11th International Conference of Management and Industrial Engineering

ISSN 2344-0937
ISSN-L 2344-0937
Volume 11
Website: https://icmie-faima-upb.ro

HISTORICAL DEVELOPMENT OF THE MODELS FOR CROSS-BORDER INSOLVENCY REGULATION IN EUROPE

Vladislav IVANOV
"Angel Kanchev" University of Ruse, Bulgaria
ORCID: https://orcid.org/0009-0005-7050-6386
Email: vrivanov@uni-ruse.bg

Abstract: *Cross-border insolvency within Europe has proven to be difficult for regulation. Several decades were needed in order to enact a Regulation on the topic. One of the most controversial matters was what model to be chosen for the regulation of cross-border insolvencies. The aim of this article is to analyse the historical development of these models up to the present moment and to outline their advantages and disadvantages.*

Keywords: *cross-border, insolvency, model, regulation.*

INTRODUCTION

The enactment of a legislation regulating such a complex topic as cross-border insolvencies involving European countries took more than 40 years. The start was given with the signing of the Treaty establishing the European Community. According to Article 3 of the Treaty one its aims is the creation of an internal market characterized by the abolition of obstacles to the free movement of goods, persons, services and capital. This will lead to more and more companies exercising their commercial activities in more than one country. Inevitably the number of cross-border insolvencies would rise. That is why rules regulating such proceedings on Community level are needed.

Understanding the models for regulation of cross-border insolvency is vital for the creation of an effective legal frame on the topic. Since the enactment of Regulation 1346/2000 and Regulation 2015/848 there have not been enough comparisons between the acting models of regulation and the past experience on the topic. This paper aims at presenting a new perspective on the models for cross-border insolvency regulation from the past and present and to outline their advantages and downsides.

EXPERIMENTAL

When preparing this paper past works and articles in this field have been analysed and compared. Furthermore, all of the major attempts of the supranational organizations in creating an act regulating cross-border insolvency have been presented with the advantages and disadvantages of their drafts. Finally, a general evaluation of the acting model of regulation has been given.

RESULTS

Overall, the comparison and analyse of the historical development of the models for cross-border insolvency proceedings gives a better understanding of the topic, the present situation and based on the practice of the courts of the Member States - what can be done to improve the acting frame on an European level.

DISCUSSION

In 1960 on the basis of Article 220 of the Treaty a Commission started work on the Brussels convention on jurisdiction and the enforcement of judgments in civil and commercial matters. During its development however, it was decided that due to the complexity of insolvency matters this topic shall be excluded from the scope of the Convention and included in a separate one. In 1963 a new Commission dedicated to creating an act regulating cross-border insolvency was established.

One of the most important issues which the Commission had to discuss and resolve was which model regulating cross-border insolvencies should be chosen. At that time 2 main models existed - universalism and territorialism, with their advantages and disadvantages.

If the universalism model is chosen then only one insolvency proceeding shall be initiated. This proceeding will include all of the debtor's assets no matter in how many countries these assets are located. Furthermore, in this proceeding all of the debtor's creditors (local and foreign) will participate. One court will have jurisdiction and shall apply its national substantive law on insolvency (lex fori concursus). Due to the significant differences in the insolvency rules of the participating countries, the application of the universalism model depends on the signing and enactment of a Convention between them, which unifies these rules.

There are several advantages of the universalism model [1]. Firstly, since only one insolvency proceeding is opened, this guarantees efficiency and economy - expenses connected to the simultaneous opening of such proceedings in other countries which must be paid from the insolvency estate are saved (court fees, remuneration for attorneys and translators etc.). These savings can then be used either for the satisfaction of the debtor's creditors to a higher degree or for the successful development of a restructuring procedure for the debtor. The latter is also in favour of the creditors because they will have a better chance of receiving payment from the debtor from future income due to the continuation of the business.

Secondly, the powers of the debtor to dispose of his assets will be restricted (if the applicable law provides for such a rule) simultaneously in all countries. That way the insolvency estate shall remain secure for the future satisfaction of the creditors from it. Furthermore, cases in which the debtor cannot dispose of assets in one country but can dispose with them in another, shall be prevented.

Another advantage of the universalism model is the fact that since only one substantive law will be applied all creditors with be treated equally, especially regarding the rules of distribution of proceeds from the insolvency estate.

Among the disadvantages of the universalism model is the fact that in order to apply this model and such unified rules a Convention between the States is needed [2]. The development and enactment of such a Convention is very difficult (as we shall see further on in this article) due to the serious differences in the insolvency laws of the different States.

Another disadvantage is the difficulty of creating a clear criterion for determining which court will have international jurisdiction to open insolvency proceedings. If a vague and unclear criterion is selected, then this will lead to easier forum shopping in such cases and an unstable internal market, which surely are not the goals of the developers.

On the other hand, the territorial model envisages the opening of insolvency proceedings in every State where the debtor has assets (territorial proceedings). An explicit Convention in this case is not needed – every court shall apply its national substantive law.

When entering into contractual relations the creditors bare in mind the eventual consequences of insolvency proceedings for their debtor and they are familiar with their national rules on the topic. If the territorial model is applied, then a clarity in debtor – creditor relations will be achieved – the local creditors will know what to expect because for every territorial insolvency proceeding their national law shall apply. Furthermore, the differences between national legislation regarding the rules on distribution of the proceeds from the insolvency estate shall not be an obstacle.

The territorial model also has disadvantages the first of which is that the opening of many simultaneous insolvency proceedings leads to more expenses, which must be paid from the insolvency estate. This puts at risk the interests of the creditors lowering the chances for them to receive a decent amount of their claims. In addition, the creditors will have to make more expenses in order to participate in more than one insolvency proceeding.

Another major disadvantage of this model is the difficulties, which the courts and appointed insolvency practitioners will face when trying to coordinate the opened proceedings in different States, a disadvantage, which only unified rules can overcome.

The 1970 Convention

In 1970 the Commission came forth with a draft of a Convention [3], which was accompanied by a report [4]. The draft has been determined as strikingly ambitious [5] for several reasons, most of them beyond the scope of this article.

The draft Convention adopted the universalism model – only one insolvency proceeding could be opened, which shall have full legal effect in all Contracting States (by that time six) and shall prevent the opening of other similar proceedings in the other States – Article 2 of the Draft. The court of a Contracting State in which the debtor's principal place of business is situated shall have exclusive jurisdiction to open the proceeding. In Article 3, paragraph 2 "principal place of business" is defined which helps in preventing forum shopping.

The draft Convention goes even further in regulating international jurisdiction. The court of a Contracting State can open insolvency proceedings even if the principal place of business is not situated in one of the Contracting States. This is the case when the debtor has a business establishment in that State. The lack of a definition of "business establishment" can be determined as a shortcoming of the draft.
As for the rules regarding applicable law and recognition of judgements they are exactly as the universalism model requires. The applicable law to the opened insolvency proceeding will be lex fori concursus. As for recognition - a judgement given by a court of a Contracting State shall be recognized in the other without any other formalities, which is a typical rule for the universalism model.

After the presentation of the draft, a few years of negotiations on the texts followed. The negotiations became even more complex due to the fact that in 1973 three more Contracting States joined the Community, each of them with their own specifics regarding insolvency proceedings. This led to the revised version of the draft Convention from 1982 [6].

Although improvements to the Draft were made, it still was not enough for the Contacting State to agree upon the Convention and enact it. In 1985 work on the Convention was put to an end. One of the main reasons for not enacting the Convention was the doubt that one court would not be able to administer the cross-border insolvency proceeding and insolvency estate by itself due to the serious differences between national insolvency laws [7].

Despite the failure of the European Community the attempts for creating a cross-border insolvency regulation did not stop there.

Istanbul Convention

In 1989 the Council of Europe started work on an own Convention on this difficult topic. By 1990 the draft of the European Convention on certain international aspects of bankruptcy (The Istanbul Convention) was finished and in order to enter into force 3 ratifications were needed.

This time a different model for regulating cross-border insolvency proceedings was chosen. The universalism model used up to this moment was modified with aspects from the territorial model. This led to the possibility according to the Istanbul Convention that more than one insolvency proceeding can be opened regarding the same debtor, more specifically main insolvency proceedings and secondary can be opened simultaneously. Such an option aims at providing more possibilities for coordination between the courts and insolvency practitioners engaged in the proceedings. Also, these changes in the model would also help the management of the insolvency estate when it is spread across different States and the realisation of assets.

According to Article 4 of the Convention the court of a Party in the territory of which the debtor's centre of main interests is located shall have international jurisdiction for the opening of main insolvency proceedings. The criterion "centre of main interests" has not been used in International Private Law by that moment and a serious drawback of the Convention is that it does not include a definition of the term. This, as mentioned before, can lead to easier forum shopping which is the opposite of the aims of the creators of such legislation.

As for secondary insolvency proceedings – they can be opened after main proceedings have been opened and the debtor must have an establishment or assets in another Party. Applying such a broad criterion for the opening of secondary proceedings can lead to the opening of too many simultaneous proceedings. This would mean more than the necessary expenses from the insolvency estate for maintaining them and even more difficulties coordinating them. That is why, in my opinion, the opening of secondary proceedings should only be allowed in cases when the debtor has an establishment in another country.

One of the main reasons the Council of Europe envisaged secondary proceedings is explained in point 91 of the Explanatory Report to the Istanbul Convention. According to it these proceedings are aimed to give full consideration to the local claims most worthy of being dealt with and to proceed to a fair liquidation of the assets at the local level. However, Article 21 of the Convention lists only a few groups of creditors who can enjoy payment in secondary proceedings. This differentiation between creditors does not correspond to one of the main principles of insolvency legislation - equal opportunity for creditors to participate in the proceeding. That is why such a restriction should be considered as a disadvantage of the Convention.

Despite the new approach and the major changes included in the Istanbul Convention its fate is the same as the draft, created by the European Community. The main reason for not receiving the necessary at least 3 ratifications is the included option for reservations (Article 40). Any State can declare that it will not apply Chapter II (Exercise of certain powers of the liquidator) or Chapter III (Secondary bankruptcies) of the Convention. This means that the courts and insolvency practitioners can find themselves in a situation in which some States recognise the secondary proceedings and other (in which the debtor has assets) – do not. This example proves how such a reservation can lead to more uncertainty than clarity and this cannot be allowed in cross-border insolvency cases. Some authors conclude that in comparison to the draft conventions of the European Community which are too ambitious the draft of the Council of Europe is not ambitious enough.
Although the Istanbul Convention also fails to be enacted, the change of the model of regulation of cross-border insolvencies, more specifically the option to open secondary proceedings, is a welcome innovation which as we will see will be used in future drafts on the topic.

The 1995 Convention

The next attempt at creating an Act regulating cross-border insolvency proceedings in Europe was again by the European Community. Work on the project began in 1989 and by 1995 the draft of the Convention [8] was ready. It was accompanied by an explanatory report [9].

In this draft Convention we can see a combination between the used up to that moment models for regulating cross-border insolvencies – the universalism and territorialism models. This combination is often referred to as "modified universalism" [10]. On the one hand, main proceedings can be opened, in which the liquidation of all assets of the debtor no matter where situated and the distribution of the proceeds can be carried out by the appointed insolvency practitioner. On the other hand, such main proceedings can be restricted and supported by the opening of secondary proceedings with their own insolvency practitioner and competent court.

Main insolvency proceedings can be opened if the debtor has his centre of main interests situated in a Contracting State – Article 3 of the Convention. A rebuttable presumption for the location of such a centre is included in the cases of debtors legal persons – their registered office. The presumption however does not compensate for the lack of a definition of "centre of main interests". The Virgos-Schmit Report gives guidelines for how the term should be interpreted – as the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties. Such interpretation can lead to the conclusion that the centre of main interests should be considered as the central administration of the debtor but the lack of certainty and clarity on this topic will provide difficulties for the courts in determining international jurisdiction.

As for secondary insolvency proceedings – when the centre of main interests is located in a Member State the courts of another State can open secondary proceedings if the debtor has an establishment in that State. In contrast to the Istanbul Convention here we can find a definition of "establishment" – any place of operations where the debtor carries out a non-transitory economic activity with human means and goods. As we can see in this case the mere presents of assets in a Contracting State is not sufficient to open secondary proceedings. This should be considered as an improvement to the regulation of the proceedings due to the fact that this way the scenario of pointless expenses, resulting from the opening of insolvency proceedings in every State where the debtor has assets, is excluded.

Another advantage of the inclusion of secondary insolvency proceedings is that the interests of local creditors are more protected. When entering into contractual relations with the establishment of the debtor the creditor will not have to worry whether his counterparty is a local or foreign entity because the creditor can file for the opening of secondary proceedings in his State. Such proceedings guarantee that the expenses of the creditor in relation to obtaining payment of his claim will be the same as if the proceedings were entirely national.

A further improvement of the used model for regulating cross-border insolvencies is that according to the Convention from 1995 in secondary insolvency proceedings all of the debtor's creditors can participate. They can lodge their claims and expect payment from the proceeds of the insolvency estate no matter whether they are local or foreign. This rule guarantees equal treatment of all creditors, which is one of the main aims of insolvency proceedings regulation.

Secondary insolvency proceedings can also be used as auxiliary proceedings. When the assets of the debtor are too complex to be administered by only one insolvency practitioner in one State, he can file for the opening of secondary proceedings in another State where the debtor has an establishment. This way another insolvency practitioner and court will provide support for the efficient conduct of the cross-border insolvency.

On the other hand, these secondary proceedings can be only of the type winding-up procedures – such including the realisation of assets and distribution of the proceeds. This rule should be considered as a shortcoming of the Convention. The reasons why is that such rule does not take into consideration the scenario when the main insolvency

proceedings are of the type reorganization/rescue proceedings, such aiming at the continuation of the commercial activities of the debtor and requiring a composition with his creditors and retention of the assets (the so-called "second chance procedures"). If main proceedings are of this type and secondary can only be liquidation proceedings, these contradictions between the aims of the two proceedings will only lead to difficulties for the insolvency practitioners and courts and the successful reorganization of the debtor will not be possible.

Overall, the Convention on insolvency proceedings 1995 overcame much of the obstacles, which were reasons for not enacting the previous drafts. In order to be enacted all 15 Member States had to ratify, accept or approve it (Article 49 of the Convention). Legal experts expected the draft to be enacted but the United Kingdom refused to sign. This led to the familiar result – the Convention did not come into force even though all the advantages of the draft.

Regulation 1346/2000

Soon after, the idea which would lead to the first Act, regulating cross-border insolvencies in Europe, came into motion. The text of the Convention on insolvency proceedings 1995 was revised in the form of Regulation 1346/2000, which applies to proceedings opened after 31.05.2002. It was finally time for the theoretical rules to be put into practice and evaluate their applicability and efficiency in regulating cross-border insolvency.

The evaluation came with the External Evaluation of Regulation 1346/2000/EC on Insolvency Proceedings [11] in 2012. Its conclusion was that the Regulation was functioning well in general but also improvements were needed for the enhancement of the effective administration of cross-border insolvencies.

Among the topics, which needed improvement, was the connection between the main and secondary insolvency proceedings. More specifically, the rule that secondary proceedings can only be liquidation proceedings proved to create difficulties for the successful reorganization of the debtor. Furthermore, as a result of the Financial crisis from 2007 and the high number of insolvency proceedings that followed [12], the Member States created regulations for the so-called "second chance procedures". Such procedures however could not be opened as secondary insolvency procedures without amending the Regulation. This restricting as practice proved hindered the effectiveness of Regulation 1346/2000. Therefore, changes in the used model for regulation of cross-border insolvencies was needed.

Other shortcomings of the Regulation were that in many cases secondary proceedings led to difficulties in the coordination with the main proceedings and only generated additional expenses. These disadvantage cannot in any way be basis for the thesis that secondary proceedings should be abolished but surely emphasise the need for improving the rules, applicable to them.

Regulation 2015/848

Based on the Report from 2012 the new Regulation 2015/848 was enacted, which applies up to this moment. With it the much needed expansion of the types of secondary insolvency proceedings was done. This way the used model for cross-border insolvency regulation was further improved, still characterized as modified universalism. Rules on coordination and communication between the courts and insolvency practitioners in the different Member States, in which main and secondary proceedings are opened, also enhanced the efficiency of the Regulation.

The last significant change in the model for cross-border insolvencies, which was introduces with Regulation 2015/848, is the possibility to avoid the opening of secondary proceedings in specific cases. Article 36 envisages that the insolvency practitioner in main proceedings can avoid the opening of secondary proceedings (and with this unnecessary expenses and the burden of coordinating proceedings) by giving an unilateral undertaking in respect of the assets, situated in the Member State where secondary proceedings can be opened. The condition is that the insolvency practitioner will comply with distribution and priority rights that the creditors would have under the applicable national law to the secondary proceedings.

The specifics of the undertaking according to Article 36 can be a topic of another article. Here, it is necessary to acknowledge that this new rules greatly improve the model for cross-border insolvency regulation. On one hand, secondary proceedings continue to be an option for the effective management and coordination of the insolvency estate in complex international cases. On the other hand, when secondary proceedings are expected to general more expenses than benefits, the main insolvency practitioner can prevent their opening with this unilateral undertaking, which also guarantees the rights of creditors as if secondary proceedings are opened. That is why this undertaking should be categorized as a welcome improvement to the model for cross-border insolvency.

CONCLUSION

Overall, the evolution of the model, regulating cross-border insolvencies has come a long way – from the universalism model, which even only on paper proved to be inefficient, through the modified universalism with the option of main and secondary proceedings, and up to the present moment when in my opinion the European legislator has found a working balance between the universalism and territorialism models. The dynamic development of international commerce, the crisis which we face in the last years (pandemics and war) will surely influence cross-border insolvency and the need for improvements. In general, however, for the time being the chosen model can be determined as an effective one.

REFERENCES

[1] Anderson, K., *The cross-border insolvency paradigm: a defense of the modified universal approach considering the Japanese experience, Available from* https://scholarship.law.upenn.edu/jil/vol21/iss4/1/
[2] Sokol, E., The fate of universalism in global insolvency: neoconservatism and new horizons, Hasting International and Comparative Law Review, volume 44, Available from https://repository.uclawsf.edu/hastings_international_comparative_law_review/vol44/iss1/4/
[3] Convention relating to Bankruptcies, Compositions and Analogous Procedures.
[4] Report on the Convention relating to Bankruptcies, Compositions and Analogous Procedures (Noel-Lemontey Report).
[5] Bork, R., Zwieten, K., *Commentary on the European Insolvency Regulation*, Oxford University Press, ISBN 9780198852117
[6] Draft Convention on bankruptcy, winding-up, arrangements, compositions and similar proceedings.
[7] Burton, L., *Toward an International Bankruptcy Policy in Europe: Four Decades in Search of a Treaty,* Annual Survey of International & Comparative law, Available from https://digitalcommons.law.ggu.edu/cgi/viewcontent.cgi?article=1043&context=annlsurvey
[8] Convention on insolvency proceedings, 1995.
[9] Virgos-Schmit Report, which is also used in construing the following Regulation 1346/2000 and Regulation 2015/848.
[10] Ouatu, M., *Modified universalism for cross-border insolvencies: Does it work in practice?*, University of British Columbia, Available from https://open.library.ubc.ca/media/stream/pdf/24/1.0103613/1
[11] Heidelberg-Luxembourg-Vienna Report.
[12] A second chance for entrepreneurs. Prevention of bankruptcy, simplification of bankruptcy procedures and support for a fresh start, Final report of the expert group, European Commission, Available from https://ec.europa.eu/docsroom/documents/10451/attachments/1/translations/en/renditions/native

This research is supported by the Bulgarian Ministry of Education and Science under the National Program "Young scientists and Postdoctoral Students - 2".

Corresponding author:
Vladislav Ivanov, Assistant Professor, PhD
Full address: Bulgaria, Ruse, 8 Studentska str.
Email: vrivanov@uni-ruse.bg