2003 and for Directive 2001/17 it is 5 May 2004, and the drafting process in all countries is nearing its final phase.

For internationally active companies, insolvency is the doom of many: the Kirch Group, Swissair, Landis, Fairchild Dornier, Philipp Holzmann, Daisytek, Parmalat, MG Rover, Collins & Aikman, and a raft of other businesses have experienced it in recent years. Most of these companies have their headquarters in one of the EU member states and several subsidiaries in other member states.

This article describes the current European legal insolvency framework relating to legal persons. I will start by describing some of the major differences between domestic insolvency laws in countries in Europe, as these differences are often regarded as too numerous to be overcome and harmonized (part 1). On the European level the Insolvency Regulation was enacted in 2002 (part 2). Decisive for the international jurisdiction of a court is a debtor's centre of main interest (part 3). The Regulation should be seen in its procedural context, as it fills the gap which had been left open by the introduction of (what then was) the 1968 Brussels Convention, dealing with the international jurisdiction and recognition of judgments in civil and commercial matters. In the context of legal proceedings the latter (now known as the Brussels Regulation 2000) forms the general rule; the Regulation (for insolvency judgments) itself forms the special rule. As “financial institutions” are not covered by the EU Insolvency Regulation, the latter serves in turn as a general rule with regard to credit institutions and insurance undertakings, for which entities Directives 2001/17 and 2001/24 were issued. After demonstrating the model on which the Regulation is built (part 4), some communal tendencies will be highlighted (part 5).

Domestic differences

National insolvency law systems diverge as a result of differences in the structure of the market in a

country's general legal system, in its order of private law and in its insolvency law itself. Insolvency focuses, as the word indicates, on a certain person (a debtor, being a natural person or a legal person) who is not paying his debts as they fall due. If a country's "insolvency test"² is met, this forms a ground for invoking certain formal insolvency proceedings. Where "insolvency" is related to the economic and financial structure of a market and given that the regulation of many markets still takes place within the confines of a national state, a government influences this structure, resulting, among other things, in countries with a market-led economy versus countries with a stringent social-economic policy.

The latter, for instance, include the former Eastern Bloc countries, with several economies in transition towards stringent social-economic policies. In addition, the tradition of the way businesses are financed will influence the robustness of rights of a creditor, for example, in some markets the financing of business through stock-listed shares or by bonds is well developed (capital markets), where in others the common method of finance is through (secured) credit either from a bank or from members of the family, with relatively strong (secured) positions for both of them. Certain social or economic policies in almost all countries lead to legal protection by way of preferences for certain creditors (employees, small business, the taxman). Secondly, as with other legal domains, the system of insolvency law is under the influence of the overall legal system of a country, such as a common law jurisdiction or a civil law jurisdiction. In the former, in general, the importance of case law, with an active role for a (sometimes specialized) court, is stressed in comparison with countries based on statute law (law in codes). Thirdly, in many countries the order of general civil law and commercial law is a matter of continuous discussion.

Some countries aim to insert both civil law and commercial law into one code (the Netherlands); others (Belgium, Germany, France) use different codes and some adjust the judicial framework accordingly. Finally, in relation to the existing market structure, the goals of insolvency proceedings may differ, e.g. plain liquidation of assets or in addition reorganization proceedings with the aim of rescuing the enterprise and/or preserving existing employment. Here a different view comes into play, as "insolvency" in its

traditional concept deals with a debtor, with (or without any) assets, creditors, their claims, etc. Some systems of insolvency law do not provide for insolvency proceedings for certain types of debtors or have (only recently) introduced specific proceedings, e.g. debt discharge proceedings, for natural persons. All in all, national attitudes towards the phenomenon of insolvency are extremely variable, as are the social and legal consequences for the debtors concerned.

The EU Insolvency Regulation

On 31 May 2002 Regulation (EC) No. 1346/2000 of 29 May 2000 on insolvency proceedings entered into force. The Regulation applied entirely and directly to the ten member states that joined the EU as of 1 May 2004.³ A Regulation is a European Community law measure which is binding and directly applicable in member states. The Regulation does not apply to Denmark, as it opted out in accordance with the Treaty of Amsterdam. The rationale for the Regulation is clear: "The activities of undertakings have more and more cross-border effects and are therefore increasingly being regulated by Community law. While the insolvency of such undertakings also affects the proper functioning of the internal market, there is a need for a Community act requiring coordination of the measures to be taken regarding an insolvent debtor's assets" (Recital 3 of the Insolvency Regulation). The Regulation acknowledges the fact that as a result of widely differing substantive laws "... it is not practical to introduce insolvency proceedings with universal scope in the entire Community" (Recital 11). The differences mainly lie in the widely differing laws on security interests to be found in the Community and the very different preferential rights enjoyed by some creditors in the insolvency proceedings.

The goals of the Regulation, with its 47 articles, are to enable cross-border insolvency proceedings to operate efficiently and effectively, to provide for coordination of the measures to be taken with regard to the debtor's assets and to avoid forum shopping. Forum shopping is the expression of a desire (of a creditor or a debtor) to look for the most favourable jurisdiction with regard to the protection of one's

² A "balance-sheet" test (assessing that the total of the debtor's outstanding liabilities exceeds the value of his assets) or a "cash-flow" test (the inability of a debtor to pay his debts as they fall due).

³ Some smaller changes, based on Article 20 of the Act of Accession (O.J. L 236 of 23 September 2003), have led to a consolidated version of the Insolvency Regulation, see http://europa.eu.int/eurlex/en/consleg/reg/en_register_1920.html. The Annexes have been amended by Council Regulation (EC) No. 603/2005, see O.J. L 100/1 of 20 April 2005.

own rights.⁴ The Regulation, therefore, provides rules for the international jurisdiction of courts in a member state for the opening of insolvency proceedings, the (automatic) recognition of these proceedings in other member states and the powers of the “liquidator” in the other member states. The Regulation also deals with important choice of law (or: private international law) provisions. These contain special rules on applicable law in the case of particularly significant rights and legal relationships (e.g. rights in rem and contracts of employment). On the other hand, national proceedings covering only assets situated in the state of opening are allowed alongside main insolvency proceedings with universal scope. The following provides a brief overview of the contents of the Insolvency Regulation (InsReg).

The general provisions establish the area of application of the Regulation. It is confined to “proceedings which entail the partial or total divestment of a debtor and the appointment of a liquidator” (Article 1(1) InsReg). As far as the jurisdiction is concerned, the Regulation is based on 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” (Article 3(1)). For a company or legal person, the presumption is that the centre of the debtor’s main interests is the place of its registered office, but this presumption may be rebutted (Art. 3(1) last line). The opened insolvency proceeding is called the main proceeding. Its most important consequence is that the law applicable to insolvency proceedings under the regulation is that “of the member state within the territory of which such proceedings are opened” (Article 4(1)), in legal jargon: *lex concursus*, and that this consequence shall be recognised automatically in all other member states (Article 16). In addition, the court of a member state other than the state opening main proceedings shall only have jurisdiction, if “... the debtor possesses an establishment within the territory of that other member state” (Art. 3(2)).⁵ The effects of the latter proceedings – referred to as secondary proceedings – are, however, restricted to the assets of the debtor situated in the territory of the other member state (Art. 3(2) last line) and this proceeding may only be a winding-up proceeding.

⁴ There is a difference between an article and a recital. The former is a binding legal text. The latter expresses an underlying rationale with a purely interpretative value.

⁵ Article 2(b) provides that for the purposes of the EU Insolvency Regulation an “establishment” shall mean “... any place of operations where the debtor carries out a non-transitory economic activity with human means and goods”.

Centre of main interests

The “centre of main interests” (in jargon: COMI) is in principle decisive for the ability of the court to deal with the proceedings and for the law which is applicable. COMI 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, as Recital 13 provides. In some 70 percent of all court cases from the mid-2002 until now, the determination of COMI is the principle point of legal conflict, with highly debated cases like *Daisytek* (involving sixteen subsidiaries in UK, Germany and France)⁶ and *Parmalat* (involving Italy, Ireland, the Netherlands and Luxembourg). The outcome of the question “where is the centre of main interest?” in these decisions is based on many facts and circumstances, e.g.:

- (i) The day to day administration is conducted in the forum state (the state the court of which opens the proceedings) (Ireland),⁷
- (ii) The directors possessed the forum’s nationality (Italy),⁸
- (iii) The (Delaware incorporated) company had presented itself to its most substantial creditor as having its principle executive offices in the forum state (England),⁹
- (iv) The debtor (natural person) has maintained, with regard to the substantial interests in a large number of companies established in the forum state, to administer these commercial interest in the forum state (the Netherlands),¹⁰
- (v) The director (of an Irish incorporated company, being a wholly owned subsidiary of a UK company) was based in the UK and was solely responsible for the companies business,¹¹
- (vi) Some remaining contractual works (conducted by a company incorporated in Finland) were still in progress in the forum state (Sweden),¹²
- (vii) The group’s parent company (of an Austrian company with its seat in Innsbruck) is located in the forum state (Germany),¹³
- (viii) The company (registered in the UK with a postal address in Spain) is a partner in a Swe-

⁶ These European subsidiaries were left out of a filing of a Chapter 11 case in the US (Dallas, Texas) for the overall holding of *Daisytek International, Inc.*

⁷ Court of Dublin 23 March 2004 in *Re Eurofood IFSC Limited* (Irish company, part of the Parmalat group).

⁸ Court of Parma 19 February 2004 in *Re Eurofood IFSC Limited*.

⁹ Court of Leeds (Ch. D) 20 May 2004 *Re Ci4net.com Inc and Re DBP Holdings Limited*.

¹⁰ Netherlands Supreme Court 9 January 2004, JOR 2004/87, with my commentary.

¹¹ High Court London (Ch. D) 2 July 2004 in *Re Aim Underwriting Agencies (Ireland) Ltd.*

¹² Svea Court of Appeal 30 May 2003 (No. Ö 4105-03).

¹³ Court of Munich 4 May 2004 in *Re Hettlage KgaA*.

dish limited partnership (“kommanditbolag”) (Sweden),¹⁴ and even

- (ix) The codes to the computer programmes of the debtor company (registered in the UK, postal address in the UK, premises in Sweden) are stored in the forum state (Sweden).¹⁵

To determine the COMI of a debtor (e.g. a Dutch B.V., subsidiary of an Antilian Holding N.V.) it is not relevant where the COMI of the debtor’s three subsidiaries (three German GmbHs) is situated. Decisive is the COMI of the debtor as a separate entity, irrespective of the fact that the debtor’s interest is involved with the activities of the three subsidiaries.¹⁶

It may follow from the above that courts determine the COMI after the interpretation of a super abundance of facts. In general, I would submit that in these court cases one sees the confrontation of two concepts. The first one is a “contact with creditors” approach: through the eyes of creditors a debtor’s COMI has to be determined. After all, Recital 13 provides that COMI 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” (my italics). The other view is the “mind of management” approach: the debtor’s COMI must be situated where decisions are actually made, which often is within the jurisdiction where the parent company has its principle place for managing its (the group’s, including the subsidiary’s) operations.¹⁷

The insolvency experts are eagerly awaiting the European Court of Justice’s decision with regard to one of the five questions referred to it by the Irish Supreme Court on 27 July 2004 (147/04). This question is worded as follows: “Where, (a) the registered offices of a parent company and its subsidiary are in two different member states, (b) the subsidiary conducts the administration of its interests on a regular basis in a manner ascertainable by third parties and in complete and regular respect for its own corporate identity in the member state where its registered office is situated and (c) the parent company is in a position, by virtue of its shareholding and power to appoint directors, to control and does in fact control the policy of the subsidiary, in determining the ‘centre of main interests’, are the governing factors those referred to at (b) above or on the

other hand those referred to at (c) above?” The European Court’s decision is to be expected early 2006.

The Regulation provides for several exceptions to the application of the “lex concursus” (Arts. 5–15 InsReg). These exceptions include third parties’ rights in rem and reservation of title (Arts. 5 and 7) and set-off rights (Art. 6). These rights (under certain conditions) are not affected by the legal consequences (*lex concursus*) of the opening of main proceedings. In other instances an exception is created in that another choice of law (instead of the *lex concursus*) has been made. Important examples are contracts relating to immovable property (Art. 8: effects of insolvency proceedings shall be governed by the law of the member state within the territory of which the immovable property is situated) and contracts of employment (Art. 10: governed by the law of the member state applicable to the contract of employment). Insolvency proceedings opened in the opening state where the debtor has his COMI will be (automatically, Art. 16) recognized in all the other member states. Nevertheless, such recognition does not prohibit the opening of secondary proceedings in a state where the debtor owns an establishment (Article 16(2)).

Furthermore, the Regulation describes, amongst others, the powers of a liquidator, the publication of the opening judgement in another member state or in public registers. Any creditor has the right to lodge claims in writing if his residence is located in a member state other than the state of the opening of proceedings. This provision is meant also for the tax authorities and social security authorities (Art. 39). The Regulation further provides for a duty to inform known creditors in the other member state and the language to be used in the specific notice. Finally, in general, the EU Insolvency Regulation only applies to intra-Community relations; in cross-border insolvency cases relating to non-EU states the rules of general private international law or specific legislation of a country in this field apply.

The model

It seems quite evident that a secondary proceeding can only have a winding-up character (Art. 27). The model of main proceedings and concurring secondary proceedings, having this nature, has been criticized. It is submitted, however, that this limitation flows from the clear desire “... to achieve a system of international cooperation that is simple and easy to under-

¹⁴ Court of Appeal Skåne and Blekinge 3 February 2005 (Ö 21-05).

¹⁵ Court of Stockholm 21 January 2005 (K 17664-04).

¹⁶ Court of Appeal The Hague 3 November 2005 (Nr. R05/1224) in *Re Q1 Deutschland GmbH*.

¹⁷ See my article “International Jurisdiction to Open Insolvency Proceedings in Europe, in Particular against (Groups of) Companies”, in Wessels (2004), 155.

stand”.¹⁸ At the same time, during the preparation of (what now is) the Regulation the predominating thought was that “... the rules of mandatory coordination and the influence rights given to the main trustee would provide enough means to protect the rescue efforts in the main forum. This line of reasoning explains the rule adopted: secondary proceedings are possible, provided they are of the winding-up type, but they are subject to the ... main-secondary scheme of coordination”.¹⁹ It is mainly in the power of the liquidator in the main insolvency proceedings to exercise measures for coordination, e.g. he may request the opening of secondary proceedings in other member states (Art. 29), participate in secondary proceedings (Art. 32(3)), request a stay of the process of liquidation of secondary proceedings (Art. 33(1)), request termination of this stay (Art. 33(2)), propose a rescue plan in the context of these secondary proceedings or he may disagree with finalizing liquidation in secondary proceedings (Art. 34(2)). He shall furthermore lodge all claims in the secondary proceedings which have been lodged in the main proceedings (Art. 32(2)), he is duty bound to communicate information (Art. 31(1)) and to cooperate (Art. 31(2)). Both latter obligations are duties for liquidators in secondary proceedings too.

The mutual duty between liquidators to communicate and to cooperate symbolizes that liquidators have to bridge the still existing deficit of uniform law. The performance of the duties to communicate and to cooperate is necessary in order to voice, with regard to all claims, the principle of equal treatment of *pari passu* ranked creditors. In a dozen or so separate provisions, the Insolvency Regulation gives shape to the idea of “unity of estate” (there is after all one debtor), with regard to which he who has the most dominant role (the main liquidator) in principle directs the completion of the insolvency process, under the supervision of a national court. In this process the main liquidator has, with regard to the secondary proceedings, a set of controlling or coordinating (procedural and substantive) powers that he can exert. It is for this reason that for the model of international insolvency law in the system of the EU, I use the description of “coordinated universalism”.

European insolvency practitioners are presently discussing the creation of a set of best practices to serve as a guide for their cross-border work.²⁰

¹⁸ See Virgós (1998), 11.

¹⁹ See Virgós, *o.c.*, 11.

²⁰ See my editorial (2005) “It’s Time to Cooperate”, *International Corporate Rescue* 2 (6), 291.

Converging tendencies

The model of the Insolvency Regulation consists of four building blocks:

- (i) main proceedings, the law of which (*lex concursus*) has universal (within the EU) effect,
- (ii) special rules on applicable law (in contrast of a choice of *law for lex concursus*) in the case of particularly significant rights and legal relationships (e.g. rights in rem and contracts of employment),
- (iii) special “territorial” proceedings (covering only assets situated in the state of opening) to run alongside main insolvency proceedings with universal scope, and
- (iv) coordination between these proceedings.

The model, as indicated and expressed in Recital 12, acknowledges the existence of widely differing substantive laws, mainly (but not exclusively) the widely differing laws on security interests and the preferential rights enjoyed by some creditors in the insolvency proceedings to be found in the Community. Is there no alignment between elements of national insolvency law systems whatsoever?

One may detect a number of general tendencies, which in my opinion reflect that those who are involved in insolvency law (states, insolvency practitioners, courts, academics) are not thrown back fully on their own national sets of legislation and rules. Some main stream of alignment or even containing elements of harmonizing can be seen in certain features or topics of (international) insolvency law. Let me just name a few of these. In Europe many countries have revised and amended their legislation on insolvency law in the last two decades. Here one may observe two tendencies. Since the 1980s in over ten EU countries specific legislation has been introduced to deal with consumer debt. The Netherlands, Belgium and Germany followed in the late 1990s.²¹ Another main stream in the domestic legislative domain is the inclusion of corporate rescue type of proceedings. Since the 1980s substantial revision has taken place in countries like England and Scotland, France and Belgium and in 1999 Germany and Italy. Poland and Romania followed in 2003, Spain in 2004 and France (again) in 2006, whilst in the Netherlands a substantial revision is underway. In many of these countries the US Chapter 11 procedure has served as a model for legislators.²² A more recent observation

²¹ Insolvency regulation for natural persons is (still) rare in Central and Eastern Europe, see Balcerowicz et al. (2004).

²² Gromek Broc and Parry, eds., (2004).

is the enactment or renewal of rules dealing with cross-border insolvency cases in relation to non-EU countries (Germany 2003; Poland, Spain and Belgium in 2004, the UK in April 2006), although remarkably the initiatives seem to progress in an uncoordinated manner.

Soft law is another tendency. Some ten years ago the Cross-Border Insolvency Concordat was adopted, which was drafted by the International Bar Association's Committee on Insolvency, Restructuring and Creditors' Rights. The concordat contains a design for the approach and harmonization of cross-border insolvency proceedings, aimed at a better collaboration and "equity". The idea of a cross-border concordat (or: protocol) was realized in practice, during ongoing international insolvency cases, such as *Re Maxwell Communication Corporation plc*²³ and *Re Olympia & York Developments Ltd. v. Royal Trust Co.*²⁴ The experience gained during these cases was shared with others, discussed and finally described in the concordat. A "protocol" has since been used in over twenty large cases, some of them also involving European insolvency proceedings.

Under the auspices of Insol International, the worldwide federation of national organizations of accountants and lawyers, specializing in the broad field of insolvency (law), issued the *Principles for a Global Approach to Multi-Creditor Workouts* in 2000. These are eight principles indicating "best practice" on how to act when a company, with a larger number of (foreign) creditors, is in financial trouble. The Principles are jurisdiction-neutral and therefore can be made in principle applicable, indifferent of the legal system in that specific country. The publication demonstrates that the principles are being endorsed by the World Bank, the Bank of England and the British Bankers Association and in several jurisdictions (e.g. Korea, Indonesia, Turkey) this approach is followed²⁵ or suggested.²⁶

The EU Insolvency Regulation may be seen as a major step in improving the lacuna of cross-border insolvency within the major part of Europe. For others, though, it symbolizes especially the great diversity of national insolvency laws, where it aims to coordinate over 80 types of insolvency proceedings in 24 countries. A group, designating itself as the "International Working Group on European Insolvency Law"

(founded in 1999, representing ten member states) has studied the question of how these differences can be reconciled with the ongoing economic integration of Europe and has done research into common characteristics in national insolvency law systems. These common elements were captured in the Principles of European Insolvency Law, fourteen in number, being presented in 2003 as reflecting "... the essence of insolvency proceedings in Europe as they reflect, on a more abstract level, the common characteristics of the insolvency laws of the European member states."²⁷ The principles do not deal with subjects like corporate groupings as an insolvent debtor or liability of directors or shareholders. Institutions like the United Nations Committee on International Trade Law (UNCITRAL), the World Bank and the European Bank for Reconstruction and Development (EBRD) promote the adoption of international standards and principles.

Thus we see the first steps are being made in a general alignment of legal systems, the application of (contracted) approaches, some first signs of willingness to look for communalities instead of stressing the differences and the availability of recommendations from several larger institutions. These may demonstrate, in the longer run, a development towards tuning and harmony. Within the EU, with ideas to support fresh start mechanisms, one may even recognize signs of a desire to establish and implement consistent policy.

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²³ [1992] B.C.L.C. 465.

²⁴ (1993), 20 C.B.R. (3d) 165.

²⁵ Pomerleano/Shaw (2005).

²⁶ Adriaanse (2005).

²⁷ See McBryde (2003). For a short review: Wessels (2003), *American Bankruptcy Institute Journal*, September, 28ff.