



Studies of the Oxford
Institute of European
and Comparative Law



Current Issues in European Financial and Insolvency Law

**Edited by
Wolf-Georg Ringe,
Louise Gullifer and
Philippe Thery**

CURRENT ISSUES IN EUROPEAN FINANCIAL AND INSOLVENCY LAW

Recent case-law and legislation in European company and insolvency law have significantly furthered the integration of European business regulation. In particular, the case-law of the European Court of Justice and the introduction of the EU Insolvency Regulation have provided the stimulus for current reforms in various jurisdictions in the fields of insolvency and financial law. The UK, for instance, has adopted the Enterprise Act in 2002, designed, inter alia, to enhance enterprise and to strengthen the UK's approach to bankruptcy and corporate rescue. In a similar vein, a recent reform in France has modernised French insolvency law and even introduced a tool similar to the successful English 'company voluntary arrangement' (CVA).

This book provides a collection of studies by some of the leading English and French experts today, analysing current perspectives of insolvency and financial law in Europe, both on the national as well as on the European level.

The book is indispensable for comparative private lawyers and lawyers with a particular interest in French law. It is also of use to all private lawyers (both academics and practitioners) looking for information on recent international and European trends in contract and tort.

**Volume 11: Studies of the Oxford Institute of European and
Comparative Law**

Studies of the Oxford Institute of European and Comparative Law

Editor

Professor Stefan Vogenauer

Board of Advisory Editors

Professor Mark Freedland, FBA

Professor Stephen Weatherill

Professor Derrick Wyatt, QC

Volume 1: The Harmonisation of European Contract Law: Implications
for European Private Laws, Business and Legal Practice

Edited by Stefan Vogenauer and Stephen Weatherill

Volume 2: The Public Law/Private Law Divide

Edited by Mark Freedland and Jean-Bernard Auby

Volume 3: Constitutionalism and the Role of Parliaments

Edited by Katja Ziegler, Denis Baranger and A W Bradley

Volume 4: The Regulation of Unfair Commercial Practices under EC
Directive 2005/29: New Rules and Techniques

Edited by Stephen Weatherill and Ulf Bernitz

Volume 5: Human Rights and Private Law: Privacy as Autonomy

Edited by Katja Ziegler

Volume 6: Better Regulation

Edited by Stephen Weatherill

Volume 7: Forum Shopping in the European Judicial Area

Edited by Pascal de Vareilles-Sommières

Volume 8: The Reform of Class and Representative Actions in
European Legal Systems: A New Framework for Collective Redress in
Europe

Christopher Hodges

Volume 9: Reforming the French Law of Obligations: Comparative
Reflections on the Avant-projet de réforme du droit des obligations et
de la prescription ('the Avant-projet Catala')

Edited by John Cartwright, Stefan Vogenauer and Simon Whittaker

Volume 10: Performance-Oriented Remedies in European Sale of Goods
Law

Vanessa Mak

Volume 11: Current Issues in European Financial and Insolvency Law:
Perspectives from France and the UK

Edited by Wolf-Georg Ringe, Louise Gullifer and Philippe Théry

Current Issues in European Financial and Insolvency Law

Perspectives from France and the UK

Edited by
Wolf-Georg Ringe, Louise Gullifer
and Philippe Théry



• H A R T •
PUBLISHING

OXFORD AND PORTLAND, OREGON
2009

Published in North America (US and Canada) by
Hart Publishing
c/o International Specialized Book Services
920 NE 58th Avenue, Suite 300
Portland, OR 97213-3786
USA
Tel: +1 503 287 3093 or toll-free: (1) 800 944 6190
Fax: +1 503 280 8832
E-mail: orders@isbs.com
Web Site: www.isbs.com

© The editors and contributors severally, 2009

The editors and contributors have asserted their rights under the Copyright,
Designs and Patents Act 1988, to be identified as the authors of this work.

All rights reserved. No part of this publication may be reproduced, stored in a
retrieval system, or transmitted, in any form or by any means, without the prior
permission of Hart Publishing, or as expressly permitted by law or under the terms
agreed with the appropriate reprographic rights organisation. Enquiries concerning
reproduction which may not be covered by the above should be addressed to Hart
Publishing at the address below.

Hart Publishing Ltd, 16C Worcester Place, Oxford OX1 2JW
Telephone: +44 (0)1865 517530 Fax: +44 (0)1865 510710
E-mail: mail@hartpub.co.uk
Website: <http://www.hartpub.co.uk>

British Library Cataloguing in Publication Data
Data Available

ISBN: 978-1-84113-935-7

Typeset by Forewords Ltd, Oxon
Printed and bound in Great Britain by
CPI Antony Rowe, Chippenham, Wiltshire

Preface

Recent case-law and legislation in European company and insolvency law have significantly furthered the integration of European business regulation. The case-law of the European Court of Justice on the free movement of companies has opened up the European-wide market for companies and has made company law systems more compatible, while the introduction of the EU Insolvency Regulation, which came into force in 2002, has provided new opportunities in the restructuring sector and created a level playing field for international strategies in insolvency.

These developments have led to increased competition between jurisdictions within Europe, comparable to the US experience in the 19th century, and this competition has provided the stimulus for current reforms in various jurisdictions. The UK, for instance, has adopted the Enterprise Act in 2002, covering a range of measures, inter alia designed to enhance enterprise and to strengthen the UK's approach to bankruptcy and corporate rescue. In a similar vein, a recent reform in France has modernised French insolvency law and even introduced a tool similar to the successful English 'company voluntary arrangement' (CVA).

This book represents the fruit of a bilingual conference held in Harris Manchester College, Oxford, on 28 March 2008, bringing together a group of mainly French and English insolvency and company lawyers to discuss these recent developments and reforms in their respective jurisdictions, as well as current developments on the European level. The conference was held under the auspices of the Institute of European and Comparative Law and was dedicated to 'current issues in financial and insolvency law: perspectives from France and the UK'. It represents the second gathering of French and English scholars from the universities Paris I/II and Oxford, building on the successful exchange programme between these universities. The conference was generously supported by the Institute of European and Comparative Law, the Faculty of Law of the University of Oxford and the Centre d'Etudes des Réglements des Conflits, Université Paris II. Contributions in French language have been translated into English.

Special thanks are due to Jenny Dix for her great support in organising the conference, to Sébastien Grifnée and Paschalis Paschalidis for helping with the discussion reports, and to Morris Schonberg for editing assistance.

Wolf-Georg Ringe
Louise Gullifer
Philippe Théry
Oxford/Paris, October 2008

Contents

<i>Preface</i>	v
<i>Contributors</i>	ix
1 The Evolution of Insolvency Law in France <i>Philippe Théry</i>	1
2 The Reforms of the Enterprise Act 2002 and the Floating Charge as a Security Device <i>Louise Gullifer</i>	17
3 The Effect of the Enterprise Act 2002: Empirical Research into Corporate Insolvency <i>Sandra Frisby</i>	45
4 Comment and Summary <i>Philippe Théry</i>	67
5 Strategic Insolvency Migration and Community Law <i>Wolf-Georg Ringe</i>	71
6 The ‘Centre of the Debtor’s Main Interests’: Comments on the Eurofood Judgment of the ECJ <i>Georges Khairallah</i>	111
7 European Insolvency Proceedings and Party Choice: Comment <i>John Armour</i>	123
8 The Recent Influence of Insolvency Law on the Evolution of Security in French Law <i>Pierre Crocq</i>	129
9 Guarantees and Collective Procedures <i>Laurent Leveneur</i>	137

10	Comments and Discussion Report <i>Hugh Beale</i>	155
11	The Exclusion of Certain Creditors from the Law of Collective Proceedings <i>Hervé Synvet</i>	159
12	How Do the Courts Choose between Different Bankruptcy Outcomes? The Results of a French Survey <i>Régis Blazy, Bertrand Chopard, Agnès Fimayer and Jean-Daniel Guigou</i>	181
13	Comments and Discussion Report <i>Robert Stevens</i>	207
14	Summary <i>Wolf-Georg Ringe and Louise Gullifer</i>	211
15	Annex <i>Index</i>	215 241

Contributors

Professor John Armour is Lovells Professor of Law and Finance at the University of Oxford.

Professor Hugh Beale QC FBA is Professor of Law at the University of Warwick. He was a Law Commissioner for England and Wales from 2000 to 2007 with responsibility for the Commercial and Common Law Team, which produced the report on Company Security Interests (LC Report No 296, 2005).

Professor Régis Blazy is Professor of Financial Economics at the University of Strasbourg, Institut d'Etudes Politiques (France). He specialises in the economics of financial distress. From 2006 to 2008, he was the director of the Centre of Research in Finance (CREFI-LSF) of the University of Luxembourg. In 1997, he received the European Jean Bastin interdisciplinary prize on credit risk.

Mr Bertrand Chopard is assistant professor of economics at the University of Nancy 2 (France) (BETA). He specialises in personal bankruptcy and corporate insolvency process. His fields of interests are in law and economics, both theoretical and empirical aspects.

Professor Pierre Crocq is Professor of Law at the University of Panthéon-Assas (Paris II). He was a member of the commission for the reform of French security law.

Ms Agnès Fimayer is a research assistant at the University of Strasbourg, Institut d'Etudes Politiques (France). She is member of LARGE (Strasbourg) and of CREFI-LSF (Luxembourg). She currently works on the prediction of corporate default.

Dr Sandra Frisby is Baker & McKenzie Associate Professor and Reader in Company and Commercial Law at the University of Nottingham.

Mr Jean-Daniel Guigou is an assistant professor of finance at the University of Luxembourg (CREFI-LSF). He has published in the fields of corporate finance, industrial competition, and banking competition. He currently works on relative performance.

Ms Louise Gullifer is a Reader in Commercial Law at the University of Oxford and a tutor at Harris Manchester College.

Professor Georges Khairallah is Professor of Law at the University of Panthéon-Assas (Paris II).

Professor Laurent Leveneur is Professor of Private Law at the University Panthéon-Assas (Paris II) and Director of the Laboratoire de Droit Civil.

Dr Wolf-Georg Ringe is a Lecturer in Law at the University of Oxford, Deputy Director of the Institute of European and Comparative Law and Fellow of Christ Church.

Professor Robert Stevens is a Barrister and Professor of Commercial Law at University College London.

Professor Hervé Synvet is Professor of Law at the University of Panthéon-Assas (Paris II) and commissioner at the Haut Conseil du Commissariat aux Comptes.

Professor Philippe Théry is Professor of Law at the University of Panthéon-Assas (Paris II), Director of the Institut d'Etudes Judiciaires 'Pierre Raynaud' (IEJ) and former Deputy Director of the Institute of European and Comparative Law, University of Oxford.

1

The Evolution of Insolvency law in France

PHILIPPE THÉRY

I. INTRODUCTION

THE SITUATION UNDER the present-day legislation of the United Kingdom and of France justifies the choice of insolvency law and the law of securities as the subject of this symposium of members of English and French universities. Although, of course, it is not possible to provide an exhaustive account here of such a wide-ranging subject, a comparison limited to certain points is of interest in that common economic considerations weigh heavily in this field, which could lead to some convergence between the two legal systems, despite the fact that the principles on which they are based may initially appear different.

The purpose of the following remarks is to provide English readers with an outline of French insolvency law in the hope that it will enable them to understand the background to the different papers. Legal provisions are often modified because they are dictated by the general economic situation, changes in which affect in turn the aims pursued by the legislature, such as maintaining business ethics (which supposes the payment of creditors and the elimination of dishonest debtors), preserving enterprises, safeguarding jobs, etc. If the incompetence or dishonesty of some entrepreneurs was for a long time the only cause of insolvency, changes in the economy, obsolescence of the productive apparatus and the stiffening of competition have become new causes of insolvency and have led to difficulties of a different magnitude altogether for enterprises.

While this changeability is a constant feature of the insolvency law, the rate of change appears to be speeding up. The Commercial Code of 1807 was amended for the first time in 1838 (Act of 28 May), and then in 1889 (Act of 4 March), in 1955 (Decree of 20 March), in 1967 (Act of 13 July),

2 *Philippe Théry*

in 1985 (Act of 25 January¹), in 1994 (Act of 10 June) and finally, but not for the last time,² by the Act of 26 July 2005.³ These stages may be briefly outlined.

(a) The Commercial Code

The extreme stringency of the provisions of the Commercial Code with regard to insolvent traders is largely due to the circumstances of the time.⁴ Because of the scandals arising from frantic speculation, Napoleon demanded that the Code should be hard on bankrupts, that is to say, debtors in a state of suspension of payments.⁵ They were to be taken to prison or, 'placed under the custody of a police officer, judicial official or gendarme' (article 455 of the Commercial Code). Dishonest bankrupts guilty of fraudulent bankruptcy were liable for 5–20 years of hard labour (article 402 of the Criminal Code).

To avoid fraudulent agreements between creditors and debtors, the supervision of bankruptcy was very restrictive. In addition, procedural costs were very high because every procedural act gave rise to fees. In those circumstances it is understandable that this extreme severity, the rigidity and the high procedural costs, had perverse effects: creditors and debtors reached an understanding by means of secret agreements to circumvent the insolvency procedure. At a time when economic development would have justified reducing the severity of insolvency rules, this situation was obviously a cause for concern.

(b) The Act of 28 May 1838

This provided certain remedies to the aforementioned problem. Firstly, debtors were no longer systematically imprisoned. Secondly, the Act provided that the proceedings could be closed for want of assets: in other words, the Act acknowledged that it was pointless to take the various measures to which the insolvency procedure gave rise if it was certain that the assets would not be sufficient to make a distribution to the creditors.

¹ The reform included preventive measures (Act of 1 March 1984); see below part I(f).

² This Act is itself in the process of reform (see below section I(i)).

³ An excerpt from the Code can be found in the annex to this volume.

⁴ In actual fact, the only persons subject to these procedures were traders, ie persons 'who carry out acts of commerce and make this their customary occupation' (art 1 of the Commercial Code). These acts of commerce are listed in art 632 of the Code (see below section II(a)(i), the observations on the sectors to which insolvency proceedings apply).

⁵ That is to say, the available assets are not sufficient to meet the outstanding liabilities.

(c) The Act of 4 March 1889

For the first time, the Act distinguished between bankrupts and unlucky debtors. A more flexible procedure was introduced for the latter—winding-up under the supervision of the court. If they filed a petition for bankruptcy within 15 days of the suspension of payments, they remained in charge of their business and were assisted by an administrator. Normally the proceedings were to end in a composition with creditors⁶ which enabled the debtor to pay the liabilities by instalments and with rebates, and, once that was done, to resume the management of his business. Otherwise, there was a return to the insolvency rules, which entailed the sale of all the debtor's assets (general body of creditors).

(d) The Decree of 20 May 1955

This modified the entire procedure after reforms which made the rules on particular points stricter.⁷ Winding-up under the supervision of the court was renamed 'administration by the court' (*règlement judiciaire*) to indicate that winding-up was not the natural outcome of the proceedings: suspension of payments should in principle lead to composition with creditors. There was a return to the insolvency rules, entailing the compulsory liquidation of the debtor's assets only where he was at fault. The opening of proceedings was a sign of economic failure and no longer, at least in principle, the consequence of conduct contrary to business probity.

The improvements made by the successive measures were based on the idea that unlucky debtors and dishonest debtors should not be treated in the same way. However, this law did not take the situation of the business into account; in other words, it did not deal with the question whether the difficulties encountered by the business could be overcome or whether they were irremediable. However, the economic situation of the time brought to the forefront the question of the distinction between the man and the business, in the famous words of *Doyen* Roger Houin.⁸

(e) The Act of 13 July 1967

This was drawn up to address the distinction suggested by Houin. Consequently, French law was then organised around two different aims. The

⁶ Composition is a collective resolution voted upon by the creditors. On certain conditions, the majority vote binds the minority, who are therefore bound by an agreement to which they have not consented.

⁷ See below section II(b).

⁸ See R Houin, 'Permanence de l'entreprise à travers la faillite' in *Liber amicorum Baron Louis Fredericq* (Ghent, E Story-Scientia, 1966).

first, *moral*, aim dealt with the debtor's conduct; the second, *economic*, aim depended on the degree of deterioration in the situation of the particular business. In the latter case, the proceedings therefore took the form either of administration by the court, or winding-up. In the case of administration, the business was given the chance to survive subject to an agreement with creditors (composition) while in the case of winding-up, the assets were sold to pay off the creditors.

This Act also provided for the possibility of an outright sale (sale of all the assets in one fell swoop for a set price). This form of sale was used, sometimes in dubious circumstances, to allow businesses to be taken over at less cost.⁹ To some extent, insolvency law served to 'restructure the capital', according to a critical view of the subject.¹⁰

Simultaneously with the Act of 13 July 1967, an ordinance of 23 September 1967 set up a procedure for the provisional stay of actions. Unlike the procedures existing up to that date, which required the business to have ceased payments, the provisional stay of actions could be ordered before then. The admitted object was to rescue businesses, the disappearance of which could seriously affect the national or regional economy.

(f) The Reform of 1984/85

This resulted from the Acts of 1 March 1984 and 25 January 1985. The reasoning behind the 1984 Act is to be found in an observation often made by specialists in the subject: that the restructuring of a business is easier the sooner the difficulties are detected. Therefore the purpose of the Act was to facilitate the early detection of difficulties by giving auditors and the works committee a greater part to play. The Act also introduced a procedure for resolving difficulties without the intervention of the courts.

The first Act of 25 January 1985¹¹ made significant changes in the general scheme of the proceedings. The aims of the Act were set out in article 1:

- to protect the business;
- to allow the business to continue operating and maintain jobs;
- to settle liabilities (and not payment!).

⁹ Some purchasers made a speciality out of the practice of paying for the business which they acquired by selling the company's assets.

¹⁰ L Boy, R Gillaumond, A Jammeaud, M Jeantin, J Pagès and A Pirovano, *Droit des faillites et restructuration du capital* (Grenoble, Presses Universitaires de Grenoble, 1982). These takeovers led to resounding failures, that of Bernard Tapie being the best-known example, and also impressive successes. The LVMH group was formed, at least partly, from the takeover of Société financière et foncière Agache-Willot by Bernard Arnault.

¹¹ There are two Acts of 25 January 1985. The first reformed procedure while the second reformed the status of the professionals who took part in insolvency proceedings.

The procedure laid down by this new Act was as follows: after an observation procedure intended to diagnose the economic and financial situation of the business, the court could choose between three possible solutions:

- a plan for continuing the business;
- a plan for its sale;
- winding-up under the supervision of the court.

The aim of protecting the business was reflected in very strict measures, particularly a rather draconian reduction in the possibilities for contesting decisions taken by the commercial court. Generally speaking, the Act and the way in which it was applied by the courts were very harsh on creditors.

(g) The Act of 10 June 1994 or the ‘Reform of the Reform’

The purpose of this Act was to remedy certain shortcomings in the 1985 Act. For example, it made it possible to order winding-up immediately, without a prior observation period where that would be pointless.¹² More importantly, it attempted to restore some balance in the position of creditors,¹³ which had been much weakened, as pointed out above.

(h) The Act of 26 July 2005¹⁴

This broadly followed the 1985 Act, ie its primary aim was to protect businesses. However, it introduced a number of innovations. Unlike the earlier acts, it did not lay down suspension of payments as a condition for starting insolvency proceedings. Thus, in line with US law, it permitted a form of proceedings known as safeguard proceedings which would enable the necessary measures to be taken as soon as the first serious difficulties appeared (see below). The other amendments consisted mainly in correc-

¹² Previously, in the morning the court would give a judgment ordering the opening of proceedings and then, in the evening, bring the observation period to an end and order winding-up because the business was in a desperate situation.

¹³ For this reason the essential provisions will be considered in the broad outline of the development of creditors’ rights.

¹⁴ Brief bibliography: it is unnecessary to cite all the works on insolvency proceedings as there are so many. This list is therefore limited to recent works which can easily be found: P Pétel, *Procédures collectives, Les cours du droit* (5th edn, Paris, Dalloz, 2006); C Saint-Alary-Houin, *Droit des entreprises en difficulté* (5th edn, Paris, Domat-Montchrestien, 2006); F Pérochon and R Bonhomme, *Entreprises en difficulté, Instruments de crédit et de paiement* (7th edn, Paris, LGDJ, 2006); PM Le Corre, *Droit et pratique des procédures collectives* (Paris, Dalloz, 2006). There are periodicals specially devoted to insolvency proceedings: *Revue des procédures collectives* and *Actualités des procédures collectives*. In addition, there are numerous reports on the subject in the different business law periodicals: *Revue trimestrielle de droit commercial*, cited as RTDCom; *Semaine juridique E(ntreprises)*, cited as JCP E; *Semaine juridique G(énérale)*, cited as JCP G; *Dalloz*, cited D; and *Les petites affiches*, cited as LPA.

tions to earlier measures. Generally speaking, it was a very complex act. As it constituted positive law, its main features are described below

(i) Expansion of Preventative Provisions

Traders and certain non-commercial companies were already required to keep accounts and this requirement was now extended to all non-trader legal persons engaged in economic activity if they fulfilled two of the three following conditions: 50 employees, turnover of €3,100,000 before tax or €1,550,000 for the balance sheet total, ie total net assets. In addition, companies and partnerships had to appoint an auditor, which was previously required only for public companies and limited partnerships with share capital. The auditors were required to use an alert procedure when they became aware of 'acts likely to jeopardize the continuation of the business' (articles L234-1 and 234-2, 251-15 and 612-3 of the Commercial Code¹⁵).

(ii) Supervision of the Conciliation Procedure

The Act gave the president of the commercial court the power to appoint an '*ad hoc* agent' to facilitate negotiation with creditors. More importantly, the Act provided for a conciliation procedure (articles L611-4 to 16) under the supervision of a conciliator appointed by the president of the court. Various provisions aimed to induce creditors to reach an agreement with the manager of the business. If an agreement was reached, it could be confirmed by the judge, but this was not compulsory. If the agreement was judicially confirmed, it produced more vigorous effects, and was thus favourable to creditors.

(iii) Safeguard Proceedings¹⁶

These could be opened as soon as the debtor provided proof of difficulties which he could not overcome and which could plunge him into suspension of payments (article L620-1 of the Commercial Code). Consequently Parliament took account of the need to intervene as soon as possible to improve the chances of saving the business by following the examples from

¹⁵ The provisions of the Commercial Code in force can be viewed on the official French Government site at www.legifrance.gouv.fr. The Commercial Code is one of the codes which have been translated into English. Provisions preceded by the letter L are legislative provisions, those preceded by the letter R are delegated legislation. This distinction applies generally to recent codes (not the Civil Code) and is based on arts 34 and 37 of the Constitution of 4 October 1958, which distribute the creation of new rules between Parliament (art 34) and the executive (art 37).

¹⁶ See Le Corre, above n 13.

comparative law, in particular Chapter 11 of the United States Act.¹⁷ In so far as these proceedings were voluntary, they enabled the debtor to continue to manage his business, if necessary under the supervision of an administrator. The proceedings normally ended with a safeguard plan which permitted the rescheduling of liabilities and restructuring of the business. The creditors' opinion on the administrator's proposals was obtained, with a view to drawing up the restructuring plan. In principle, creditors were consulted individually unless committees of creditors were formed. Committees were normally required for businesses with auditor-certified accounts, which had more than 150 employees and a turnover exceeding €20m. The first committee consisted of credit institutions, while the second consisted of the main suppliers of goods and services. Subject to certain conditions concerning a majority, the committees were allowed to vote on a draft plan which would be submitted to the court. If the plan adopted by the court was not carried out, it would be terminated, which would lead to winding-up under the supervision of the court. This was the procedure used to rescue the Eurotunnel company.

(iv) Administration

Going into administration assumed that the debtor had ceased payments, and was a procedure very similar to that existing under the 1985 Act. It began with an observation period which would make it possible to take stock of the situation of the business. A plan for settling liabilities would be drawn up if the situation so permitted.¹⁸

An administrator could be appointed either to assist the debtor (legal documents had to be signed by the debtor and the administrator) or to act in his place and on his behalf. The purpose of the resulting restructuring plan was the same as that of the safeguard plan. If the plan was not carried out, this likewise led to winding-up.

(v) Winding-up

The purpose was simple: to realise the debtor's assets in the best interests of the creditors. Here, the debtor was necessarily relieved of the management of the business, which is entrusted to a liquidator. The assets would be sold separately or form part of a comprehensive transfer plan which enabled the business to be sold to a purchaser. Unlike the arrangement in the 1985 Act, which characterised the transfer as a means of recovery, the

¹⁷ See the report by MP Clément, which can be found on the National Assembly site: MP Clément 'Rapport D'Information sur la réforme du droit des sociétés—traitement des entreprises en difficulté', www.assemblee-nationale.fr/12/rap-info/i2094.asp#P123-13279, accessed 9 July 2008.

¹⁸ The plan is drawn up in accordance with the same rules as those for the safeguard plan.

Act of 2005 classified it among the winding-up procedures. In actual fact, once the assets were sold, it only remained to distribute the proceeds among the creditors.

(i) Reform of the 2005 Act¹⁹

Although this Act only recently came into force, the Ministry of Finance has drawn up a draft ordinance to amend it. The objective is not to change its general structure, but rather to make it more flexible and clear up some uncertainties revealed by the early cases. The titles of the chapters of the ordinance clearly demonstrate that the general principles of the 2005 proceedings have been retained: improvement of conciliation, advantages of the safeguard procedure, improvement of winding-up, etc. A few general rules of the draft may be highlighted:²⁰

- Greater powers for the prosecuting authorities²¹ in two matters: the appointment of the bodies constituted in the proceedings and remedies against decisions made during the proceedings. Insolvency proceedings sometimes give rise to questionable practices and the intervention of a judge with the duty to point out how the law should be properly applied is no doubt a good thing. However, there is probably some wishful thinking in this well-intentioned reform—after all, the public prosecutor has been able to act in the commercial courts²² since 1981 without the questionable practices having been curbed. This may be explained by two things, among others: firstly, the public prosecutor, rightly, gives priority to criminal matters, so that civil and commercial matters take second place; and secondly, the ideal, so to speak, of rescuing the business allows the rules to be bent where a solution appears to be satisfactory in economic terms.
- Greater flexibility in the safeguard rules creates a greater distinction between safeguard proceedings and going into administration. For example, no reference is now made to the possible suspension of payments—the opening of safeguard proceedings only requires the debtor to ‘provide proof of difficulties which he cannot overcome’. In the same vein, certain measures traditionally connected with the opening of insolvency proceedings have been abolished (replacement

¹⁹ Brief bibliography on the reform of the 2005 Act: G Teboul, ‘La nouvelle réforme du droit des entreprises en difficulté: le projet d’ordonnance’ [2008] *Gazette du Palais* 6–8 April; C Saint-Alary-Houin and H Monsérie-Bon, ‘La loi de sauvegarde des entreprises: nécessité et intérêt d’une réforme annoncée’ (2008) 14 *Recueil Dalloz* 941; see an opinion of the Paris Chamber of Commerce and Industry ‘Projet de Reforme de la Loi de Sauvegarde des Entreprises, Contribution de la CCIP’, www.etudes.ccip.fr/archrap/pdf08/projet-reforme-loi-de-sauvegarde-des-entreprises-0802.pdf, accessed 9 July 2008.

²⁰ Other changes relating to the comments following this brief history will be mentioned in the appropriate places.

of one or more company directors, declaration of non-transferability of shareholders' rights or, on the contrary, compulsory transfer). Finally, the sale of the business outright could take place within the safeguard proceedings.²³

- The ordinance gives details of the procedural rules for the committees set up by the 2005 Act.
- The ordinance amplifies the definition of suspension of payments by stating that: 'a debtor who shows that his credit reserves or the moratoriums granted to him by creditors enable him to meet the liabilities due and payable with his available assets is not in suspension of payments'.
- The ordinance strengthens the rights of two categories of creditors: henceforward the rights of creditors who are beneficiaries of a *fiducie*²⁴ will be protected in the proceedings, and furthermore the measure amends the Civil Code to give a right of retention to creditors holding a charge without dispossession.²⁵

Following this general outline, more detailed comments are given below on certain points necessary for a proper understanding of the various papers. The first section relates to debtors, the second to creditors.

II. DEBTORS

(a) A Scope of Insolvency Proceedings

(i) Gradual Extension of Insolvency Proceedings to All Economic Activities

The scope of application of insolvency proceedings has been constantly extended since the Commercial Code. At that time insolvency applied only to traders, ie persons carrying out acts of commerce on a habitual basis, whether natural persons, partnerships or companies. Examples of acts of commerce include: purchase for resale, banking operations and everything involving maritime commerce. However, a good deal of economic activity was not commercial. Two important sectors in the 19th-century economy thus avoided that description: agriculture, whatever the size of the business

²¹ Judicial officers of the prosecuting authorities do not judge the case. They are responsible for making whatever submissions are required by the general interest in the particular case.

²² Insolvency proceedings take place in the commercial court.

²³ In so far as a business in safeguard proceedings is now subject to lighter supervision, the possibility of outright sale introduces an arrangement rather similar to the 'pre-packs' described by Frisby at ch 3.

²⁴ Transfer of title as security.

²⁵ This amendment was introduced in Act no 0181 dated 4 August 2008, 'Loi de modernisation de l'économie', which modified art 2286 of the Civil Code.

and the form in which it was carried on; and building construction operations.

The first extension of insolvency law was to result from the Act of 1 August 1893, which made *sociétés par actions* (public companies and limited partnerships with share capital²⁶) subject to ‘the laws and usages of commerce’, even if they had a civil object, eg agriculture. The same rule was adopted by the Act of 7 March 1925, which introduced in French law the *société à responsabilité limitée* (private company).²⁷

In 1967 insolvency proceedings were extended to ‘all private-law legal persons’. Consequently non-commercial companies²⁸ and associations could now be put into administration or winding-up under the supervision of the court. The 1985 Act extended administration and winding-up to artisans and an Act of 30 December 1985 extended them to agricultural enterprises.

Insolvency proceedings were extended to all economic activities by the 2005 Act, which is applicable to ‘all natural persons pursuing a self-employed activity’ (article L620-2).

(ii) Over-indebtedness of Individuals

At the same time the legislature introduced specific proceedings for dealing with the difficulties of individuals by an Act of 31 December 1989, which has since been revised on a number of occasions. These provisions appear in articles L330-1 *et seq* of the Consumer Code.²⁹ Their main purpose is to make it possible to reschedule the debts and, possibly, to gain rebates from the creditors. However, in the most difficult cases, it enables the liabilities of over-indebted debtors to be discharged (the so-called ‘personal recovery’ proceedings).

Therefore insolvency proceedings now have the broadest possible scope: any person in difficulty may find himself subject to them, with different rules depending on whether the debts are connected with professional activity or not.

(b) Personal Situation of Directors

For a long time acting as a director of a company made it possible to avoid the hardship of insolvency. The directors of public and private companies

²⁶ For a long time large businesses took the form of *sociétés en commandite par actions*, because until the Act of 24 July 1867, public companies could not be formed freely. After that Act, most companies took the form of public companies.

²⁷ These companies are therefore described as *commercial in form*.

²⁸ Particularly non-commercial professional companies.

²⁹ This code has also been translated into English and the text can be found at www.legifrance.gouv.fr.

did not have the status of traders and their liability was limited to the contributions they had made when the company was formed. Although their company could be made insolvent, they themselves could not, and this gave rise to the misuse of legal personality. An Act of 1935 remedied these abuses by penalising the use of legal personality for personal ends. An Act of 16 November 1940 on public companies provided for an action against the directors for an order to pay all or part of the company's debts. This measure was extended to private companies by the Act of 9 August 1953.

This 'action to make good the liabilities' has now become a civil action for insufficiency of assets (article L651-2 *et seq* of the *Commercial Code*). It is brought in the case of winding-up or where a safeguard or restructuring plan is set aside, and presupposes the existence of 'management faults' resulting in insufficiency of assets.³⁰ Where these conditions are fulfilled, the court may order the offending directors to make good all or part of the insufficiency. The sums paid are distributed among the creditors *au marc le franc*, ie all creditors are treated on an equal footing, irrespective of the securities which some of them may hold.

In addition to this action for faults of management, article L652-1 provides that the directors are liable for the company's debts in certain specifically listed cases which constitute misuse of legal personality or fraud on creditors' rights: disposing of the company's property as if it were their own, using the company to carry out acts of commerce in their personal interest, using the company's property or credit for personal ends, trading at a loss in their personal interest, and finally, concealing all or part of the assets or fraudulently increasing the liabilities. This action precludes the foregoing civil action for insufficiency of assets.

The draft reform of the 2005 Act affects these provisions in two areas. First, it will be possible to bring the civil action for insufficiency of assets only in the case of winding-up and not, as at present (see above) where the safeguard or restructuring plan is set aside. Secondly, the distribution of the sums obtained as a result of the directors being ordered to pay the company's debts, which at present must be made 'according to the ranking of securities' (article L652-3 of the *Commercial Code*), would have to be *au marc le franc*, as in the case of an order arising from insufficiency of assets.

³⁰ The insufficiency is measured only in relation to the liabilities prior to the opening of the proceedings.

³¹ Which explains why it does not arise in safeguard proceedings.

III. CREDITORS

(a) The Suspect Period

The history of insolvency shows that the fear has always been that the debtor, sensing impending difficulties, is becoming insolvent fraudulently or is favouring certain debtors to the detriment of the others, thus violating the principle of equality among them all, at least in so far as ordinary creditors are concerned. The court may therefore set a 'suspect period' prior to the opening of proceedings, which will allow certain acts of the debtor or the creditors to be reviewed and voided as the case may be. This arrangement is necessarily connected with the suspension of payments.³¹ When the court opens administration or winding-up proceedings, it must fix the date of suspension of payments without going back more than 18 months before the judgment opening the proceedings (article L631-8). The suspect period is that running from the date of suspension of payments to the date of the judgment.

Certain acts during that period are void as of right because they are deemed to be fraudulent in themselves. The court has no power of assessment. This applies to acts without consideration, one-sided contracts, payment of debts not due, payments made by unusual means,³² securities given to cover a pre-existing debt, or protective measures taken by a creditor.

Other acts are subject to optional avoidance. If the conditions are fulfilled, the judge retains a power of assessment. The most frequent situation is where contracts are concluded or payment received *in the knowledge of the suspension of payments*. While such acts are not open to criticism objectively, they may be so subjectively if it is proven that they were done in full knowledge of the suspension of payments.

(b) Classes of Creditors

In insolvency law it is customary to distinguish creditors according to their ranking. These rankings, while essential in the past, may now be wholly or partly irrelevant, but it is still useful to have a general overview.

(i) *Prior and Subsequent Creditors*

A traditional distinction is made between creditors whose rights originated prior to the opening of insolvency proceedings and those whose rights

³² Eg accord and satisfaction, where the debtor obtains discharge by transferring the title to goods.

originated after the judgment. Until the Act of 26 July 2005, only the so-called prior creditors were subject to the constraints of the proceedings. Until the 1985 Act they were grouped together in the general body of creditors—an entity that was a legal person, which made it possible to treat them all in the same way. For example, a security for a prior claim registered before the proceedings opened was not effective³³ with respect to the general body of creditors, ie all the prior creditors, despite the fact that the ordinary rules could have imposed distinctions between creditors. The 1985 Act dropped the technique of grouping the creditors into a legal person. The result of this was that the penalty for fraudulent acts was changed, and these acts, which during the suspect period had been valid with respect to the debtors but had been without effect with respect to the general body of creditors, were now voided.

To share in distributions,³⁴ prior creditors were required to declare their claims³⁵ within strict time limits. Declaration was also a technical requirement for the business liabilities to be known. Individual actions by creditors were stayed; after the judgment no individual proceedings for payment purposes could be brought.³⁶

On the other hand, subsequent creditors, ie those whose claims originated after the judgment opening the proceedings, retained their rights as if the debtor were *in bonis*. The reason for this was simple: rescue of the business could not be contemplated if trading could not be financed after proceedings were opened, and a lender could only contemplate financing it if he had a guarantee or security, which in this case was the possibility of being paid *before the prior creditors*.³⁷ The Cour de Cassation has stated on several occasions that subsequent creditors can bring proceedings in respect of all the debtor's assets and, for example, has held that it was possible to seize the proceeds of sale of the business for the payment of taxes levied on trading profits arising after the judgment opening the insolvency proceedings.³⁸

This distinction was partly undermined by the Act of 26 July 2005. The aforementioned guarantee was now available only to creditors who *stricto sensu* financed the activity of the business.³⁹ The subsequent creditors were

³³ An ineffective act is one which, although intrinsically valid, cannot be pleaded in relations with a person or class of persons whom the law aims to protect. Consequently the ineffectiveness of a mortgage means that the creditor is treated 'as if' the mortgage did not exist.

³⁴ Under the 1985 Act, the sanction was much more drastic: claims which were not declared within the time limits were extinguished. This had radical consequences with regard to guarantees (see Leveneux, ch 9 below).

³⁵ Traditionally, French law sees the declaration as an application to take part in the payment operations.

³⁶ With the exception of maintenance creditors.

³⁷ Regarding these reasons, see eg C Saint-Alary-Houin, *Droit des entreprises en difficulté* (Paris, Précis Domat Editions Montchrestien 2006) nos 47–8.

³⁸ Com 8 December 1998, judgment no 95-15460 (as to unpublished decisions, using the number of the case is the easiest way to find the decision on the Legifrance website).

³⁹ See the presentation by Pierre Crocq, para 11.

more or less subject to the constraints of the proceedings. In particular, they had to declare their claims if they wished to share in distributions.

(ii) *Secured and Unsecured Creditors*

The distinction between secured and unsecured creditors was fundamental until the 1967 Act. In actual fact, the constraints of insolvency proceedings applied only to ordinary prior creditors. Secured creditors escaped them. Consequently they remained free to have the charged assets sold, as if the insolvency proceedings had not existed.

However, there were two major exceptions to this rule. Firstly, a supplier of movables could not benefit from the security if he had delivered the goods sold. Due to this, some suppliers had the idea of inserting a retention-of-title clause in their contracts which operated until the price had been paid. The Cour de Cassation vitiated this clause by finding that it could not be pleaded in insolvency proceedings to the detriment of the general body of creditors.⁴⁰ This situation persisted until the Act of 10 May 1980, which restored the effectiveness of the retention of title clause. Secondly, the legislature⁴¹ reduced the security (which was in fact excessive) that the Civil Code had granted to owners of business premises⁴² because the latter were needed for running the business.

After the 1967 Act came into force, it was interpreted by the Cour de Cassation in a manner unfavourable to secured creditors, who found themselves subject to the same rules as ordinary creditors. Accordingly they were required to submit their claims for verification by the insolvency judge and were subjected to the rule staying individual actions. The application of collective discipline to secured creditors is still today the general principle,⁴³ at least where the recovery of the business can be envisaged. It seemed to Parliament that it was legitimate—temporarily, it hoped—to sacrifice the interests of secured creditors. On the other hand, there was no reason for doing so if the business was bound to fail. That is why the Act of 10 June 1994 restored to a certain degree the effectiveness of security for prior claims where the business was to be wound up.

The draft provisions in respect of safeguard also improve the situation of certain creditors. Firstly, a creditor who is a beneficiary of a *fiducie* will be better protected against the risks of insolvency proceedings while remaining subject to certain essential rules—eg a *fiducie* set up in the suspect period to

⁴⁰ Because the creditors were right to think that movables in the debtor's possession belonged to them.

⁴¹ Act of 12 February 1872.

⁴² If the lease had a fixed date, the owner could obtain payment *on a preferential basis* of all the rents to fall due (Cass Civ 28 March 1865, S 1865, I 201; D 1865, I, 201).

⁴³ For secured creditors with a registered security, the time limit for a declaration of claim runs from the date of the notice which must be sent to them (art L622-24 of the Commercial Code).

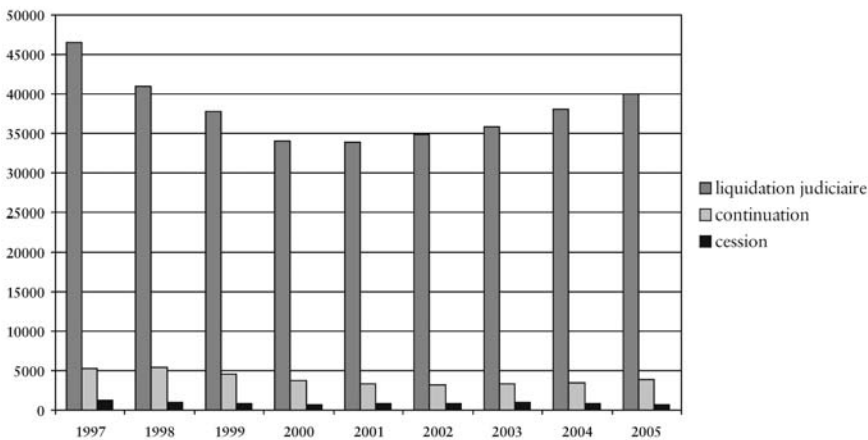


Figure 1. Trends in the numbers of insolvency proceedings. *Source:* the statistics of justice for 2003–7.

secure debts originating earlier will be voided. Secondly, the draft ordinance confers a right of retention on all holders of charges without dispossession. Institutional creditors will certainly be pleased at this upgrading of their rights since they would find themselves with an exclusive right of retention or property right immune to the requirements of the insolvency proceedings. That being said, a legislator who promotes a right of retention or a property right only after doing its best to deprive conventional security of any effect can hardly be congratulated . . .

(iii) Situation of Employees

The old article 2101-4⁴⁴ of the Civil Code gave ‘people in service’ a preferential right to their wages due for the past year and what was due for the current year. Because of the strict interpretation of ‘preferential right’, special acts were needed for ‘workers and subordinates’, whom we would today refer to as employees, to receive the benefit thereof (Act of 28 May 1838, later the Act of 4 March 1889). Today, this right guarantees pay for the last six months and certain allowances. However, to strengthen employees’ rights in insolvency proceedings, Parliament introduced special guarantees in their favour. In 1935 it introduced a salary guarantee known as ‘*superprivilège*’ because it enables employees to be paid, within certain limits, before all other creditors.⁴⁵ The fact remains that a priority is really effective only if the business still has liquid funds. The bankruptcy of LIP,

⁴⁴ Now art 2331.

⁴⁵ See arts L622-17 and 641-13-III of the Commercial Code.

the last French watchmaker, at the beginning of the 1970s shows that the best guarantees are worthless if the coffers are empty. It is true that the situation of LIP's employees, which was much discussed in the media, led Parliament to set up an insurance scheme financed by employers' contributions, known as *assurance générale des salaires* (AGS).⁴⁶ If a business does not have sufficient funds to pay employees, the amounts due will be advanced by the AGS and then recovered when distributions are made.

⁴⁶ Act of 27 December 1973. See the provisions in the Employment Code, arts L143-II-1 *et seq.*

2

The Reforms of the Enterprise Act 2002 and the Floating Charge as a Security Device

LOUISE GULLIFER*

TWO YEARS AGO, the UK Government passed the Companies Act 2006, which introduced many reforms to English company law as well as reproducing existing law in one (very long) statute. Significant changes in corporate insolvency have been introduced by the Enterprise Act 2002, and by case-law. This chapter will focus on the current fate of the floating charge as a security device.

1. THE POSITION OF THE FLOATING CHARGE IN 2001

The floating charge¹ was initially developed in England² in the late 19th century as a way for lenders to take security over the whole undertaking of a company without paralysing the operation of that company.³ It was a

* A version of this paper was first presented at the 37th Workshop on Commercial and Consumer Law held at the University of Toronto on 18 and 20 October 2007 and subsequently published in the *Canadian Business Law Journal*, the editors of which have kindly given permission for publication in this volume.

¹ The security interest here discussed is referred to in this paper as a charge. It is, however, perfectly possible to have a floating (or fixed) equitable mortgage. The distinction between mortgages and charges in this regard is little discussed in the cases, and is of limited significance. In the Companies Act, the term 'charge' includes a 'mortgage' (Companies Act s 865).

² The law discussed is the law of England and Wales (the position in Scotland and Northern Ireland is different in some respects, although similar in others). For ease of reference, this chapter will refer to 'English law' and 'England'.

³ For accounts of the history of the floating charge in England, see RR Pennington, 'The Genesis of the Floating Charge' (1960) 23 *Modern Law Review* 630; RM Goode, 'The Exodus of the Floating Charge' in D Feldman and F Meisel (eds), *Corporate and Commercial Law: Modern Developments* (London, LLP Professional Publishing, 1996); R Gregory and P Walton, 'Fixed and Floating Charges—A Revelation' (2000) *Lloyd's Maritime & Commercial Law Quarterly* 123; H Beale, M Bridge, L Gullifer and E Lomnicka, *The Law of Personal Property Security* (Oxford, Oxford University Press, 2007) 4.42–4.

device combining two important features: both present and future property could be used as security without any further action, and the chargor could dispose of the charged assets without the consent of the chargee. The floating nature of the charge came to an end on crystallisation, which occurred on liquidation, on the appointment of a receiver and on cessation of business. On crystallisation, a charge ceased to float and became a fixed charge, so that the assets could no longer be disposed of, and the chargee could enforce its security.

The fact that a floating charge could easily be taken over all the assets of a company meant that, on enforcement, a chargee was in a position to appropriate all the assets of the company which were not the subject of specific mortgages or charges, to the payment of the company's indebtedness to it. This draconian nature of the floating charge, especially vis-à-vis unsecured creditors, has meant that legislative attempts have been made over the years to decrease its effect. As long ago as 1897, priority over a floating chargee (but not a fixed chargee) was given to some preferential creditors.⁴ Initially, this class comprised largely the employees of the company, on the grounds that floating charges were typically over raw materials and manufactured goods of the company, which benefited from the efforts of the workforce, and it was therefore unfair that a secured creditor should have priority over the claims of employees,⁵ but also included the Crown in relation to various taxes.⁶ Thus by 2001, the following preferential creditors had priority over a floating chargee: sums due from the company to the Inland Revenue in respect of deductions of income tax which were made or should have been made from employees' pay; VAT and other customs duties payable by the company; contributions in relation to National Insurance and occupational pensions; employees' remuneration;⁷ and other statutory payments due to employees.⁸ Further, the statutory provisions on the payment of liquidator's expenses⁹ were interpreted in *Re Barleycorn Ltd*¹⁰ to mean that such costs were to be paid out of floating-charge assets, in priority to the floating chargee.¹¹

⁴ Those classes of unsecured creditors who were paid in preference to all other unsecured creditors—Preferential Payments in Bankruptcy Act 1897 s 10. For further discussion see text below at nn 73–87.

⁵ Parliamentary debates in relation to the 1897 legislation, in particular HC Deb 10 February 1897 cols 72–3, Mr George Kemp, and see R Goode, *Principles of Corporate Insolvency Law* (3rd edn, London, Sweet & Maxwell, 2005) 208–9.

⁶ See below, pp 27–8. See also A Keay and P Walton, 'The Preferential Debt Regime in Liquidation Law: In the Public Interest?' (1999) 3 *Company Financial and Insolvency Law Review* 84. The category of preferential debts was reduced in the Insolvency Act 1986 so that it only covered taxes which were collected by the company on behalf of the Revenue, which are those listed in the text.

⁷ See n 84 below.

⁸ Insolvency Act 1986 sch 6.

⁹ Now Insolvency Act 1986 s 115

¹⁰ *Re Barleycorn Ltd* [1970] Ch 465 (CA)

¹¹ For further discussion see below, pp 29–37.

Other provisions had also been introduced to protect unsecured and other secured creditors from the floating charge. In 1900 floating charges became registrable in the register of Company Charges.¹² Floating charges created within one year of the onset of insolvency are invalid if not granted for new value.¹³

Another advantage of the floating charge was the ability of the chargee to appoint a receiver to realise the charged assets for the benefit of the chargee.¹⁴ Since the charged assets amounted to the entire undertaking of the company, a receiver appointed by a floating chargee usually operated by managing the business in a way that would best maximise the floating chargee's recovery.¹⁵ A receiver appointed by a floating chargee over the whole of a company's property was called an administrative receiver by section 29(2) Insolvency Act 1986.¹⁶ Before 1986, the only form of formal collective insolvency proceedings in England was liquidation (either compulsory or voluntary): liquidation would usually follow administrative receivership. However, the Insolvency Act 1986 introduced administration in order to promote corporate rescue. An administrator was a court-appointed officer, whose tenure had four statutory purposes:¹⁷ the survival of the company and/or its businesses; approval of a voluntary arrangement; entering into a compromise or scheme of arrangement with the company's creditors; or the more advantageous realisation of assets than on a winding up. The administrator had to nominate which purpose he was going to pursue before the company entered into administration. Administration was considered an alternative procedure to the appointment of an administrative receiver: a floating chargee with the ability to appoint an administrative receiver was able to veto the appointment of an administrator.¹⁸ Many did so, as administration was disadvantageous to a floating chargee in a number of ways. First, the administrator's primary duty was to all the creditors and not just the floating chargee.¹⁹ Second, the costs of the administration were paid out of assets subject to the floating charge in

¹² Companies Act 1900 s 14. Not all security interests, or even all charges, are registrable in England. Proposals to rationalise the registration system were made by the Law Commission of England and Wales in 2005 but have not yet been enacted.

¹³ S 245 Insolvency Act 1986

¹⁴ Where a mortgage or charge is made by deed, the mortgagee or chargee has the right to appoint a receiver of the income of the mortgaged property, s 101(1)(iii) Law of Property Act 1925, but since the exercise of the statutory power is limited, a charge agreement normally includes a much wider express power to appoint. A mortgagee or chargee also has the right to apply to the court for the appointment of a receiver, but this power is rarely used.

¹⁵ In theory the receiver is the agent of the company (s 109(2) Law of Property Act 1925 in relation to receivers appointed under the statutory power, s 44 Insolvency Act 1986 as regards an administrative receiver), but his primary duty is to the chargee who appointed him to realise the company's property for his benefit.

¹⁶ Previously called a receiver and manager.

¹⁷ S 8 Insolvency Act 1986.

¹⁸ See further text at nn 28–30 below.

¹⁹ *Re Charnley Davies Ltd (No 2)* [1990] BCLC 760 (Ch).

priority to the floating chargee.²⁰ Third, the administrator had the power to dispose of assets subject to a floating charge without the leave of the court.²¹ Disposition of all other assets, including those subject to a fixed charge, required leave.

By 2001, a floating chargee had little advantage in terms of priority, given the large number of claims which had statutory priority over it.²² The ability of a floating chargee to protect itself against the priority of subsequent secured creditors was also limited. Although a floating chargee could include a negative pledge clause in the charge agreement, prohibiting the subsequent grant of security ranking in priority to the floating chargee, such a term was not binding on a third-party secured creditor unless it had notice of it, and registration of the charge document did not constitute constructive notice.²³ The ability of the chargor to dispose of the assets, though in some ways a virtue of the floating charge, also weakened the security. The only weapon available to the chargee to prevent disposal was to crystallise the charge: however, not only could this be seen as overkill as it potentially had the effect of paralysing the business, it was not necessarily very effective in that the chargor would still have apparent authority to make dispositions, so unless a third-party disponee had notice of the crystallisation he would take free of the crystallised charge.²⁴ Another benefit of crystallisation, namely that if the floating charge crystallised before the onset of insolvency, the statutory provisions described above did not apply, was removed in 1985 by what soon became section 251 Insolvency Act 1986, which provided that a floating charge, for the purposes of the legislation, was a charge which was a floating charge as created. The only significant benefit of crystallisation which remained was that it was effective in achieving priority for the floating chargee against unsecured

²⁰ Insolvency Act 1986 ss 15(1) and 19(4), now Insolvency Act 1986 sch B1 paras 70 and 99. This was also true of the costs of a liquidation until *Buchler v Talbot*, see text at nn 98–9 below.

²¹ Subject to the chargee's priority being transferred to the proceeds acquired from the disposition of the charged property. Insolvency Act 1986 s 15, now Insolvency Act 1986 sch B1 para 70.

²² Floating chargees did, of course, recover in situations where there were sufficient assets to pay all other secured creditors, the preferential creditors and the costs as well as the floating chargee, but these situations were relatively rare.

²³ *English and Scottish Mercantile Investment Co v Brunton* [1892] 2 QB 700 (CA); *Re Castell & Brown Ltd* [1898] 1 Ch 315 (Ch); *Re Standard Rotary Machine Co Ltd* (1906) 95 LT 829 (Ch); *Welch v Bowmaker (Ireland) Ltd* [1980] IR 251 (Ir SC). A sensible fixed chargee, however, on seeing a prior registered floating charge, would make enquiries of the floating chargee and, on discovering the negative pledge clause, would come to an arrangement with the floating chargee. It is thought that this is the reason why there are few cases on this particular point, although for a recent case see *ABN Amro Bank NV v Chiyu Banking Corp Ltd* [2001] 2 HKLRD 175 (HK HC).

²⁴ See RM Goode, *Legal Problems of Credit and Security* (3rd edn, London, Sweet & Maxwell, 2003) 146–7; G Lightman and G Moss, *The Law of Receivers and Administrators of Companies* (3rd edn, London, Sweet & Maxwell, 2000) 3-081–3. There is little English authority on this point, but see *Fire Nymph Products Ltd v Heating Centre Property Ltd* (1992) 7 ACSR 365 (SC NSW) 374.

creditors levying execution,²⁵ and, to some extent, against landlords levying distress for rent and councils executing distress for rates.²⁶

Secured creditors therefore attempted to take fixed security over as many of the company's assets as they could. The relatively wide interpretation given by the courts in the 1980s and 1990s as to what constituted a fixed charge²⁷ meant that it was possible to take a fixed charge over nearly all a company's assets. However, lenders still took a floating charge over any residual assets, both to mop up any priority advantages, and also to enable the lender to appoint an administrative receiver and to veto the appointment of an administrator, sometimes known as a 'lightweight' floating charge.²⁸

Some saw the ability to appoint an administrative receiver and to veto the appointment of an administrator as the chief, and maybe the only, benefit of the floating charge;²⁹ by 2001 the concept was deemed to have outlived its usefulness and be ripe for abolition.³⁰ The effect of the various developments since 2001 may be to reinforce this view. It is now proposed to discuss these developments both in relation to the floating charge itself and to the insolvency procedures in which the floating chargee has hitherto played such a significant role.

II. THE ENTERPRISE ACT 2002

This Act contained, inter alia, very important reforms in two areas: administrative receivership and administration; and the priority of preferential creditors over a floating chargee.

(a) Administrative Receivership and Administration

Section 248 of the Enterprise Act replaced the existing provisions on administration in the Insolvency Act 1986 with a whole new code in Schedule B1 of that Act. The ability of a floating charge holder to appoint an administrative receiver was abolished: instead the floating charge holder

²⁵ Provided that the charge crystallised before execution was completed, *Re Standard Manufacturing Company* [1891] 1 Ch 627 (Ch) 639–41; *Re Opera Ltd* [1891] 3 Ch 260 (Ch); *Taunton v Sheriff of Warwickshire* [1895] 2 Ch 319 (Ch) 323; *Evans v Rival Granite Quarries Ltd* [1910] 2 KB 979 (CA).

²⁶ *Re ELS Ltd* [1995] Ch 11 (Ch).

²⁷ Discussed below pp 37–43.

²⁸ It was possible to have a valid floating charge for these purposes even though all the company's assets fell within a fixed charge, *Re Croftbell Ltd* [1990] BCLC 844 (Ch).

²⁹ R Mokal, *Corporate Insolvency Law: Theory and Application* (Oxford University Press, 2005) ch 6.

³⁰ R Goode, 'The Exodus of the Floating Charge' in D Feldman and F Meisel (eds) *Corporate and Commercial Law: Modern Developments* (London, LLP Professional Publishing, 1996) 193.

was given the power to appoint an administrator out of court.³¹ Directors of the company and the company itself also have this power,³² but all other creditors have to apply to the court for such an appointment.³³ The purposes of an administration were changed from the four described earlier,³⁴ so that the primary objective is now to rescue the company as a going concern. Only if that is not possible is the administrator's objective to achieve a better result for the company's creditors than would be possible in a winding-up, and only if that is not possible is the administrator to realise property to distribute to secured or preferential creditors.³⁵ The length of administration was previously unrestricted; now there are strict time limits (although these can be extended by application to the court)—in particular the length of an administration is limited.³⁶

The thinking behind these changes was to promote a 'rescue culture'.³⁷ The Government wanted to do two things: first, to enable more businesses to survive insolvency, whether through trading or reorganisation; and second, to create a more level playing-field between creditors in the course of insolvency proceedings. In relation to the first, there was concern that administrative receivers (and the floating chargees to which they owed their primary duty) had incentives which led them to act in ways which militated against the rescue of the business. First, a floating chargee could appoint an administrative receiver at the first sign of trouble: this sent out a signal to other creditors and trading partners which meant that they would then refuse to extend credit, which had the effect of reducing the value of the business.³⁸ Second, there was no incentive to sell the company's business as a going concern if sufficient value to reimburse the floating chargee could be obtained by a piecemeal sale of assets, which would usually be quicker and would involve the administrative receiver in less of a market judgment.³⁹ Third, an administrator can put proposals to creditors for a Company Voluntary Arrangement,⁴⁰ which is an important vehicle for corporate restructuring in English law.

It can be strongly argued that what is important is rescuing the business

³¹ Insolvency Act 1986 sch B1 para 14. This only applied to floating charges created after the date this part of the Act came into force, namely 15 September 2003.

³² Insolvency Act 1986 sch B1 para 22. The holder of a floating charge can, however, veto an appointment by the company or directors and appoint its own choice of administrator (para 36).

³³ Insolvency Act 1986 sch B1 para 12.

³⁴ See text at n 17 above.

³⁵ Insolvency Act 1986 sch B1 para 3(1).

³⁶ Insolvency Act 1986 sch B1 para 76. The period of administration can be extended for any specified period by the court, and for six months by consent.

³⁷ Secretary of State for Trade and Industry 'Insolvency—A Second Chance' (Cm 5234, 2001) para 2.1.

³⁸ R Stevens, 'Security after the Enterprise Act' in J Getzler and J Payne (eds), *Company Charges: Spectrum and Beyond* (Oxford University Press, 2006) 158.

³⁹ Mokal, above n 29, 212, n 108.

⁴⁰ Insolvency Act 1986 sch B1 para 49(3).

rather than the company, since this protects the human capital and goodwill, while the company is a mere shell.⁴¹ Administrative receivership was a reasonable vehicle for rescuing a business, in that in many cases the business was sold as a going concern⁴² (although in other cases the assets would have been sold piecemeal, thus destroying the business⁴³) but was not appropriate to rescue the corporate structure. This had to be done through a reorganisation for which administration is appropriate. Corporate rescue is particularly beneficial to management and shareholders (in smaller companies these are often the same people) and so the reforms are said to give an incentive to directors to take action early enough to enable rescue.⁴⁴ Further, corporate rescue reduces the number of liquidations, which improves the Government's insolvency figures.⁴⁵ However, research carried out since the Enterprise Act throws doubt on whether the new system has improved the number of corporate rescues, and the number of business rescues may indeed have declined.⁴⁶

In relation to the creation of a more level playing-field between creditors, it was felt that the insolvency officer should have more incentive to take account of the interests of all the creditors. The duties of an administrative receiver to the chargor, and the other creditors, are very limited. The primary duty of the receiver is to the chargee, and the receiver manages the property for the benefit of the chargee.⁴⁷ In relation to the sale of the charged property, the receiver owes the same duties to the chargor and other creditors as a mortgagee in possession, which means that the receiver can choose when and whether to sell, and does not have to spend time, money or effort in improving the asset so as to obtain a better price.⁴⁸

⁴¹ Stevens, above n 38, 155.

⁴² S Frisby, 'Not Quite Warp Factor 2 Yet? The Enterprise Act and Corporate Insolvency' (2007) 7 *Journal of International Banking & Financial Law* 398.

⁴³ An administrative receiver would sell the assets on this basis either where such a sale would yield more than a sale of the business as a going concern, or where the floating chargee was oversecured, so that there was no incentive to maximise value (see Mokai, above n 29, 213).

⁴⁴ Mokai, above n 29, 212.

⁴⁵ Stevens, above n 38, 156.

⁴⁶ Frisby, above n 42, and S Frisby, 'Report on Insolvency Outcomes', Report to Insolvency Service, 26 June 2006, <http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/research/corpdocs/Insolvency>

⁴⁷ *Re B Johnson & Co (Builders) Ltd* [1955] Ch 634 (Ch) 646 aff'd in *Medforth v Blake* [2000] Ch 86 (Ch) 95–6.

⁴⁸ *Silven Properties Ltd v Royal Bank of Scotland plc* [2004] 1 WLR 997 (CA). In that case, Lightman J set out the duties of a mortgagee as follows (at para 20): 'A mortgagee is entitled to sell the property in the condition in which it stands without investing money or time in increasing its likely sale value. He is entitled to discontinue efforts already undertaken to increase their likely sale value in favour of such a sale.' See also *Meftah v Lloyds TSB Bank plc* [2001] 2 All ER (Comm) 741 (Ch) 744, 766, per Lawrence Collins J; *Garland v Ralph Pay & Ransom* [1984] 2 EGLR 147 (Ch) 151, per Nicholls J; *Routestone Ltd v Minorities Finance Ltd* [1997] BCC 180 (Ch) 195–, per Jacob J. By contrast, an administrator, even under the 1986 Act, has been held to be under a duty to take care in relation to the timing of the sale of the charged property, *re Charnley Davies Ltd* (No 2), above n 19.

The fact that an administrative (or any kind of) receiver owed very limited duties to other creditors also concerned the Government more generally.⁴⁹ There had been extensive and recent case-law on the duties of a receiver,⁵⁰ but the position remained that, except for rather ill-defined duties in relation to the management of the charged property and the actual sale of property,⁵¹ the receiver is free to pursue the interests of the chargee. Despite academic calls for reform⁵² there had been no real consideration of this by the UK Government, unlike in other Commonwealth jurisdictions.⁵³ Some take the view that reform in this area would have been a better way of dealing with the perceived problem than abolishing administrative receivership altogether.⁵⁴

In contrast, an administrator owes a common law duty of care to the company,⁵⁵ so that, for example, the administrator is under a duty to take reasonable care both in obtaining a proper price for the sale of the company's property and also as to the timing of any such sale. Further, the administrator is constrained by the hierarchy of objectives mentioned above,⁵⁶ and unless he thinks that it is not reasonably practicable to achieve either of the first two objectives (in which case he must perform his functions merely in order to distribute to the secured creditors) he must perform his functions in the interests of the company's creditors as a whole.⁵⁷ Once an administrator is appointed there is a moratorium on the enforcement of security by secured creditors (which also applies to enforcement of hire purchase agreements and sales on retention of title terms).⁵⁸

In addition, in administration (as opposed to an administrative receivership) the unsecured creditors and secured creditors other than the floating charge holder have a voice.⁵⁹ An administrator must call an initial

⁴⁹ Secretary of State for Trade and Industry 'Insolvency—A Second Chance' (n 37) para 2.2.

⁵⁰ *Medforth v Blake* (n 47) 95–6; *Silven Properties Ltd v Royal Bank of Scotland plc*, above n 48.

⁵¹ The duty in these areas is a combination of a duty to act in good faith and a flexible equitable duty of care (while not acting against the interests of the chargee). The fact that the receiver is under such a duty when managing the assets is a perverse incentive not to manage them at all.

⁵² Goode, above n 5, 284–5; P Omar, 'A Delicate Balance of Interests: The Power of Sale and the Duty to Maximise Asset Values' (2005) 69 *Conveyancer* 380, 399–400.

⁵³ Australia: Corporations Act 2001 ss 180–84, 420A; New Zealand Receiverships Act 1993 ss 18 and 19; Canadian Bankruptcy and Insolvency Act s 247.

⁵⁴ Stevens, above n 38.

⁵⁵ *Re Charnley Davies Ltd (No 2)*, above n 19. The company can therefore sue the administrator for breach of duty. In relation to an administrator appointed under the 1986 Insolvency Act, no duty of care is owed by the administrator to the unsecured creditors (as opposed to the company itself), *Kyrris v Oldham* [2004] 1 BCLC 305 (Ch) 331.

⁵⁶ See text at n 17 above.

⁵⁷ Insolvency Act 1986 sch B1 para 3(2)

⁵⁸ Insolvency Act 1986 sch B1 para 43. There is also an interim moratorium once an administration application has been made or a notice of intention to appoint an administrator out of court has been filed (para 44).

⁵⁹ Secretary of State for Trade and Industry 'Insolvency—A Second Chance', above n 37, para 2.3. The Government was particularly concerned that creditors did not have the chance to challenge the costs of an administrative receivership.

creditors' meeting which must approve his statement of proposals (which the meeting can modify if desired), and has to return to the meeting if he amends his proposals significantly.⁶⁰ However, the administrator is not obliged to call a meeting if there are sufficient funds in the company to pay all the creditors, or if there are not sufficient funds to pay any unsecured creditors except via the ring-fenced fund.⁶¹

One final concern of the UK Government was that the administrative receivership procedure was not compatible with international developments in insolvency law,⁶² which were based on the concept of a 'collective procedure' whereas administration was so compatible.⁶³

It is important to notice the limitations on this area of reform in the Enterprise Act. First, the new regime only applies to charges created after 15 September 2003: chargees whose charges were created before that date can still appoint an administrative receiver. It was thought that such chargees would want to use the old procedure, which was perceived to have advantages. However, perhaps surprisingly, recent evidence shows that since the Enterprise Act came into force the number of administrative receiverships has dropped and the number of administrations has risen to such a degree that it seems that administrators are being appointed even where a floating charge was created before 15 September 2003.⁶⁴ Second, there is nothing in the new legislation preventing the appointment of a receiver over part of the assets of the company by the holder of a charge covering just those assets.⁶⁵ There would be little advantage in such an appointment by the holder of a floating charge over part of the assets, since they would be unable to block the appointment of an administrator, and the administrator could dispose of the floating charge assets without the leave of the court. However, if a chargee had a fixed charge over part of the assets, it might be worth appointing a receiver under section 101 Law

⁶⁰ Insolvency Act 1986 sch B1 paras 50–58. The creditors can also demand a meeting at any time, or one can be ordered by the court. The meeting can establish a creditors' committee to which the administrator has to report.

⁶¹ Insolvency Act 1986 sch B1 para 52. However, creditors to whom is owed more than 10 per cent of the total debts owed by the company can call for a meeting (para 56). The provisions relating to the calling of meetings and voting are designed to ensure that those who have most to lose have a voice in the insolvency proceedings; see J Armour and R Mokal, 'Reforming the Governance of Corporate Rescue: The Enterprise Act 2002' [2004] *Lloyd's Maritime & Commercial Law Quarterly* 28.

⁶² Eg Council Regulation (EC) 1346/2000 on Insolvency Proceedings [2000] OJ L160/1.

⁶³ Secretary of State for Trade and Industry 'Insolvency—A Second Chance', above n 37, para 2.3.

⁶⁴ Department of Trade and Industry statistics. This is confirmed by a report by J Armour, A Hsu and A Walters, 'The Impact of the Enterprise Act 2002 on Realisations and Costs in Corporate Rescue Proceedings', Report to the Insolvency Service, December 2006, <http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/research/corpdocs/ImpactofEARReport.pdf>, accessed 9 July 2008, 16. The reason suggested is that unless the bank (holder of the floating charge) is under-secured, or there are obvious tax advantages, banks prefer to be seen to favour corporate rescue, and often encourage directors to make the appointment of the administrator themselves.

of Property Act 1925 or under an express power contained in the charge agreement.⁶⁶ This will not prevent the appointment of an administrator, but could enable a chargee to protect the assets pending administration and even (if the statutory limitations on the receiver's power of sale have been extended or replaced in the charge agreement) sell the charged assets before an administrator is appointed. Third, there are significant 'carve-outs' from the regime for capital and financial market arrangements, public-private partnerships and other project finance arrangements.⁶⁷ These carve-outs were the result of much lobbying by various interest groups, and the exact demarcation of the boundaries of the carve-outs have inevitably been the subject of comment and litigation.⁶⁸

What have been the effects of the Enterprise Act reforms so far? It is too early to come to any conclusions, but some preliminary studies have arrived at some tentative views. A study measuring realisations and costs in administrative receiverships and administrations has concluded that, though more assets are recovered in an administration than in an administrative receivership, the costs of the administration are commensurately higher, so that creditors are not necessarily significantly better off.⁶⁹ Other studies have shown that the advent of more administrations has not increased the incidence of either corporate or business rescue, so that asset sales are just as prevalent, although 'pre-pack' administrations, which have a higher incidence of business rescue (but a lower rate of recovery for unsecured creditors) are becoming more prevalent of late.⁷⁰ There does seem to be a change in relation to the choice of insolvency procedure: there is a marked increase in administrations even where the possibility of appointing an administrative receiver is still available, and there also has been a very marked shift from liquidations to administrations.⁷¹ In terms of recovery for creditors, there appears to be little or no difference in the recovery of

⁶⁵ An administrative receiver is a receiver appointed over the whole or substantially the whole assets of the company by the holder of a floating charge (s 251 Insolvency Act 1986 referring to s 29 of that Act). S 72A Insolvency Act 1986 (inserted by s 250 Enterprise Act 2002) prohibits the appointment of an administrative receiver by the holder of a qualifying floating charge (a charge which, alone or in combination with other charges, covers the whole or substantially the whole of the company's property).

⁶⁶ For further discussion, see V Finch, 'Reinvigorating Corporate Rescue' [2003] *Journal of Business Law* 526, 537 and Stevens, above n 38, 166–7.

⁶⁷ Ss 72B–72G Insolvency Act 1986 inserted by s 250 Enterprise Act 2002.

⁶⁸ Most notably in the case of *Cabvision Ltd v Feetum* [2005] EWCA 1601 (for comment see G Yeowart (2006) 5 *Journal of International Banking & Financial Law* 214), which clarified the meaning of s 72E in three regards: the term 'project' was not limited to construction or engineering projects, the requirement of a debt of £50m had to be a realistic expectation and not just a hope, and the requirement of 'step-in rights' was not fulfilled merely by a contractual power to appoint a receiver.

⁶⁹ Armour, Hsu and Walters, above n 64.

⁷⁰ S Frisby, 'Report on Insolvency Outcomes', above n 46.

⁷¹ A Katz and M Mumford, 'Study of Administration Cases' [2006] *Insolvency Intelligence* 97. This shift is bigger and earlier than might be explained just by the effect of *Buchler v Talbot*, see text at nn 98–9.

secured creditors between administration and administrative receivership.⁷² In relation to other creditors, it is too early to give a clear picture.

(b) Priority of Preferential and Other Creditors Over the Floating Charge

The UK Government followed what it saw as an international trend in abolishing Crown preference.⁷³ It is, in fact, the second stage, since preference in relation to taxes paid directly by companies was abolished in 1986, leaving preference merely for tax collected or withheld by the company from others (eg employees' income tax and VAT paid by customers).⁷⁴ The argument for preferential status for such claims by the Revenue is particularly strong, as, on one view, it is hard to see such money as the company's assets to which unsecured creditors should have a claim.⁷⁵ However, this preference has now been abolished, and the 'benefit' thereby accruing to the company is ring-fenced for the unsecured creditors. The mechanics of the fund are that a 'prescribed part' is taken out of assets subject to any floating charge created by the company.⁷⁶ The proportion is 50 per cent of the first £10,000 and 20 per cent of any assets above that figure, with a ceiling of £600,000 for the prescribed part.⁷⁷ On one view, the ring-fenced fund was a way of making sure that the floating chargee banks did not obtain a windfall by the abolition of Crown preference (as arguably, they had done when preference for direct taxes was abolished in 1986).⁷⁸ On

⁷² S Frisby, 'Interim Report to the Insolvency Service on Returns to Creditors from Pre- and Post-Enterprise Act Insolvency Procedures', 24 July 2007.

⁷³ Germany and Australia were countries which were cited as having done the same. In Australia, the first steps towards abolishing Crown preference (for direct taxes) were taken in 1981. Priority over other creditors for unremitted tax was abolished in 1993, interestingly at the same time as the introduction of an administration procedure as the primary insolvency vehicle. Claims by employees still have priority over assets subject to a floating charge (Corporations Act 2001, ss 433 and 561), and also, in a receivership, claims under insurance policies and certain auditor's expenses (s 433). All preferential claims were abolished in Germany by the introduction of the Insolvenzordnung of 5 October 1994 (BGBl I 2866) which came into force in 1994. However, Crown preference, at least in some form, is retained in New Zealand, Canada, USA, France, Mexico. For an overview, see B Morgan 'Should the Sovereign Be Paid First? A Comparative International Analysis of the Priority for Tax Claims in Bankruptcy' (2000) 74 *American Bankruptcy Law Journal* 461, 479–80.

⁷⁴ S386 and sch 6 Insolvency Act 1986.

⁷⁵ See the argument in the Report of the Review Committee on Insolvency Law and Practice, 1982, Cmnd 8558 ('The Cork Report') on which the Insolvency Act 1986 is based, para 1418 ('[In relation to such monies] the debtor is to be regarded as a tax collector rather than a taxpayer. Unless some measure of priority were accorded to the Crown for moneys collected on its behalf, or they were to be regarded as impressed with a trust, [the moneys] would go to swell the insolvent's estate to the advantage of the general body of creditors. We cannot think it right that statutory provisions enacted for the more convenient collection of the revenue should enure to the benefit of private creditors.')

⁷⁶ Enterprise Act s 252.

⁷⁷ The Insolvency Act 1986 (Prescribed Part) Order 2003. This has the effect that no deduction is made from floating charge assets over £2,985,000.

⁷⁸ Stevens, above n 38, 162.

another view, the abolition of Crown preference was a way of providing for the ring-fenced fund, which was a recommendation of the Cork Report in 1982.⁷⁹

There are three rather odd things about this reform. First, it can be argued that it will make very little difference indeed to the unsecured creditors. At best, and on the Government's own figures, it will yield about £100m extra for unsecured creditors each year.⁸⁰ Unsecured creditors, before the change comes into effect, recover about £2.1bn each year (about 7 pence in the pound). Adding an extra £100m will increase this to 7.4 pence, an increase of less than 1 per cent.⁸¹ Further, the Crown is now an unsecured creditor, and so debts owed to it will swell the claims on the ring-fenced fund. These figures are averages, and obviously there will be some insolvencies where the ring-fenced fund will make the difference between the unsecured creditors receiving nothing and receiving something. However, viewed in the light of the figures, the reform seems relatively modest in the benefits it will bring.⁸²

Second, the abolition of Crown preference took effect when the Enterprise Act came into force (15 September 2003) but the ring-fenced fund only applies to charges created after that date.⁸³ Thus existing charge holders are currently getting the best of both worlds (and the Revenue is relegated to being an unsecured creditor without the ability to claim from the ring-fenced fund, which gives an even stronger incentive to collect moneys as they become due.)

Third, preferential status has been retained for claims by employees. Direct claims against the employer are limited to £800 per employee.⁸⁴ However, on the insolvency of an employer, an employee can claim arrears of pay for up to eight weeks (at a maximum of £310 per week) from the

⁷⁹ Paras 1538–49. The stories as to the origins of this idea are various. It can be traced back to Lord Macnaughten's speech in *Salomon v Salomon & Co* [1897] AC 22 (HL) 53 when he said: 'I have long thought, and I believe some of your Lordships also think, that the ordinary trade creditors of a trading company ought to have a preferential claim on the assets in liquidation in respect of debts incurred within a limited time before the winding up.' Professor Roy Goode traces it back to a conversation he had with a member of the Cork Committee in the bar at St Pancras Station (Goode, above n 5, 166). A set-aside for unsecured creditors was proposed as an amendment to UCC Art 9 by Professor Elizabeth Warren, see E Warren, 'An Article 9 Set-Aside for Unsecured Creditors', (1997) 51 *Consumer Finance Law Quarterly Report* 323.

⁸⁰ On figures based on data collected between 2001 and 2004, the Crown has lost about £135m per annum (Frisby, above n 72). It is really too early to track the benefit to unsecured creditors as the ring-fenced fund only applies to charges created after 15 September 2003.

⁸¹ The calculations and the argument are taken from Mokai, above n 29, 129–30.

⁸² There are other possible effects of the abolition of Crown preference, such as that the Revenue will be more energetic in collecting moneys due to it immediately, which could have the effect of putting pressure on struggling companies who hitherto have operated using Revenue money, see Finch, above n 66, 539.

⁸³ This was because of concerns about the application of the Human Rights Act 1998.

⁸⁴ This relates to wages for four months before the date of administration or winding-up, with a maximum of £800, plus any accrued holiday pay within certain limits (Sch 6, Insolvency Act 1986).

Secretary of State.⁸⁵ The Secretary of State then has a subrogated claim against the employer, which ranks as a preferential claim.⁸⁶ Thus, although the Crown has given up preference in relation to its Revenue claims, it has retained it in relation to the scheme for enabling employees to be paid quickly rather than having to wait to claim in the insolvency.⁸⁷

III. COSTS OF LIQUIDATION

In addition to the changes in the order of priority brought about by the Enterprise Act, there have been interesting developments in the law relating to the priority of the costs of a liquidation. The position, which had been considered settled since 1970, was overturned by the House of Lords in 2004, and then statutorily reinstated in the Companies Act 2006 (after a great deal of lobbying and discussion on both sides by both lawyers and insolvency practitioners).

In the early 19th century, all unsecured creditors ranked equally, including the liquidator. In the Companies Act 1862, provision was made for the payment of liquidation costs in priority to all other claims.⁸⁸ In the Companies Act 1883, certain debts⁸⁹ were made 'preferential' so that they were to be paid 'in priority to other debts' '[i]n the distribution of the assets of any company being wound up'.⁹⁰ The class of preferential debts was extended in 1888 to include various taxes.⁹¹ In the same Act, provision was made for the priority of liquidation expenses over the preferential debts.⁹² It was clear at this point that, despite this section, chargees, including floating chargees, had priority over liquidation expenses and preferential creditors in relation to all assets covered by the charge.⁹³ Thus,

⁸⁵ Ss 182–6 Employment Rights Act 1996. The weekly limit is raised regularly: the current limit was imposed by SI 2006/3045 Art 3 sch para 7.

⁸⁶ S 189 Employment Rights Act 1996.

⁸⁷ The inconsistency between the treatment of subrogated employee claims and revenue claims has been pointed out by Mokal, above n 29, 131.

⁸⁸ In relation to a voluntary liquidation, s 144 provided that: 'All Costs, Charges, and Expenses properly incurred in the voluntary Winding-up of a Company, including the Remuneration of the Liquidators, shall be payable out of the Assets of the Company in priority to all other Claims', and in relation to winding-up by the court, s 110 provided that: 'The Court may, in the event of the Assets being insufficient to satisfy the Liabilities, make an Order as to the Payment out of the Estate of the Company of the Costs, Charges, and Expenses incurred in winding up any Company in such Order of Priority as the Court thinks just.'

⁸⁹ At this point these were just debts owed to employees.

⁹⁰ Companies Act 1883 s 4.

⁹¹ Preferential Payments in Bankruptcy Act 1888 s 1(1).

⁹² *Ibid* s 1(3): 'Subject to the retention of such sums as may be necessary for the costs of administration or otherwise, the foregoing debts shall be discharged forthwith so far as the . . . assets of the company . . . are sufficient to meet them.'

⁹³ *Re Marine Mansions Co* (1867) LR 4 Eq 601; *Re Oriental Hotels Co* (1871) LR 12 Eq 126; *Regent's Canal Ironworks Co, Re, ex p Grissell* (1875) 3 Ch D 411 (CA); *Richards v Overseers of Kidderminster* [1896] 2 Ch 212 (Ch); *Re Waverley Type Writer* [1898] 1 Ch 699 (Ch).

the phrase ‘assets of the company’ in each statutory provision referred only to assets available to general creditors, and not encumbered by any security interest.

However, it was found that with the growth of the floating charge, floating chargees were enforcing their security against all the assets of the company and there was nothing left to pay any unsecured creditors, even preferential ones. Therefore in 1897, preferential debts were given priority over assets comprised in a floating charge.⁹⁴ Both these provisions related specifically to the ‘debts mentioned in section 1 of the Preferential Payments in Bankruptcy Act 1888’ which were debts due to employees and the Revenue. Expenses of the liquidation were not mentioned at all in the 1897 Act.

These various sections were re-enacted over time, and formed part of the Companies Act 1948⁹⁵ at the time that *Re Barleycorn* came before the Court of Appeal.⁹⁶ In that case, a winding-up order was made in respect of a company. Although a bank held a floating charge over all the assets of the company, no receiver had been appointed. A firm of accountants drew up a statement of affairs for the liquidator, for which a fee was payable. There were also preferential claims, which exhausted all the assets. The Court of Appeal held that the accountants’ fees were to be paid first in priority to the preferential claims and the floating chargee. The reasoning was that the term ‘assets of the company’ in section 309 Companies Act 1948 (formerly section 144 Companies Act 1862) had been changed in meaning by the 1897 Act to include assets subject to a floating charge, so that that section, and also Rule 195 of the Companies (Winding-Up Rules) 1949,⁹⁷ meant that the costs were to be paid first out of such assets. They said that the effect of the 1897 Act was that the costs of the liquidation had priority

⁹⁴ Preferential Payments in Bankruptcy Amendment Act 1897 s 2 provided that: ‘In the winding up of any company . . . the debts mentioned in section one of the Preferential Payments in Bankruptcy Act, 1888, shall, so far as the assets of the company available for payment of general creditors may be insufficient to meet them have priority over the claims of holders of debentures or debenture stock under any floating charge created by such company, and shall be paid accordingly out of any property comprised in or subject to such charge.’ The same Act made provision for the payment of such debts out of the assets coming into the hands of a receiver appointed by a floating chargee in priority to the floating chargee (s 3).

⁹⁵ The changes might be best seen as a table:

19th century legislation	Companies Act 1948	Insolvency Act 1986
s 110 Cos Act 1862	s 267	s 156
s 144 Cos Act 1862	s 309	s 115
s 1(2) and (3) 1888 Act		
s 2 1897 Act	s 319	s 175

⁹⁶ *Re Barleycorn*, above n 10.

⁹⁷ Which provided that: ‘(1) The assets of a company in a winding up by the court . . . shall . . . be liable to the following payments, which shall be made in the following order of priority, namely: *First*.—The taxed costs of the petition . . . ; *Next*.—The remuneration of the special manager (if any); *Next*.—The costs and expenses of any person who makes or concurs in making, the company’s statement of affairs. . . .’

over the preferential claims, and the preferential claims were to be paid in priority to those of the floating chargee, and therefore the costs of the liquidation were to be paid in priority to the claims of the floating chargee.

This was treated by all as the correct position for nearly 35 years, until the case of *Buchler v Talbot*⁹⁸ came before the House of Lords. Here, an administrative receiver had been appointed by the floating chargee who had realised various assets and paid some preferential creditors. The company then went into voluntary liquidation, and, as there were insufficient 'free' assets to pay the liquidator, it was argued that the liquidator's costs should be paid out of the assets subject to the floating charge, in priority to the floating chargee. The House of Lords overruled *Re Barleycorn*, on the basis that there were two separate funds in liquidation—those assets subject to security interests and 'free' assets—and that the costs of the liquidation were only to be paid in priority to other claims on the 'free' assets. Thus, except for costs incurred by the liquidator in realisation of the floating charge assets,⁹⁹ the costs of the liquidation were not to be paid out of the floating charge assets at all.

There are two problems thrown up by the question of payment of liquidator's costs.¹⁰⁰ First, there is the policy question of who should bear these costs. Second, once this has been decided, there is the question of how this decision can be put into statutory language. There is no doubt that whatever the answer to the first question would have been at the time of drafting the 19th century legislation, the second question was not satisfactorily answered, in that the legislation was not clear. Thus the decisions of *Re Barleycorn* and *Buchler v Talbot* were essentially cases about statutory interpretation, and show the courts trying to extract meaning from statutory provisions that were far from clear.

It is hard even to pinpoint which statutory provision the courts were trying to interpret. In *Re Barleycorn* the focus was on what are now

⁹⁸ *Buchler v Talbot* [2004] 2 AC 298 (HL)

⁹⁹ These remained payable by the floating chargee, on the principle articulated in *Re Berkeley Applegate (Investment Consultants) Ltd* [1989] Ch 32 (Ch) and *Re Regent's Canal Ironworks Co, ex p Grissell* (1875) 3 Ch D 411 (CA).

¹⁰⁰ The decision in *Buchler* has attracted much academic and practitioner discussion, much of which is drawn on in the discussion which follows. For academic discussion, see R Mokai, 'Liquidation Expenses and Floating Charges—The Separate Funds Fallacy' [2004] *Lloyd's Maritime & Commercial Law Quarterly* 387; J Armour and A Walters, 'Funding Liquidation: a Functional View' (2006) 122 *Law Quarterly Review* 295. Much of the academic debate has focused on whether the 'fund' of charged assets is separate from the 'fund' of assets available to the liquidator to meet debts. For practitioner discussion, see G Moss, 'Liquidators Stung for Costs and Expenses' (2004) 17 *Insolvency Intelligence* 78; L Hiestand and C Pilkington, 'The Impact of Leyland Daf' (2005) *Recovery* 18; letter from G Yeowart (on behalf of the Financial Law Committee of the City of London Law Society to S Leinster of the Insolvency Service, dated 5 January 2006 and published at (2006) 3 *Journal of International Banking and Financial Law* 101. See also the comment of the Insolvency Law Committee of the City of London Law Society to the Insolvency Service dated 13 March 2006, referred to in afternote at (2006) 3 *Journal of International Banking and Financial Law* 101.

sections 115 and 156 Insolvency Act 1986 and the rules made thereunder.¹⁰¹ These sections provide that liquidation costs are to be paid out of the ‘company’s assets’ in priority to other claims. Section 115, which applies to a voluntary liquidation and so was more appropriate to the position in *Buchler* rather than *Barleycorn*, was also considered in the Court of Appeal in *Buchler*, which confirmed that the words ‘company’s assets’ in that section meant assets including floating charge assets. However, the House of Lords in *Buchler* hardly considered the section at all but focused on section 175(2) Insolvency Act 1986, which derived from the provisions about preferential claims in the 1883, 1888 and 1897 Acts. This section only mentions liquidation expenses in that ‘preferential debts rank equally among themselves after the expenses of the winding up’.¹⁰²

In relation to the meaning of ‘assets of the company’ in sections 115 and 156, the reality appears to be that the phrase ‘assets of the company’ (and the similar phrase ‘property of the company’) means different things in different sections of the Insolvency Act. Some sections, eg those dealing with the powers of an administrative receiver and misbehaviour, clearly use the phrase to mean assets including those subject to a security interest.¹⁰³ In many contexts, this is the most natural meaning of the phrase. However, if ‘assets’ in the three sections in question were to be interpreted in this way, it would surely include assets subject to a fixed charge, and maybe even a mortgage: however, there is no question of the liquidator’s expenses having priority over such interests since preferential creditors do not have such priority.¹⁰⁴ In some other sections, it is equally clear that the phrase relates

¹⁰¹ S 115 was originally s 144 of the 1862 Act; this now reads: ‘All expenses properly incurred in the winding up, including the remuneration of the liquidator, are payable out of the company’s assets in priority to all other claims.’ This section applies in a voluntary liquidation: the liquidation in *Re Barleycorn* was a compulsory liquidation and so in theory the section did not apply. S 156 was originally s 110 of the 1862 Act and now reads: ‘The court may, in the event of the assets being insufficient to satisfy the liabilities, make an order as to the payment out of the assets of the expenses incurred in the winding up in such order of priority as the court thinks just.’ This section applies in a winding up by the court. The rules are now r 4.218–20 of the Insolvency Rules 1986, and make provision for the order of priority within ‘the expenses of the liquidation’.

¹⁰² S 175(2) which says: ‘(2) Preferential debts—(a) rank equally among themselves after the expenses of the winding up and shall be paid in full, unless the assets are insufficient to meet them, in which case they abate in equal proportions; and (b) so far as the assets of the company available for payment of general creditors are insufficient to meet them, have priority over the claims of holders of debentures secured by, or holders of, any floating charge created by the company, and shall be paid accordingly out of any property comprised in or subject to that charge.’

¹⁰³ I am grateful to Dr R Mokal for drawing my attention to these sections (and for his helpful discussion of the points raised in this section). The phrase ‘property of the company’ is also used in the sections dealing with administration (now sch B1) indiscriminately to mean property subject to a floating charge and property subject to other security as the context requires (see paras 70 and 71).

¹⁰⁴ See Lord Millett in *Buchler v Talbot*, above n 98, 318. It has always been the case that giving preferential creditors priority over fixed security has been seen as an unwarranted interference with proprietary rights.

to the unencumbered assets. Section 107, which falls within Chapter V of Part IV of the Insolvency Act dealing with voluntary liquidations, as does section 115, provides that:

Subject to the provisions of this Act as to preferential payments, the company's property in a voluntary winding up shall on the winding up be applied in satisfaction of the company's liabilities *pari passu*.

The equivalent section in relation to winding up by the court is found in Insolvency Rules 4.181 which provides that:

Debts other than preferential debts rank equally between themselves in the winding up and, after the preferential debts, shall be paid in full unless the assets are insufficient for meeting them, in which case they abate in equal proportions between themselves.

It would seem that these sections, which establish the *pari passu* principle of distribution, refer only to the unencumbered assets.¹⁰⁵ It is certainly possible to argue that these provisions mirror more closely the context of sections 115 and 156 than the provisions in which the term 'assets' is interpreted more broadly.¹⁰⁶

As explained above, in *Buchler*, their Lordships concentrate on section 175 rather than sections 115 and 156, and rely on the fact that 'assets' in section 175(2) clearly referred to unencumbered assets in the 1888 Act and that nothing in the 1897 Act expressly (or impliedly) changed this meaning. Those who argue that it *has* changed also rely on the fact that all three sections in question were re-enacted in the 1986 Insolvency Act, after *Re Barleycorn* had been accepted as good law for many years, and no attempt was made to clarify or change the position.¹⁰⁷ In retrospect, given the ambiguity of the statutory provisions, this was unfortunate. If as a matter of policy it is desired that liquidation expenses are to be paid out of floating charge assets, it is a reasonably simple matter to draft a statute which makes this clear.¹⁰⁸

However, whatever the shortcomings of the statutory provisions, the substantive question is one of policy: who should pay the liquidator's costs? As a matter of principle, it might be said that those who benefit from a

¹⁰⁵ This appears from the discussion of these provisions in a number of cases, the most recent being *Re SSSL Realisations (2002) Ltd* [2005] 1 BCLC 1 (Ch) 10 and *Financial Services Compensation Scheme Ltd v Larnell (Insurances) Ltd* [2006] QB 808 (CA) 825–6.

¹⁰⁶ This argument does not appear to have been made in the House of Lords.

¹⁰⁷ This argument was made forcefully in the House of Lords (*Buchler v Talbot*, above n 98, 303, 301) but strangely was not dealt with expressly in the judgments.

¹⁰⁸ The Enterprise Act 2002 did this in relation to administration expenses. Insolvency Act 1986 sch B1 para 99 provides: '(3) The former administrator's remuneration and expenses shall be—(a) charged on and payable out of property of which he had custody or control immediately before cessation, and (b) payable in priority to any security to which paragraph 70 applies.' Para 70 refers to 'property subject to a floating charge'. Further, the statutory reversal of *Buchler* is comprehensive if not succinct (see below).

service should pay the costs of it.¹⁰⁹ As explained earlier, the usual procedure where there was a floating chargee was for an administrative receiver to be appointed to get in the charged assets and pay the chargee; only once this had been done would the company go into liquidation. In these circumstances, it made sense for the floating chargee to pay the costs of the administrative receiver and the general creditors to bear the costs of the liquidation, since they were the beneficiaries of the liquidator's services. The pre-*Barleycorn* and post-*Buchler* position could be justified on these grounds. Further, where the liquidator's expenses included paying the costs of an unsuccessful challenge to the floating charge, it seemed odd for those costs to be borne by the floating chargee (who also has to pay its own costs when in most actions they would be recovered from the losing party).¹¹⁰ The floating charge holder had little control over the costs incurred by the liquidator who was not obliged to consult or get permission from the floating chargee for any expenditure. Even when the liquidator recovered money as a result of transaction avoidance or wrongful trading actions, that money was held for the benefit of the unsecured creditors and not for the floating chargee.¹¹¹ It therefore seemed wrong that the floating chargee had to pay any outstanding costs of that action.

However, although liquidation and administrative receivership have often been separate, sometimes they overlap. In a situation like *Re Barleycorn* where no administrative receiver is appointed, there is much to be said for the floating charge contributing to or paying the liquidator's costs. It is true that where the liquidator performs functions which benefit the floating chargee (as was done in *Re Barleycorn*) the House of Lords was happy for the costs to be paid by the floating chargee. The only question, then, is whether the floating chargee should pay for costs from which it has no obvious immediate benefit. It can be argued that liquidation is a collective procedure, the orderly conduct of which benefits everyone involved in insolvency. Since floating chargees are usually institutional lenders, they reap this general benefit and so should fund the procedure when the general creditors cannot.¹¹² Further, once the Enterprise Act reforms begin

¹⁰⁹ This principle underlies some of the cases in which an equitable lien has been imposed where a trustee, liquidator or court-appointed receiver has expended money in the preservation of assets, see *Mellor v Mellor* [1992] 1 WLR 517 (Ch); *Re Berkeley Applegate (Investment Consultants) Ltd* [1989] Ch. 32 (Ch); *Shirlaw v Taylor* (1991) 102 ALR 551 (Aust Fed Ct). However, these cases are themselves an exception to the general principle that no lien on the benefited property arises when a person spends money, or performs labour, in order to preserve or benefit the property of another, *Falcke v Scottish Imperial Insurance Co* (1885) 34 Ch D 234 (CA) 241 per Cotton LJ, 248 per Bowen LJ, on the grounds that liabilities are not to be forced on people behind their backs (*ibid* 248).

¹¹⁰ This was the position in *re M C Bacon Ltd (No 2)* [1991] Ch 127 (Ch). Millett J avoided the result which would otherwise have been inevitable after *Re Barleycorn* by holding that the costs of the litigation were not 'expenses of the liquidation' within the relevant rule.

¹¹¹ *Re Yagerphone Ltd* [1935] Ch 395 (Ch).

¹¹² Where there are enough funds available to the general creditors to meet the liquidation costs, then the floating chargee does not pay. This is the position in relation to preferential creditors, and was the position in relation to liquidation expenses during the *Barleycorn* era.

to bite, the dichotomy between administrative receivership and liquidation will no longer exist: either a company will go into administration or liquidation, with only one set of costs. It therefore makes sense to have the same funding regime for both.¹¹³

As well as these general policy considerations, the arguments about the effect of *Buchler* also focused on the practical. The decision in *Buchler* was welcomed by the lending institutions and those who acted for them. They had felt beleaguered by the abolition of administrative receivership in the Enterprise Act and by the *Spectrum* decision,¹¹⁴ and saw *Buchler* as going some way to redress the balance between their interests and those of other creditors. However, there was considerable concern among insolvency lawyers and practitioners that the decision in *Buchler* would mean that insolvency practitioners would not be paid, and so that some at least would refuse to act as liquidators.¹¹⁵ Further, they would be very cautious as to the expenses they incurred, particularly where there were few 'free' assets. Many would only take on a liquidation after negotiating with the floating charge holder for payment of some or all of the costs (which would seem to defeat the purpose of *Buchler*). This also would seem to defeat the purpose of the Enterprise Act reforms, in that the floating chargee still would hold the whip hand in relation to the conduct of the insolvency procedure.¹¹⁶ The other main concern was that there were now different rules for administration (where costs were paid out of floating charge assets)¹¹⁷ and liquidation. Not only was this inconsistent¹¹⁸ but it created perverse incentives for office holders to seek the administration route rather than liquidation, which might be more appropriate.¹¹⁹ Further,

¹¹³ In consultation on the statutory reforms there has been considerable support for the view that the two regimes of administration and liquidation should be merged into one.

¹¹⁴ See text at n 140 below.

¹¹⁵ See the comment from the Insolvency Committee of the City of London Law Society to the Insolvency Service, above n 100.

¹¹⁶ This was confirmed by the answers to a questionnaire sent out by the Insolvency Service in June 2005, which was answered by 428 insolvency practitioners. The replies showed that although most practitioners did not experience significant difficulties in obtaining agreement with floating charge holders regarding fees, many felt that this gave the banks more control over the extent of the liquidation to the possible detriment of the general body of creditors.

¹¹⁷ See n 108 above.

¹¹⁸ Some attempted to explain the inconsistency on the grounds that administration is a rehabilitation procedure which could benefit the floating charge holder, that following the Enterprise Act, administration was a substitute for administrative receivership, which was funded by the floating chargee, and that there could not be concurrent administrations and liquidations, and so could not be two sets of costs (letter from G Yeowart to Insolvency Service on behalf of Financial Law Committee of the City of London Law Society referred to in n 100 above). However, in commenting on the draft rules to s1282 Companies Act 2006 (see text at n 127 below), the Financial Law Committee now argue that the regime in the draft Rules should also apply to administration expenses as the same approach should apply in both administration and liquidation (see paper dated 19 October 2007 at <http://www.citysolicitors.org.uk/FileServer.aspx?oID=195&lID=0>, accessed 30 July 2008).

¹¹⁹ This was already happening, see text at n 71 above and A Katz and M Mumford, 'Study of Administration Cases' (2006) 19 *Insolvency Intelligence* 97.

administration can lead to liquidation: it is unsatisfactory to have different funding regimes for each stage of the process.¹²⁰ It was this anomaly that appears to have persuaded the UK Government to reverse the *Buchler* decision by statute.¹²¹

The insolvency profession gave its enthusiastic support to the proposed statutory reversal of the decision.¹²² Inevitably, concerns were expressed by those representing banks and other floating charge holders. As well as the concerns mentioned above about insolvency officers running up large costs which the floating chargees could not control and did not benefit from, there were specific concerns about the effect on structured finance deals. After the Enterprise Act reforms, administrative receivers could still be appointed for such deals,¹²³ leaving the prospect of two insolvency procedures taking place, with two sets of costs. Further, the uncertainty of the amount of liquidation costs which the floating chargee would have to bear would make it difficult for rating agencies who rate the assets-backed securities on the basis, inter alia, of the enforceability of security over the underlying assets. Following *Spectrum*, this security is more likely to be a floating charge, and so vulnerable to costs of liquidation.¹²⁴

The response of the UK Government was to take on board some of the concerns expressed by the banks, by giving more control over costs to floating charge holders,¹²⁵ but to enact the basic reform overruling *Buchler v Talbot* in section 1282 Companies Act 2006. This time care was taken to make the legislation unambiguous in expressing Parliament's intention, although this has had the effect of making the section rather complex.¹²⁶

¹²⁰ Many of these points were made at a seminar held by the Insolvency Service on 17 February 2005 about the implications of *Buchler*.

¹²¹ HL *Parliamentary Debates* vol 675 pt 54 at column WS28 (3 November 2005) (Lord Sainsbury of Turville).

¹²² Insolvency Practices Council, Annual Report 2005; City of London Law Society Insolvency Law Committee report 13 March 2006.

¹²³ See text above at n 67.

¹²⁴ This is a particular problem in whole-business securitisations, where there are likely to be tax or other outside liabilities.

¹²⁵ The detail of these controls will be in the Rules governing the operation of s 1282, which are still in the process of being drafted.

¹²⁶ S 1282 introduces a new s 176ZA into the Insolvency Act 1986 which reads:

(1) The expenses of winding up in England and Wales, so far as the assets of the company available for payment of general creditors are insufficient to meet them, have priority over any claims to property comprised in or subject to any floating charge created by the company and shall be paid out of any such property accordingly.

(2) In subsection (1)—

(a) the reference to assets of the company available for payment of general creditors does not include any amount made available under section 176A(2)(a);

(b) the reference to claims to property comprised in or subject to a floating charge is to the claims of—

(i) the holders of debentures secured by, or holders of, the floating charge, and

(ii) any preferential creditors entitled to be paid out of that property in priority to them.

(3) Provision may be made by rules restricting the application of subsection (1), in such circumstances as may be prescribed, to expenses authorised or approved—

The rules made under the power of section 1282 provide that a liquidator must obtain approval before incurring litigation expenses from floating charge holders and preferential creditors, where recourse is to be had to floating charge assets, as the assets of the company made available to general creditors are insufficient to meet the expenses. In the absence of such approval, the liquidator may apply to the court for approval.¹²⁷ Clearly this is a compromise—it only addresses litigation expenses—that was the result of a consensus of views following a consultation by the Insolvency Service in May 2006.¹²⁸ Further, there is no change to the rule that recoveries in litigation are usually only for the benefit of the unsecured creditors.¹²⁹ There is also no exception made for structured finance deals: the combination of the uncertainty generated by this and by the *Spectrum* decision may therefore have the effect of making the UK a less attractive place for such deals.¹³⁰

IV. CHARACTERISATION OF A FIXED CHARGE

In order to know when the various statutory provisions mentioned above apply to a charge, it is necessary to know whether it is fixed or floating. As explained above, lenders wished to have a floating charge in order to have the right to appoint an administrative receiver (and now to appoint an administrator) but in relation to any assets to which they were looking for reimbursement in the event of default or insolvency, they wanted a fixed charge if possible. This was partly because of the weak priority position of the floating charge¹³¹ and partly because, in an administration, the adminis-

(a) by the holders of debentures secured by, or holders of, the floating charge and by any preferential creditors entitled to be paid in priority to them, or

(b) by the court.

(4) References in this section to the expenses of the winding up are to all expenses properly incurred in the winding up, including the remuneration of the liquidator.

¹²⁷ New rule 4.218C–E of the Insolvency Rules 1986 (SI 1986/1925). The rules are available online from the Office of Public Sector Information: <http://www.opsi.gov.uk>. See the comments on the rules referred to in n 118 above and online from the City of London Law Society: <http://www.citysolicitors.org>.

¹²⁸ Letter inviting comments on the draft rules from the Insolvency Service, 16 August 2007.

¹²⁹ Although to the extent that this swells the amount available to the unsecured creditors, this will benefit floating chargees in that (a) there might be enough to pay all unsecured creditors so that not all of the ‘ring-fenced’ fund is needed to pay them and even (b) there might be a surplus available to pay the costs of the liquidation. It is suggested in the comments of the Financial Law Committee of the City of London Law Society that the floating charge holder should have a right to recoup any recovery in proceedings, the cost of which it had been borne, from the assets available for payment of general creditors.

¹³⁰ This point was forcefully made by G Yeowart in the letter to the Insolvency Service on behalf of Financial Law Committee of the City of London Law Society (above, n 100). Other jurisdictions in Europe have ring-fenced securitisations from claims by other creditors in order to encourage such deals to take place in those jurisdictions.

¹³¹ See text above at nn 22–6.

trator could dispose of assets only subject to a floating charge without the leave of the court;¹³² in other words, such assets would be used to fund the continuation of the business. Further, the administrator's costs are to be paid out of floating charge assets. This particular weakness of the floating charge became even more marked after the reforms of the Enterprise Act. A lender would therefore seek to take fixed charges over all the company's assets: land (although increasingly the company would lease its premises rather than own it); equipment and machinery (again largely acquired on hire purchase or finance lease terms); raw materials and stock-in-trade (though many of these are likely to have been sold to the company on retention-of-title terms, which were effective in English law provided that the goods had not changed their nature in manufacture or had been sold); and book debts (receivables). As other assets were increasingly likely to be financed by asset-based financing, charges over receivables became increasingly important.

In 1979, in the first-instance decision of *Siebe Gorman & Co Ltd v Barclays Bank Ltd*,¹³³ Slade J held that a charge over book debts in favour of a bank could be fixed if the chargor was obliged to pay the proceeds into an account with that bank, and if the charge was expressed to be a fixed charge. Before then, it had always been thought that a charge over book debts had to be floating, since the chargor would want free access to the proceeds of the debts to run the business, and the ability to dispose of the charged assets without the consent of the chargee was one of the badges of a floating charge.¹³⁴ The decision in *Siebe Gorman* meant that the chargee could have sufficient control for a charge to be fixed merely because the charger was obliged to pay the proceeds into an account held by the chargee. In the years following *Siebe Gorman*, fixed charges over book debts were used extensively by the clearing banks, with which the borrower company could have an account. However, where the lender was not a clearing bank, this criterion could not be fulfilled, and so a new type of charge was developed, consisting of a fixed charge over the debts themselves (which could not be disposed of without the consent of the chargee) but a floating charge over the proceeds (which the company could use in the ordinary course of business). That such a charge was fixed was challenged by the Inland Revenue (as a preferential creditor) in 1994, but the Court of Appeal upheld it on the grounds of freedom of contract.¹³⁵ However, this decision provoked considerable adverse academic reaction¹³⁶

¹³² Insolvency Act 1986, sch B1 para 70.

¹³³ *Siebe Gorman & Co Ltd v Barclays Bank Ltd* [1979] 2 Lloyd's Rep 142 (Ch).

¹³⁴ *Re Yorkshire Woolcombers Association Ltd* [1903] 2 Ch D 284, 295 (CA).

¹³⁵ *Re New Bullas Trading Ltd*. [1994] 1 BCLC 485 (CA).

¹³⁶ R Goode, 'Charges over Book Debts: A Missed Opportunity' (1994) 110 *Law Quarterly Review* 592; S Worthington, 'Fixed Charges over Book Debts and other Receivables' (1997) 113 *Law Quarterly Review* 562; Lightman and Moss, above n 24, paras 3-030 et seq. There was also some qualified support: see A Berg, 'Charges over Book Debts: A Reply' [1995] *Journal of*

on the grounds that control of the proceeds of the book debts by the chargee was as necessary for a charge to be a fixed charge as control over the debts themselves. This view was upheld by Lord Millett giving the opinion of the Privy Council in *Agnew v Commissioner of Inland Revenue*¹³⁷ in a judgment that also threw doubt on the correctness of *Siebe Gorman*.¹³⁸ From the time of *Agnew* there was general concern that *Siebe Gorman* was being overturned, and in 2003 the Crown, on behalf of preferential creditors, gave notice that it was going to challenge *Siebe Gorman*, which it did in the case that became *Re Spectrum Plus*. From the time of that notice, and probably from the time of *Agnew* itself, liquidators froze distributions pending the result of the case,¹³⁹ and the backlog of cases explains why the Crown mounted the challenge, even though its own status as a preferential creditor had been abolished by the Enterprise Act which came into force in September 2003.

All doubts as to the position of *Siebe Gorman* were dispelled in the House of Lords judgment in *Re Spectrum Plus* which was delivered in 2005.¹⁴⁰ The House of Lords was considering a debenture modeled on that in *Siebe Gorman* and a seven-person House decided unanimously that it was a floating charge. It was made clear that the only firm criterion when deciding whether a charge is fixed or floating is the degree of control the chargee has over the charged assets,¹⁴¹ and that in the case of debts ‘the charged assets’ include the collected proceeds of the debts as well as the debts themselves. The requisite degree of control is that the chargor cannot dispose of charged assets without the consent of the chargee. This

Business Law 433 (where the distinction between the positioning relation to clearing banks and other lenders was pointed out and criticised); Varen and Rubinstein ‘Separation of Book Debts and their Proceeds’ [1994] *Cambridge Law Journal* 225.

¹³⁷ *Agnew v Commissioner of Inland Revenue* [2001] AC 710 (HL). The case is also known as *Re Brumark Investments Ltd* and many commentators refer to it in shorthand as *Brumark*.

¹³⁸ Lord Millett only made two statements which overtly threw any doubt on that decision, see para [21]. When discussing *Siebe Gorman*, he said: ‘The debenture placed no express restrictions on the company’s right to draw on the account, which was the company’s ordinary business account, and the judge’s finding in this respect has been doubted’, and at para [38]: ‘But, as the Court of Appeal observed, such a charge is normally accompanied by restrictions on the use to which the company may put the receipts, so that the situation is analogous to that which was thought to obtain in the *Siebe Gorman* case [1979] 2 Lloyd’s Rep 142 and did obtain in *In re Keenan Bros Ltd* [1986] BCLC 242.’ However, the chief concern was the unequivocal statement that in order for a charge to be fixed where the proceeds are paid into an account with the chargeholder, the debenture must provide that the account must be blocked, and it must be operated as such (para [48]). The apparent approval of the New Zealand decision of *Supercool Refrigeration and Air Conditioning v Hovord Industries Ltd* [1994] 3 NZLR 300 (NZ HC), which overtly disapproved of *Siebe Gorman*, also added to the speculation.

¹³⁹ Note that HM Revenue and Customs issued a statement in March 2006 to R3, the Association of Business Recovery Professionals, (after the *Spectrum* decision) requiring funds distributed to chargeholders since the date of the *Brumark* decision on the basis of a *Siebe Gorman* type debenture to be repaid by chargeholders and distributed to creditors in the relevant order.

¹⁴⁰ *Re Spectrum Plus* [2005] 2 AC 680 (HL).

¹⁴¹ Para [111].

requirement must be expressly provided in the charge agreement, and must be carried out in practice.¹⁴² In the context of proceeds paid into a bank account, whether held with the chargee or not, no withdrawals must be able to be made from that account by the chargor without the consent of the chargee.¹⁴³

The ramifications of the decision in *Spectrum* are numerous. As with any decision, there are a number of points that remain undecided. First, given that for a charge to be fixed there has to be control over 'the charged assets', it is not clear what counts as 'the charged assets' in various contexts. This is particularly a problem where an asset generates income without itself being disposed of. It is often said that two close analogies are that of a tree bearing fruit (the fruit is a separate asset from the tree and control over it is not required for a charge over the tree to be fixed) and a caterpillar turning into a butterfly (control over the butterfly is required for a charge over the caterpillar to be fixed).¹⁴⁴ True though this may be, it does not tell us when a situation falls within the tree–fruit analogy and when it does not. It is suggested that there are three main relevant factors: first, how directly the asset generates the income; second, how close the generation of income comes to being the sole value of the asset; and third, whether the asset is destroyed by the generation of income.¹⁴⁵ The most problematic situation is where a single contract gives rise to a stream of income. This could be a lease of chattels,¹⁴⁶ or the operating contract in a project finance structure. It is the application of *Spectrum* to such contracts that has given rise to much debate in the City.¹⁴⁷

Another point that remains undecided concerns the exact boundaries of 'control'. Two particular problems occur: the first is whether, to be a fixed charge, every disposal by the chargor has to be with consent amounting to the independent will of the chargee, or whether consent in advance is sufficient. The second is whether a limited power to dispose of assets provided an equivalent is substituted is consistent with a charge being fixed. Discussion of the first issue has been largely in the context of a structure

¹⁴² See Lord Hope's analysis of the ways a charge over debts can be made to be fixed in para [54], Lord Scott paras [107], [111], Lord Walker, [138]–[139]. See also the unconditional approval of the views expressed in *Agnew*, above n 137.

¹⁴³ *Ibid* [117] (Lord Scott).

¹⁴⁴ Stevens, above n 38, 165–6.

¹⁴⁵ Beale *et al*, above n 3, 4.99.

¹⁴⁶ A charge over such a lease was held to be fixed in *Re Atlantic Medical Ltd* [1993] BCLC 386 (Ch), but it is widely thought that this case is likely to be overruled after *Agnew* and *Spectrum* (see F Oditah, 'Fixed Charges over Book Debts after *Brumark*' (2001) 14 *Insolvency Intelligence* 49).

¹⁴⁷ N Frome and K Gibbons 'Spectrum—An End to the Conflict or the Signal for a New Campaign?' in Getzler and Payne, above n 38, ch 5, and P Wood, 'A Review of *Brumark* and *Spectrum* in an International Setting' in Getzler and Payne, above n 38, ch 6; N Ali, 'Developments in Fixed and Floating Charges: Legal Principles, Policy Issues and Implications for Structured Finance' [2006] *Commercial Law Practitioner* 46.

used in *Re Keenan Bros Ltd*.¹⁴⁸ In this Irish case, a charge agreement created a fixed charge over book debts and provided that the proceeds should be paid into a blocked bank account with the chargee. Later, a second account was set up, into which the chargee could permit the chargor to transfer sums from the blocked account, and from which the chargor could freely withdraw. This 'two-account' structure is now being suggested by legal advisers as the way to create fixed charges over book debts after *Spectrum*.¹⁴⁹ However, it is debatable whether banks will be prepared to make an independent decision each time money is moved from the blocked account to the second account, and this appears to be the only way in which this structure will pass the *Spectrum* test. The other context in which this issue has arisen is that of a 'waterfall' clause, which is common in project finance and other structured finance. Here, it is agreed between all parties that income received by a special purpose vehicle as a result of one or more income-producing contracts is to be applied in a preordained way, so that little or any income is at the free disposal of the chargor. It has been strongly argued that this means that the chargor has no real freedom to dispose of the assets, and that it does not matter whether the secured creditors agree to the payments in advance or as the need to make them arises.¹⁵⁰

Finally, there is the issue of whether a power to substitute prevents a charge from being fixed. This arises particularly in the case of charges over equipment, where there is generally a power to replace outdated stock, and charges over securities, where a right of substitution is common. Cases before *Spectrum* appear to endorse the proposition that a limited right to substitute is consistent with a fixed charge.¹⁵¹ However, following *Spectrum*, it seems reasonably clear that a general power to substitute, limited just by the criterion that the value of the security remains the same, is not consistent with the requisite level of control.¹⁵² The more specific the criteria for substitution, the more likely it is that a court will hold that there is sufficient control, but a blanket consent in advance is unlikely to be sufficient for the charge to be fixed.

The difficulties and uncertainties that have blighted this area of the law for many years, and are likely to continue to do so,¹⁵³ mean that it can be

¹⁴⁸ *Re Keenan Bros Ltd* [1986] BCLC 242 (Ir SC).

¹⁴⁹ Eg J Simmonds, 'Book Debts as Security (Part 2)' [2006] 1 *Finance & Credit Law* 1; Ali, above n 147.

¹⁵⁰ N Frome, 'Spectrum—An End to the Conflict or a Signal for a New Campaign', (2005) 11 *Journal of International Banking and Financial Law* 433; cf S Worthington, 'The Use and Abuse of Doctrinal Analysis' in Getzler and Payne, above n 38.

¹⁵¹ *Holroyd v Marshall* (1861–1862) 10 HLC 191 (HL); *Re Cimex Tissues Ltd*. [1995] 1 BCLC 409 (Ch).

¹⁵² See also *re Lin Securities* [1988] 1 SLR 340 (HC Singapore); *Dresdner Bank Aktiengesellschaft v Ho Mun-Tuke Don* [1993] 1 SLR 114 (Singapore CA); *Re EG Tan & Co (Pte)* [1990] 1 SLR 1030 (HC Singapore).

¹⁵³ There have already been cases on the same point since *Spectrum: Fanshaw v Amav*

strongly argued that to use the distinction between fixed and floating charges as a trigger for so many statutory consequences is very unsatisfactory.¹⁵⁴ A better trigger would be that adopted in New Zealand as a consequence of the abolition of the floating charge in the Personal Property Securities Act 1999. There the trigger for priority of preferential creditors is a security interest over the receivables and inventory of a company.¹⁵⁵ The reasoning in New Zealand was that most floating charges covered these types of property, and so the actual impact of the law would be little changed.

However, developments in the UK following *Brumark* and *Spectrum*, at least in relation to receivables, may mean that more radical reform is required. Banks and other lenders had become used to being able to take a fixed charge over receivables, and many were not prepared to lend merely on the security of a floating charge. There has been a very significant growth in invoice discounting, where the financier takes an absolute assignment of receivables in return for up-front payments as to part of the value of the receivable, and the rest when the receivable is collected. In invoice discounting (as opposed to factoring) the receivables are collected by the company, and the debtors are not notified of the financing arrangement.¹⁵⁶ The rise in invoice discounting has a number of possible effects. First, the receivables of a company are less likely to be covered by a charge, whether fixed or floating, but will 'belong' to the finance company. Therefore, preferential creditors and the ring-fenced fund will have no claim on them under the existing legislation, and a change of statutory trigger to 'charge over receivables' would not change this.¹⁵⁷ Second, there will be very few

Industries Ltd [2006] EWHC 486 (Ch) (charge over debts characterised as floating as the charge agreement gave the chargor power to dispose of the proceeds, although later they were paid into a blocked account); *The Russell-Cooke Trust Company v Elliott* [2007] EWCA 1443 (Ch), where, unusually, a charge was described as floating but was recharacterised by the court as fixed.

¹⁵⁴ L Gullifer and J Payne, 'The Characterisation of Fixed and Floating Charges' in Getzler and Payne, above n 38, ch 4.

¹⁵⁵ Cl 9 of sch 7 Companies Act 1993 as amended by sch 1 Personal Property Securities Amendment Act 2001.

¹⁵⁶ Many commentators remark on this growth, which is seen as a direct consequence of *Spectrum*. J Armour, 'Shall We Redistribute in Insolvency?' in Getzler and Payne, above n 38, 204; Armour *et al*, above n 64). However, figures from the Asset Based Finance Association show that there has been a steady growth in invoice discounting from 1995, although the rate of growth does increase significantly from 2003 onwards. This accords with research by Frisby, above n 72, involving interviews with financiers showing that banks were moving away from traditional overdraft lending towards asset-based financing from the early to mid-1990s onwards, because of the high level of receiverships in the 1990s. Although the banks all have asset financing arms, the market has been swelled by specialist invoice discounters. Other, more anecdotal, commentators are less sure that the change has been significant, see C Addy, 'Re Spectrum Plus, a Year (And a Bit) On – What Conclusions Can Now Be Drawn?' (2007) 2 *Journal of International Banking and Financial Law* 67.

¹⁵⁷ Note, however, that at present some invoice discounting is done on the basis of a (registered) fixed charge. However, if the law was changed to make such a charge vulnerable to statutory provisions, it would be easy for the structure to change to an absolute assignment.

assets available to an administrator which can be disposed of without the leave of the court (floating charge assets) and a reduced number which can be disposed of with the leave of the court as the legislation stands.¹⁵⁸ Third, there will be no floating charge assets from which the costs of a liquidator can be paid. Fourth, there is less likely to be a floating charge holder who can appoint an administrator out of court, although this is not necessarily the case, as an invoice discount agreement often includes a charge over all of the company's assets as well as an absolute assignment of receivables. This is partly to mop up any assets not otherwise encumbered,¹⁵⁹ but also to give the financier the right to appoint an administrator.¹⁶⁰ In this respect, it can be called a 'lightweight' floating charge.¹⁶¹ However, concern has been expressed that the fragmentation of security and quasi-security interests may mean that there is no one with an interest in saving the company, thus militating against the object of corporate rescue.¹⁶²

V. COMBINED EFFECT OF THE RECENT DEVELOPMENTS

The picture emerges when all the pieces are put together. What are the pros and cons of taking a floating charge as security in 2007? The floating chargee now has only a limited amount of control of the insolvency process: it has the opportunity to appoint an administrator out of court, and will be given the opportunity to veto the incurring of litigation costs by a liquidator. However, recent research has shown that floating chargees are rarely appointing administrators, preferring to leave this to the directors of the company unless there is a pressing reason to do otherwise.¹⁶³ Floating charges created before 15 September 2003 in theory give the right to appoint an administrative receiver, but again research shows that this is not happening.¹⁶⁴ As a priority device, the floating charge is still weak. There are too many calls on the assets charged in priority to the floating chargee. Although the number of preferential creditors has diminished, the ring-fenced fund has been introduced. Both these liabilities are reasonably easily calculated in advance, and can be covered by over-collateralisation (if

¹⁵⁸ Para 71 sch B1 Insolvency Act 1986 enables an administrator to dispose of 'property subject to a security . . . as if it were not subject to that security' with the leave of the court. Para 72 is in the same terms in relation to property in the possession of the company 'under a hire-purchase agreement': this includes goods sold to the company under retention of title clauses. There is no provision for the disposal of debts belonging to a financier.

¹⁵⁹ It is very likely that equipment and vehicles will also belong to asset financiers, the company having possession on the basis of a lease or hire purchase agreement.

¹⁶⁰ Frisby, Report in *Insolvency Outcomes*, above n 46, 9, 33–43.

¹⁶¹ See F Oditah, 'Lightweight Floating Charges' [1991] *Journal of Business Law* 49.

¹⁶² Frisby, above n 46, 9, 39–43.

¹⁶³ Armour *et al*, above n 64.

¹⁶⁴ See *ibid*.

the market will bear this). However, a liquidator's costs are still unpredictable (though this has been controlled to some extent by the requirement of approval) and an administrator still has the ability to dispose of floating charge assets. Further, the floating chargee bears an administrator's costs, and these are likely to be higher than those of an administrative receiver.¹⁶⁵ Despite this, a floating charge does give some protection, and it may be the only security interest it is possible to take where the charged assets need to be disposed of by the chargor. The *Spectrum* decision widens this class of assets. Some will take the view that any security interest is better than none. Others will be content to lend unsecured in relation to any assets which cannot be the subject of a fixed charge, on the basis of strict covenants which approximate the same amount of control as a floating charge with stringent automatic crystallisation clauses. Others will seek to 'secure' themselves by other devices, such as asset financing. The growth of those financing in this way, and the diversity of those in this market, has meant that in the future there is unlikely to be one dominant creditor to control an insolvency process. Further, if floating charges are not taken for the reasons given above, the priority of preferential creditors, the ring-fenced fund and the costs of administration and liquidation will be nugatory. It may yet be necessary to amend the legislation once again, to give priority to deserving claims over invoice discounters and others with absolute interests over revolving assets. However, if this trend in financing also has a detrimental effect on the conduct of corporate rescue, more radical reform may be needed to achieve the aims of the Enterprise Act.

¹⁶⁵ See research, *ibid*, concluding that the recovery rate is higher in administrations but so are the costs.

3

The Effect of the Enterprise Act 2002: Empirical Research into Corporate Insolvency

SANDRA FRISBY

I. INTRODUCTION

THIS CHAPTER DRAWS upon the author's empirical research into the corporate insolvency landscape following the coming into force of the corporate insolvency provisions of the Enterprise Act 2002. The Act heralded what was hoped to be a new era for corporate insolvency law in the United Kingdom. Its provisions were designed to increase the incidence of corporate rescue, to improve the prospects of a meaningful dividend to unsecured creditors in particular, to afford all stakeholders the opportunity to participate in the procedure and to ensure that the interests of all stakeholders be taken into account in the decision-making process. One of the central planks in the accomplishment of these objectives was the prospective abolition of the administrative receivership procedure in order to boost recourse to a new 'streamlined' administration procedure. These ambitions were announced in the foreword to the White Paper preceding the Enterprise Act itself:

Companies in financial difficulties must not be allowed to go to the wall unnecessarily. Administrative receivership which places effective control of the direction and outcome of the procedure in the hands of the secured creditor is now seen by many as outdated. There are many other important interests involved in the fate of such a company, including unsecured creditors, shareholders and employees. We propose to create a streamlined administration procedure which will ensure that all interest groups get a fair say and have an opportunity to influence the outcome.¹

¹ See Secretary of State for Trade and Industry, 'Insolvency—A Second Chance' (Cm 5234, 2001), foreword by The Right Honourable Patricia Hewitt MP, Secretary of State for Trade and Industry.

It would be difficult to oppose the broad objectives of the White Paper, although one might contend that an indiscriminate pursuit of corporate rescue would be undesirable and that a more selective approach, offering rescue opportunities to only those companies with a viable prospect of future survival, is preferable. A rather different enquiry, however, is as to whether the Enterprise Act has actually had the desired effect: are more companies being rescued following the coming into force of its provisions, are a wider range of stakeholders involved in the decision-making process as envisaged by the streamlined administration procedure and are unsecured creditors enjoying enhanced dividends? And, if the answer to one or more of these questions is in the negative, does this *necessarily* indicate that the initiatives contained in the Enterprise Act are flawed? Or might case-law developments or developments in professional practice have some impact? In order to investigate these matters, an empirical research programme was designed and carried out, and, indeed, is still ongoing. The next two sections of this chapter describe the genesis of the two empirical projects under discussion and outline the methodology adopted. The remainder of the chapter considers some of the findings thus far.

II. INSOLVENCY OUTCOMES: THE FIRST STEPS

The initial ambition was quite simple: to discover whether the Enterprise Act had had the desired effect on outcomes in corporate insolvency. The initial question was equally straightforward: how to go about this? One possible approach suggested itself. Where formal insolvency procedures are commenced in relation to corporate entities, insolvency practitioners are required to file certain documents at Companies House, including statements of proposals and reports to creditors,² statements of affairs, progress reports,³ and abstracts of receipts and payments. If it were possible to have sight of these various reports, would they contain the kind of information upon which an evaluation of the Act's effect could be based? A trial with Companies House Direct, a facility which allows the user to download documents filed at Companies House, was arranged and revealed that for the sum of £4 one could download an 'insolvency package' containing all insolvency-related filings for a particular company.

The next stage was to consider in more precise terms the shape of any research project. It was decided to focus on the main objectives of the Enterprise Act and to attempt to devise a method of assessing whether the provisions of the Act had resulted in their achievement. The insolvency packages had proved to be a veritable goldmine of quantitative and quali-

² For administrators and administrative receivers, respectively.

³ Only in administration.

tative information, and it was decided to attempt to chart certain features of a number of companies entering administration or administrative receivership in both the pre- and post-Enterprise Act periods, to similarly document certain aspects of the procedures themselves, but also to record certain outcomes for each company, including its eventual fate and the level of returns to its different classes of creditor. The overall intention was to compare those outcomes in administration and receivership, and in pre- and post-Enterprise Act administration.

This approach involved the construction and analysis of a database of companies entering administration and administrative receivership in both the pre- and post-Enterprise Act periods.⁴ This quantitative aspect of the research should, it was decided, be complemented by a qualitative programme. Without having much beyond a hunch of what analysis of the data would eventually reveal, it was anticipated that any findings might themselves prompt further research questions, and that these could only be properly answered by the main protagonists in insolvency proceedings themselves: the practitioners who act as receivers and administrators and representatives of the financial institutions who will often be involved in their appointment.

One final burning question remained, and that was how to fund the project. The main costs would be downloads from Companies House and travelling to interviews. In this regard luck was on the author's side: the Insolvency Service was as interested in the impact of the Enterprise Act as was the author, and, following e-mail exchanges and a meeting, agreed to meet the costs of the research,⁵ which was entitled 'Research into Insolvency Outcomes' (hereinafter 'the outcomes project'). The first stages of this project have so far produced two reports.⁶

III. RESEARCH INTO PRE-PACKS: THE FIRST STEPS

As interviews progressed in relation to the outcomes project⁷ it became clear that one very interesting practice was becoming prevalent amongst practitioners acting as both administrators and receivers. This was the 'pre-pack' strategy. Pre-packing is simply one method of selling *the business* of an insolvent company, as opposed to *shares in* the insolvent company,

⁴ It should be acknowledged here that the involvement of Professor Cees van der Eijk, Head of the Methods and Data Institute at the University of Nottingham, turned out to be critical to the development of this project and sincere thanks are due to him.

⁵ Particular thanks here are due to Mike Norris (Director of Policy) and Stephen Leinster (Director of Policy Technical, Legislative and Professional Regulation) of the Insolvency Service.

⁶ S Frisby, 'Report on Insolvency Outcomes', Report to Insolvency Service, 26 June 2006, <http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/research/corpdocs/Insolvency>

⁷ The interviews took place between August and November of 2005. Twenty-three practitioners and four bankers were interviewed.

and involves the negotiation of the contract of sale, the identification of the assets to be transferred and the agreement of a consideration *prior* to the commencement of the procedure itself. The appointment of an administrator or a receiver is then made and the sale executed shortly thereafter.⁸ Practitioner interviewees expressed both support for and concerns about the pre-pack approach, a typical remark being as follows:

It's practical, but it's a difficult concept to explain to other creditors, and it's one that I think the whole profession needs to work hard on, to explain why they do consider the pre-pack the best solution, to explain exactly why there hasn't been a big advertising campaign, and so on.

By this time the author had already written a short piece⁹ on the outcomes project for *Recovery*, the quarterly magazine published by R3, the Association of Business Recovery Professionals. R3 is the leading professional association for insolvency practitioners in the UK, and therefore has a very clear interest in ensuring that the activities of its members engender confidence in those affected by corporate insolvency. The idea behind writing the piece was to generate interest in the outcomes project amongst practitioners, but also to seek their co-operation in the interview process. In this regard it proved successful, but had the additional benefit of attracting the attention of R3 itself to the possibility of commissioning academic research.

Following discussions, it was agreed that the pre-packing strategy was an area of massive potential in research terms, not least because of the division of opinion on its utility. In essence, many, but by no means all, practitioners consider the pre-pack to be a valuable tool which, in appropriate circumstances, can overcome the particular commercial exigencies of selling businesses once an insolvency procedure has commenced. These include the fact that funding for trading during the marketing campaign may not be readily available and that the very fact of the commencement of the procedure has a depressive effect on the value of goodwill attached to the company's business. Opponents of pre-packs, on the other hand, argue that the strategy may fail to capture value because of the failure to expose the business to the competitive forces of the market, that it is insufficiently transparent (in that certain classes of creditor have no opportunity to participate in the decision-making process) and that it is open to abuse, particularly where the business is sold to its pre-existing owner/managers.

R3 therefore agreed to fund a research project into pre-packs (hereinafter 'the pre-pack project'), with a view to evaluating the strategy, investigating the incidence of pre-packs and the means by which they are

⁸ The author is by no means the first academic to consider the pre-pack strategy: see V Finch, 'Pre-packaged Administrations: Bargains in the Shadow of Insolvency or Shadowy Bargains?' [2006] *Journal of Business Law* 568; P Walton, 'Pre-Packaged Administrations: Trick or Treat?' (2006) 19 *Insolvency Intelligence* 113.

⁹ See S Frisby, 'Researching Rescue', [Summer 2005] *Recovery* 22–3.

operated and how far any potential for abuse is actually being realised, if at all. This project also involves the collection and analysis of both quantitative and qualitative data, again through the Companies House Direct facility and through interviews, although the interview process will be necessarily much wider ranging. Not only are practitioners and financiers being consulted, but also valuers, representatives of regulatory bodies, representatives of Her Majesty's Revenue and Customs (almost invariably the largest unsecured creditor in terms of debt owed) and, where possible, trade creditors. The preliminary report on this research has now been made available on the R3 website.¹⁰

IV. METHODOLOGY

(a) The Outcomes Project

All companies which entered into either administration or administrative receivership during the sample period of September 2001 to September 2004 were initially identified from records in the Gazette.¹¹ These were then randomly sampled by procedure and insolvency packages were downloaded via the Companies House Direct service. Preference was given to those companies for which the insolvency package contained most information.

The database itself recorded the following information (where available): the company name; the company's business activity; location (town and postcode) of the company; procedure (administration or administrative receivership); appointing charge holder (receivership) or practitioner firm (administration);¹² practitioner(s) appointed; start and end dates of the procedure; amount of secured debt owed at the beginning of the procedure; amount of preferential debt owed at the beginning of the procedure; amount of unsecured debt owed at the beginning of the procedure; payments made to secured, preferential and unsecured creditors during the procedure;¹³ the amount set aside under the 'prescribed part';¹⁴ and the

¹⁰ See S Frisby, 'A Preliminary Analysis of Pre-packaged Administrations', Report to the Association of Business Recovery Professionals, August 2007, http://www.r3.org.uk/uploaded_documents/Edited%20version%20-%20ready%20for%20design.pdf, accessed 9 July 2008.

¹¹ The database is being consistently updated and expanded, and cases from September 2004 to September 2005 are currently being added to it.

¹² Where the administration post-dates 15 September 2003 (the date on which the Enterprise Act came into force) the method of appointment (ie by the court, under sch B1 para 12 Insolvency Act 1986, by a qualifying floating charge holder under para 14 or by the company or its director(s) under para 22) were recorded, where this information was available.

¹³ Where the procedure in question was followed by liquidation, payments to creditors made during the liquidation were included in these totals.

¹⁴ S 176A Insolvency Act 1986.

outcome of the procedure. This last category consists of six subcategories. These are:

- (A) Rescue of the company¹⁵
- (B) Rescue of part of the company¹⁶
- (C) Going concern sale of the business of the company¹⁷
- (D) Going concern sale of part of the business of the company¹⁸
- (E) Asset sale¹⁹
- (F) Procedure ongoing

It should be noted that in a number of cases a combination of outcomes was recorded.²⁰

As the data were recorded emerging patterns were noted. Further, the documents in the insolvency packages, in particular receivers' reports to creditors and administrators' statements of proposals, contained detailed information regarding the companies in the sample which, whilst not being specifically recorded on the database, revealed further emerging patterns. Whilst it was always envisaged that the database would be statistically analysed, it was recognised that particular findings would require further investigation, and that the most appropriate source of information in this regard would be two of the major players in insolvency, ie practitioners and bankers.

Interviews were digitally recorded and transcribed, and lasted between 45 minutes and 1 hour 40 minutes. In general, questions were asked about appointment trends, trends in secured lending, the effect of the Enterprise Act 2002 on insolvency practice and insolvency outcomes, the approach to paragraph 3 of Schedule B1 Insolvency Act, the legal and practical constraints on achieving survival of the company or its business, the attitudes of various classes of stakeholder, and future developments that would be advisable or desirable. During the course of the research it became obvious that the receivables financing businesses²¹ were widely involved in making appointments and equally would often be a major creditor in insolvency. One interviewee had considerable experience of this type of financing, as

¹⁵ Where the company emerges from the procedure under the same ownership and conducting substantially the same activities.

¹⁶ Where the company emerges from the procedure under the same ownership but conducting a reduced activity or set of activities. An example of this, drawn from the sample, was a company which produced conveyor belts and which also operated two other types of business. The two other operations were closed, but the company emerged with the conveyor belt arm intact.

¹⁷ Where *the business* of the company is sold as a going concern.

¹⁸ An example, drawn from the sample, was a company operating a chain of pubs. Several of the pubs were sold as going concerns and the remainder closed.

¹⁹ Where the company's assets were sold on a break-up basis.

²⁰ The most common of these being where the procedure was still ongoing but one of the other outcomes had occurred (eg C/F, E/F, etc). However, different combinations also occurred, including combinations of going concern sales and asset sales and partial rescue and asset sales.

²¹ Factors and invoice discounters, both bank-led and independent.

well as of insolvency practice in general. It was difficult to carry out an interview-based investigation of this particular sector as firms tend to be many and dispersed and identifying subjects for interview was therefore problematic. However, e-mails were sent to a number of enquiry desks²² and short telephone conversations provided some useful information in this regard.

Once the database was complete, analysis was possible²³ in order to quantify certain aspects of its content and to discern whether the results were statistically significant. Overall, the database contained 2,063 cases, comprising 1,110 of companies in administration and 953 of companies in administrative receivership. The next sections of this paper focus on particular results and attempts to demonstrate how external factors, as revealed by the interview data, may have an unforeseen impact on legislative initiatives.

(a) The Pre-Pack Project

Pre-packing is just one strategy for selling a business. In rather simplistic terms, upon appointment to an insolvency post, the office holder, whether administrator, administrative receiver or liquidator, is faced with a number of commercial decisions directed towards maximising the value of the estate for the benefit of one or more stakeholders. The identity of the beneficiary of the practitioner's efforts depends, as a matter of law if not practice, on the procedure in question. By and large, the orthodox understanding is that liquidators and administrators act in the interests of the general body of creditors, whereas receivers focus on the interests of their appointor. This understanding is open to debate, but in any event it would probably be accepted that the main concern of the practitioner is to deploy the assets comprising the estate so as to achieve optimal value.

The perceived wisdom is that a sale of the *business* of an insolvent company will almost invariably raise more than a sale of its component assets on a piecemeal basis: synergy is preserved, a premium may be negotiated for the goodwill of the business, key employees essential to its operation may be transferred to the purchaser and debts owed to the original entity may prove far easier to collect. While the proposition that business sales achieve higher realisations cannot be taken as a universal truth, it is reasonably widely accepted. The debate around pre-packs essentially centres upon whether or not the pre-pack is *an appropriate and effective* method of selling a business, or whether the more orthodox

²² Found on the website of the Factors and Discounters Association (FDA).

²³ Using SPSS but also by moving selected data between Microsoft Access and Excel.

approach of placing the company into an insolvency procedure and subsequently marketing and selling its business produces 'better' results overall.

This latter approach, denominated a 'business sale' for the purposes of the research, does not necessarily encompass the case where the appointee has *no* involvement with the company prior to the actual appointment; indeed, the author's research on the outcomes project suggests that such cases are very rare indeed. There will usually be a period, which can range from days to weeks, or even months, during which the practitioner will have had the opportunity to assess the financial state of the company and its business and to formulate a strategy in relation to it, often at the behest of a secured creditor or, indeed, the company's management. The main distinction between the pre-pack and the business sale is that in the former case the sale itself, and to whom it is to be made, and what assets it will comprise, and at what price, has been almost irrevocably predetermined prior to the appointment and simply remains to be executed very swiftly thereafter. As far as a business sale is concerned, the practitioner remains open to offers for the business following his appointment, and may take active steps to elicit them via a marketing campaign in the local or national press, or by some other method of ensuring that the market has been at least sensibly tested. One important aspect of the pre-pack research was to attempt to compare the 'performance' of both types of going concern sale according to criteria such as transparency, the accountability of the practitioner(s), returns to creditors and employment preservation.

The comparative approach described above was carried out through the use of two databases, one comprising information on pre-packs, the other on business sales. In this regard, the Insolvency Service agreed to the use of the data recorded on the outcomes database, which was revisited to identify those cases where the business of the insolvent company had been sold as a going concern. The reports in relation to those cases were then consulted and used to construct both pre-pack and business sale databases. The information recorded on each database was as follows:

- (a) company;
- (b) procedure (administration or receivership);
- (c) practitioner(s) appointed;
- (d) practitioners' firm;
- (e) date procedure commenced;
- (f) date of exit from procedure;
- (g) purchaser of the business;
- (f) whether the purchaser had a prior connection to the business—this essentially encompassed purchasers who were directors or shareholders of the original company;
- (g) date of sale;
- (h) whether a valuation was carried out;

- (i) whether the business was marketed prior to sale;
- (j) the number of employees transferred;
- (k) the percentage of employees transferred;
- (l) the amount of secured, preferential and unsecured debt at the commencement of the procedure;
- (m) returns to secured, preferential and unsecured creditors;
- (n) the overall percentage return to creditors;
- (o) whether 'Newco', the purchaser of the business, has since entered into an insolvency procedure;
- (p) and if so, the nature of the follow-on procedure, and whether the practitioners were the same as those conducting the original sale.

Once complete, these databases were used to compare outcomes in pre-packs and in business sales and also to map certain trends in the use of pre-packs, including their incidence and whether this is increasing over time. Again, the very process of constructing and analysing the databases was as valuable for the identification of *questions* as it was for the provision of answers and these questions are currently being put to a range of stakeholders in the pre-pack strategy.

(c) Hitting the Ground Running: Some Lessons Learned

Before moving on to consider some of the results of both projects, it is worth reflecting briefly on lessons learned during the data-gathering process, not least because they will hopefully inform the next phases of research. The first of these would probably have occurred to seasoned empirical researchers at the very outset: when planning a project of this nature it is important to appreciate that necessary data may only become available over a protracted period of time or may not be available at all from the selected source. In this context, practitioner reports were heavily relied upon in the data-gathering exercise, and the author rather underestimated just how long corporate insolvencies may last from beginning to end.²⁴

This meant, in essence, that the outcomes project database, at the reporting stage, was incomplete, particularly in relation to information on returns to creditors.²⁵ This in turn meant that analysis in relation to certain variables was only possible in relation to subsamples (this afflicted both

²⁴ Ie from the commencement of one procedure to the final distribution to creditors, if there is one, usually effected through another procedure. Both receiverships and administrations may be followed by a creditors' voluntary liquidation during which unsecured creditors claims are dealt with and distributions made.

²⁵ The Insolvency Service has sponsored a further period of research in this regard, so that gaps in the information will gradually be filled as procedures draw to a close (usually with the dissolution of the company).

projects, especially in the context of returns to creditors, and to unsecured creditors in particular). Whilst the numbers in the subsamples might, in the overall scheme of things, be regarded as significant, the possibility of bias towards a certain outcome amongst the cases in the subsamples had to be factored into the findings. As an example, zero returns to unsecured creditors are most likely to occur in cases where a receivership or an administration procedure moves into dissolution²⁶ and these cases inevitably ‘close’ more quickly than those where the receivership or administration moves into a creditors’ voluntary liquidation.²⁷ Thus, the subsample of cases used to analyse returns to unsecured creditors in both projects may well comprise those cases inherently more likely to result in a zero return. The best the author could do in these circumstances was to acknowledge the fact that results might be skewed and continue to fill in gaps over time to see whether this was actually the case.

Secondly, and more positively, the author learned one of the very real values of databases, and that this is that the information contained on them allows for a huge variety of different analyses, including some never contemplated at the outset. This flexibility was brought sharply into focus as the interview data was collected and new research questions emerged. As an example, analysing data according to a timeline to detect possible responses to case-law developments is possible. The decision of the House of Lords in *Buchler v Talbot*²⁸ was reported in March 2004, and interview data had highlighted one potential change in professional practice consequent upon the decision.²⁹ It was possible to investigate this by using the database to attempt to discover any correlation between particular outcomes and the decision itself.

V. SELECTED RESEARCH FINDINGS: UNINTENDED CONSEQUENCES BECAUSE OF HOW LAW WORKS?

(a) Introduction

There are many fields calling out for empirical research and this is important for reasons of policy, for reform and for deeper understanding of the law and legal

²⁶ In administration, under para 84 sch B1 Insolvency Act 1986. In receivership, the most usual sequence of events is that the receiver vacates office and the company’s directors apply to the registrar of companies to have the company dissolved on the grounds that it has ceased to trade.

²⁷ In administration, under para 83 sch B1 Insolvency Act 1986, with the incumbent administrators usually continuing to act as liquidators. In receivership either the receiver or the company’s directors place the company in liquidation. It is less often the case here that the same practitioner will continue to act as liquidator. ‘Follow-on’ CVLs may add at least 18 months to the overall length of the formal insolvency.

²⁸ *Buchler v Talbot* [2004] UKHL 9.

²⁹ This is considered in a little more detail below in the text at n 47.

processes in action. The field is therefore wide open for researchers and the scarcity of empirical legal research virtually guarantees originality. There are areas where the most basic descriptive information is lacking, creating opportunities for researchers interested in entering a substantive field.³⁰

Although neither of the research projects was explicitly designed to examine the impact of the operation of law in the real world *per se*, clearly the interview stages in particular were expected to illuminate, at least to some extent, this particular phenomenon. Insolvency practitioners, whilst directed by law to attempt to achieve particular results,³¹ have practical and commercial experience and expertise that lawmakers (and academics) may lack, and so may have their own ideas about *how* the prescribed ends are best pursued. Financiers, particularly large institutions, are repeat players in insolvency and have the resources and expertise to devote to protecting their interests against potentially disadvantageous legal interventions.

It became patently obvious during the course of interviews for the outcomes project that certain findings from an analysis of the database were explicable not by reference to the coming into force of the provisions of the Enterprise Act *per se*, but rather were a function of developments in professional practices facilitated by those provisions. Equally, case-law developments preceding the Act itself, sometimes by some distance, had already prompted institutional lenders to take steps to adapt their lending methods *in anticipation* of further developments that might threaten their interests. These developments may have been unknown to or unanticipated by the policymakers, but they demonstrably skewed certain of the outcomes under investigation.

A further point should be made here, and that is that there turned out to be certain advantages in undertaking simultaneously two distinct, but contextually related, empirical research projects.³² In short, the projects complemented and informed each other to a significant and unexpected extent, and assisted the author's understanding of the highly complex and intricate interaction of a wide range of exigencies and demands in insolvency. Even now, the sense is very much that the surface has been only faintly scratched and that there is much more to be discovered. This chapter does not attempt to outline the full findings of the two projects to date. Rather, the following two sections focus on those findings from each project that particularly illustrate the tendency of professional practice to have consequences for legislative aspirations.

³⁰ H Genn, M Partington and S Wheeler, 'Law in the Real World: Improving Our Understanding of How Law Works', The Nuffield Foundation, November 2006, para 25.

³¹ See eg para 3 sch B1 Insolvency Act 1986.

³² The disadvantages are, generally, red-eye syndrome and a dramatic acceleration of the ageing process.

(b) The Outcomes Project*(i) The Rise and Rise of Receivables Financing*

An analysis of receivership appointments from the outcomes project demonstrated that 22 per cent of such appointments were made by receivables financiers, whether independent or arms of the major clearing banks. This finding suggested that there has been a gradual ‘fragmentation’ of secured lending to corporations which probably started some time before the beginning of the sample period but has been accelerated by the *Brumark* decision.³³ This was comprehensively confirmed by the interview data. The same trend has been cogently described and considered by Professor John Armour.³⁴

The availability of debts owed to a company as security for debts owed by it has been a perennial feature of lending practice. The decision in *Siebe Gorman Ltd v Barclays Bank Ltd*³⁵ confirmed that debts could be the subject of a fixed, rather than a floating charge.³⁶ The advantages of a fixed charge over a floating charge are that it is not vulnerable to the claims of preferential creditors,³⁷ or to the ‘prescribed part’,³⁸ nor can administration costs and expenses be claimed out of its proceeds. Further, a fixed charge given for past value cannot be challenged under section 245 Insolvency Act 1985, and assets subject to a fixed charge cannot be disposed of by an administrator without the leave of the court. There are, therefore, a number of incentives for lenders to ensure that as many asset groups as possible fall under the fixed charge portion of the security and book debts, as an asset group, tend to be of high value.³⁹

The *Brumark* litigation was not in fact concerned with a debenture of the *Siebe Gorman* variety.⁴⁰ However, Lord Millett’s judgment appeared to question, at least in veiled terms, the correctness, *on its facts*, of the earlier decision. Alerted to the possibility that a highly convenient and straightforward method of acquiring the best possible security might be open to challenge, the clearing banks accelerated a process that was already in motion, namely the shifting of some of their riskier loans away from

³³ *Agnew v Commissioner of the Inland Revenue* [2001] 3 WLR 454 (HL)

³⁴ See J Armour, ‘Should We Redistribute in Insolvency?’ in J Getzler and J Payne (eds), *Company Charges: Spectrum and Beyond* (Oxford University Press 2006) 189–226.

³⁵ *Siebe Gorman & Co Ltd v Barclays Bank Ltd* [1979] 2 Lloyd’s Rep 142 (Ch).

³⁶ Provided that the debenture prohibited dealings with the debts prior to collection and required the proceeds of the debts to be paid into a *blocked* account with the chargee bank.

³⁷ Ss 175, 45, sch B1 para 65(2) Insolvency Act 1986.

³⁸ S 176A Insolvency Act 1986.

³⁹ Statements of affairs and receipts and payments accounts demonstrate that a company’s book debts are very often the most valuable of its assets.

⁴⁰ One interviewee wryly commented that the decision itself was a virtual irrelevance in New Zealand, where legislation had overtaken its effects, and expressed regret that the practitioners had not seen fit to settle before the Privy Council had an opportunity to comment.

overdraft facilities and into receivables financing. Interviewees, both practitioners and bankers, confirm that this practice was established some time before the *Brumark* decision.⁴¹ More recently, the House of Lords in *Re Spectrum Plus*⁴² has confirmed that the approach of the Privy Council to the characterisation of charges over book debts as fixed or floating is the correct one, and this may well even further accelerate the move towards receivables financing for the future.⁴³

It should be emphasised that the advantages of receivables financing accrue to the 'borrowing' company, as well as to the financiers themselves, as one interviewee pointed out in the following terms:

The market works well, and particularly for the SME company, where the world and his wife will be wanting to lend money to them. So assuming the company raises its money when it's looking okay, they will probably have played off two or three debt financiers against each other, and there are two main parameters I guess, one is the percentage advance that you can get, which can be anything from 60 per cent to maybe 90 per cent.

Whilst this form of borrowing is probably more expensive for companies, it almost certainly allows for a higher gearing than traditional overdraft and term lending, and it is extremely flexible in that it allows for speedy increases in finance provision commensurate with the growth of the business.

To what extent has the acceleration in recourse to receivables financing affected the attainment of the objectives of the Enterprise Act? To recap, the Act was designed to increase the incidence of corporate rescue but also to enhance returns to creditors. As to the first of these, interviewees considered that where receivables financing is the only, or the main, source of the company's cash-flow, this may affect that company's ability to seek a turnaround solution, either in or outside of an insolvency procedure. This was generally attributed to a different perspective on lending between mainstream banking and receivables financing. Whilst banks might be inclined to seek a solution for a troubled customer, rather than to exit at the first possible opportunity, this may be different for a receivables financier. On the other hand, several interviewees pointed out that receivables financiers were themselves beginning to develop processes which might in time provide as effective a support network as that currently said to be offered by the clearing banks through their 'relationship lending'

⁴¹ The majority of interviewees suggest that the banks were investigating alternatives to the traditional overdraft facility or term loan at least 12 years ago, and in response to the recession of the early 1990s which saw unprecedented levels of receivership appointments. This was coupled with the development of far more sophisticated support services which sought to address financial distress at an early stage and to consider methods of restoring financial health without resort to insolvency procedures.

⁴² *Re Spectrum Plus* [2005] UKHL 41.

⁴³ It may not be too much of an exaggeration to suggest, as did one interviewee, that *Spectrum* may lead to the 'death of the overdraft' as far as lending to small and medium-sized companies is concerned.

approach. Nevertheless, the ease with which receivables financiers can exit from a relationship with a troubled borrower, and the prospect of the much higher returns likely in such a scenario, may make corporate rescue a less achievable outcome.

As to the second, the fact that receivables financing agreements are structured so as to allocate book debt collections to a fixed charge means that the floating charge portion of the security is depreciated and, therefore, that there may be less funding available to mount a trading strategy within insolvency. This may lead to premature liquidation of the assets of the business. It will also mean that the proportion of realisations available to unsecured creditors under the prescribed part⁴⁴ is inevitably reduced.

Indeed, it is worth noting here that the research found that in many cases the insolvent company has had recourse to a plethora of financing options, including hire purchase, chattel leasing and sale and lease-back, so that virtually all of its assets are encumbered in some way or another, and very few of them either 'free' assets or subject to a floating charge. As one practitioner put it:

A second, much more recent phenomenon, is that there is so much more secured lending around now that we are finding it rarer and rarer to go into a small/medium sized basic business, a metal bashing business or whatever, and finding that there are any unencumbered assets. We typically find a sale and lease back of property, the book debts have been factored, the plant and machinery has finance on it and the bank will have an overdraft and a charge on any goodwill. When you then come to realise the assets you can find that there's nothing covered by a floating charge, it's arguably all fixed charge, and that means that there's even less coming through to unsecured creditors because of the way the funding market is changing.

Developments in lending practice, leading to a fragmentation of security and quasi-security interests amongst several holders, each with their own agenda, will, therefore, make the task of formulating a rescue strategy that much harder, and may also leave less assets available to meet the claims of unsecured creditors in particular, at least in the short term.

(ii) Disguised Liquidations⁴⁵

The research found that, whilst rescue of the corporate entity itself in the

⁴⁴ See s 176A Insolvency Act 1986.

⁴⁵ This phenomenon is also documented by two excellent research projects, both sponsored by the Insolvency Service. See A Katz and M Mumford, 'Study of Administration Cases', Report to the Insolvency Service, October 2006, <http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/research/corpdocs/studyofadmindcases.pdf>, accessed 9 July 2008. See also J Armour, A Hsu and A Walters, 'The Impact of the Enterprise Act 2002 on Realisations and Costs in Corporate Rescue Proceedings', Report to the Insolvency Service, December 2006, <http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/research/corpdocs/ImpactofEAREport.pdf>, accessed 9 July 2008.

course of an insolvency procedure is extremely rare, nevertheless sales of the company's business as a going concern accounted for 40 per cent of all administration cases and 41 per cent of all receivership cases. In both procedures, the most frequent outcome was a break-up sale of the company's assets (in 53 per cent of administrations and 54 per cent of receiverships). However, one surprising finding was that post-Enterprise Act administrations appeared more likely to result in a break-up sale than pre-Enterprise Act administrations (44 per cent in pre-Enterprise Act administrations and 56 per cent in post-Enterprise Act administrations). Ostensibly, therefore, far from leading to more *business* rescues and fewer asset sales, the Enterprise Act appears to have had precisely the opposite effect.

Further investigation of this finding produced clear evidence from the interview data, to some extent supported by further analysis of the database, that a number of post-Enterprise Act administrations are 'liquidations in disguise': they are cases which, prior to the coming into force of the Enterprise Act would almost certainly have been carried out as a liquidation. Now that an administration can be entered into without the involvement of the court,⁴⁶ the question arose as to why it would be used in this way.

One explanation was dubbed 'the *Leyland DAF* effect'. The decision of House of Lords in *Buchler v Talbot*⁴⁷ overturned the earlier Court of Appeal decision in *Re Barleycorn*⁴⁸ to the effect that the costs and expenses of a liquidation were payable in priority to the claims of a floating charge holder. Liquidators no longer had access to floating charge assets to meet their costs and expenses except to the extent that those costs were incurred in the realisation of secured assets. Therefore the only funds available to pay such costs, and, critically, the liquidator's fees, would be the unencumbered assets of the company, of which there were unlikely to be many. The position is different in administration, where costs, expenses and fees have statutory priority to floating charge claims. The ease with which administration can now be entered, and the potential for recouping fees from floating charge assets, offers an immediate and convenient solution to the *Leyland Daf* problem.

There is no doubt that this solution has been adopted. Further analysis of the database demonstrated a notable increase of 7 per cent in the number of asset sales in the post-*Leyland Daf* period in administration and, overall, rescue outcomes and business sales decrease correspondingly. Whilst section 1282 Companies Act 2006⁴⁹ will to a considerable extent reverse the *Leyland DAF* decision, there remains for the time being a clear incentive for practitioners who envisage incurring substantial expenses in the

⁴⁶ See paras 14 and 22 sch B1 Insolvency Act 1986.

⁴⁷ *Buchler v Talbot* [2004] UKHL 9.

⁴⁸ *Re Barleycorn* [1970] Ch 465 (CA).

⁴⁹ Which came into force on 1 April 2008.

course of a procedure to steer the company into administration rather than liquidation.

A second explanation, and one that was mentioned by several interviewees, is that administration will be preferred to liquidation because it secures the appointment for the practitioner in question. The basic premise is this: a practitioner may be approached for advice by management, and, finding that the company is terminally insolvent, and with no prospect of a business sale, may recommend administration over liquidation to avoid the prospect of losing the appointment at a subsequent liquidation creditors' meeting. The prospect of an administration rather than a liquidation will also be more attractive for the directors of an insolvent company for obvious reasons. Given that directors now have power to make administration appointments under paragraph 22 of Schedule B1, there is room to suggest that, with the blessing of any qualifying floating charge holder, they may be making administration appointments in circumstances where, prior to the Enterprise Act, a creditors' voluntary liquidation would have been the only available choice.

One final explanation for the rise in post-Enterprise Act asset sales is that administration has considerable advantages over liquidation in terms of the speed at which it can be entered, and the enhanced powers of an administrator in dealing with assets and managing the business of the company. Liquidation has some deleterious effects in terms of terminating contracts subject to *ipso facto* clauses which may not arise in an administration and trading in a liquidation may be difficult or even impossible. Some interviewees offered this as an explanation as to why, even where it was contemplated that an asset sale would follow, administration was still an appropriate choice of procedure.

Overall, therefore, it appears that the initial finding that post-Enterprise Act administrations resulted in less business sales, may have as much to do with unanticipated professional responses to certain aspects of the Act.

(c) The Pre-Pack Project

(ii) *The Incidence of Pre-Packs*

The number of pre-packs has risen over time, but most sharply in administration, and in post-Enterprise Act administration in particular. As noted earlier, cases in which the business of an insolvent company had been sold as a going concern were identified from the outcomes database and were then categorised as either pre-packs or 'business sales'. Of 639 cases altogether, 227 fell into the former category and 412 into latter. Thus, in the period under investigation, 35.5 per cent of going-concern sales in the sample were effected through a pre-pack.

Interestingly, the Enterprise Act is clearly of some significance as far as pre-packaged administrations are concerned. Whilst the proportion of pre- and post-Enterprise Act *receiverships* was reasonably even (47.7 per cent and 52.3 per cent of the sample, respectively) there was marked increase in the frequency of pre-packs in administration after the Enterprise Act came into force (33.9 per cent of administration pre-packs took place in the pre-Enterprise Act period and 66.1 per cent in the post-Enterprise Act period). Numbers of pre-packs began to rise quite sharply in receivership from around December 2002, and in administration from December 2003, which tends to support the suggestion that the Enterprise Act, which came into force on 15 September 2003, has prompted a rise in administration pre-packs. Thus, a certain synergy between the two different projects emerges.

It is pertinent to question why the Enterprise Act should make any difference:⁵⁰ given that 38 (32.2 per cent) administration pre-packs took place prior to the coming into force of the Enterprise Act, it can probably be assumed that the courts themselves were not averse to granting administration orders to effect pre-packs.⁵¹ One possible explanation is that practitioners themselves may have been cautious in taking pre-pack proposals to courts prior to the Enterprise Act, and that, whenever the strategy commended itself, would advise that the transaction be effected through receivership instead. The out-of-court entry route to administration in paragraphs 14 and 22 of Schedule B1 Insolvency Act would enable a pre-pack through administration without court scrutiny and, if the above explanation is valid, at least partly explain what was behind the impact of the Enterprise Act.

An interesting further enquiry is whether the rise in post-Enterprise Act administration pre-packs is *necessarily* a function of the desire to avoid court scrutiny in the pre-Enterprise Act period, or whether some other consideration is at work here. At the risk of speculation, it may be that the court appointment route is seen as inherently problematic in terms of cost and delay where a pre-pack is envisaged, and is therefore only used when its benefits clearly outweigh its drawbacks.⁵² This is a question that can usefully be addressed more fully in the next phases of the research. One final point that should be acknowledged is that, as this research is necessarily historical, it does not capture further developments in the pre-pack landscape. It is certainly possible that, as an example, the decision in *Exeter*

⁵⁰ The sample profile of itself would not appear to have any impact on this trend.

⁵¹ In eight of the cases in the pre-Enterprise Act sample the practitioners explicitly referred to the fact that the judge in question had been given full details of the proposed sale in the Rule 2:2 report accompanying the application.

⁵² Fortunately enough, a delegate at the R3 Lite Conference in Cambridge explained that, in relation to one case on which he was advising, the open-court route was considered expedient where there was significant opposition to the contemplated pre-pack from one major creditor. In one sense, therefore, the court route may be being used as a quasi-cramdown device.

City Council v Bairstow,⁵³ which holds that business rates are payable as an expense of the administration, may prompt an acceleration in the pre-pack trend. Moreover, any doubts about the legality of the pre-pack process *per se* are, arguably at least, inferentially dispelled by the decision in *Re DKLL Solicitors*,⁵⁴ and so a further rise in their numbers might be anticipated. Again, this is an area where further and continuous investigation is clearly called for.

(ii) *Employment Preservation and Some Other findings*

In comparing pre-packs and business sales, the similarities were as notable as the differences. However, it appeared that business sales tended to produce better returns to unsecured creditors than did pre-packs, and that this finding was especially pronounced in relation the post-Enterprise Act administrations. Whilst the finding is somewhat tentative, being based on subsamples of each type of sale which themselves may be inherently biased towards a particular outcome,⁵⁵ there is some weak evidence to support the proposition that pre-packs will deliver lower returns to unsecured creditors and zero returns in a higher number of cases.

One possible explanation for this may be that pre-pack sales have a tendency to take place at a consideration which will deliver value to secured and preferential creditors and cover the costs of the procedure, but will fail to capture any premium which would then drip down to unsecured creditors. This is clearly a matter for further investigation. However, there is one further possible factor in play here, and this is the finding that pre-packs have a much more pronounced tendency to preserve employment than do business sales. In the 65 per cent of the business sale cases where information was available, 100 per cent of employees of the company transferred to the eventual purchaser of the business by virtue of the Transfer of Undertakings (Protection of Employment) Regulations.⁵⁶ This compares to a transfer rate of 100 per cent in 92 per cent of pre-pack cases for which the information was available.

In fairness, this finding should not really come as any great surprise. One factor common to most administrations and receiverships, and one that is often documented by practitioners as driving the pre-pack, is the scarcity of resources with which to trade for any protracted period after appointment. It is usually the case that the business will have to keep trading if there is to be any prospect of a going concern sale, but lack of funding will in many cases be a barrier to a long-term trading strategy. Where savings have to be made, therefore, one of the first casualties is likely to be that section of the

⁵³ *Exeter City Council v Bairstow* [2007] EWHC 400 (Ch).

⁵⁴ *Re DKLL Solicitors* [2007] EWHC 2067 (Ch).

⁵⁵ See text above at nn 25–7.

⁵⁶ Transfer of Undertakings (Protection of Employment) Regulations 2006 SI 2006/246.

workforce that is not thought to be critical to the business's continued operation. A number of the business sales reports document this process explicitly; on appointment, the practitioner takes steps both to sell the business but also to minimise the costs of keeping it running in the interim, and many reports referred to the need to make 'some', or 'a few', or 'a majority' of the workforce redundant.

The pre-pack sale, on the other hand, is often preferred precisely because it avoids any need to find a means of funding trading. By definition, there is no gradual necessity to make employees redundant. What is more, there is far less scope to effect 'opportunistic' redundancies in advance of a pre-pack in order to make the business more saleable. 'Economic, technical or organisational reasons entailing changes in the workforce of the transferor or transferee'⁵⁷ are far less likely to be available in a pre-pack scenario than they are in a business sale scenario, and it is thought unlikely that either practitioners or purchasers of businesses in a pre-pack form would wish to chance their hands in an attempt to rely on such, particularly given the consequence that, if unsuccessful, the employees in question will have been unfairly dismissed and a further liability on the purchaser will arise.

One intriguing question arising from this finding is whether the higher rates of employment preservation in pre-packs may have a knock-on effect on returns to unsecured creditors, and might, therefore, partially explain the finding that pre-packs seem to return proportionately less to unsecured creditors than do business sales. The basic point is this: where the transfer of a business is contemplated, a well-informed and well-advised prospective purchaser may well make some estimation of the level of actual and contingent employee liabilities, which he may then use to calculate what he is prepared to offer for the business. It is not just actual liabilities that are important here: these may well be quite small, but the uncertainty associated with insolvency sales, and the prospect of having to make post-transfer redundancies of possibly long-serving employees, may lead to a much higher estimation of *contingent* liabilities. In short, the extent to which purchasers accept a high proportion of employees from the vendor may dispose them to discount their offer for the business to take account of this.⁵⁸

The effect of this is to lower, to a greater or lesser degree, the price of the business, and this depreciation is inevitably borne by creditors at the tail end of the queue for payment. It may be, therefore, that unsecured creditors are subsidising employment preservation, and this may shed some light on what appear to be lower returns to them in pre-packs. If this is correct, it raises a fascinating policy dilemma. It might be thought that in this scenario employees should be prioritised. The personal cost to them, and to

⁵⁷ *Ibid*, reg 7.

⁵⁸ Interviewees in the outcomes project mentioned that this was not uncommon.

the state, which may have to support them in the short to medium term, might be thought to outstrip by some distance the cost to unsecured creditors in terms of their return. This is especially the case when one considers that while levels of unsecured debt may appear high, the total sum is made up of the claims of often high numbers and, of course, HM Customs and Revenue. Moreover, the monetary difference to unsecured creditors between a 1 per cent dividend and a 4 per cent dividend is in many, but not all, cases likely to be negligible. Of course, some unsecured creditors are 'more equal' than others, and if called upon to referee the relevant merits of the interests of the Kwik Save employees and the Farepak families, public opinion might find itself somewhat troubled.

This is, of course, a highly speculative proposition, and requires far deeper investigation. It should certainly be borne in mind that employment preservation will also mean that the company's preferential debts are lower (as those obligations transfer to the purchaser of the business) and, equally, the body of unsecured creditors does not include those employees who have transferred to the purchaser. In one sense, therefore, one might expect *lower* returns to unsecured creditors as a class where they include a constituency of redundant employees. It may, however, be possible that the discount applied to take account of potential and contingent claims is higher than will actually materialise, being based on a worst-case scenario. Hopefully the true position will become clear as the research progresses.

One further point should also be made which might take the gloss off the finding that pre-packs tend to preserve employment, and this is that the research also demonstrates that a slightly higher proportion of pre-packs sales subsequently 'fail', in that the purchasing company enters insolvency proceedings at some point after the acquisition of the business. Whilst this dichotomy is not markedly pronounced (39 per cent of pre-packs fail, as compared to 35 per cent of business sales), its significance is amplified by the finding that sales to connected parties (most usually incumbent owner/managers) are slightly more likely to fail than those to independent purchasers, and that in the post-Enterprise Act administration pre-pack sample sales to connected parties are somewhat more prevalent. Overall, therefore, whilst there remains much work to be done in this area, initial findings already throw up some tantalising questions which themselves may engender debate.

VI. SOME CONCLUDING REMARKS (BUT NOT CONCLUSIONS!)

The effect of the Enterprise Act is, as far as the author concerned, very much a work in progress, and the questions posed at the beginning of this chapter cannot, as yet, be answered definitively. However, a few proposi-

tions that will stand up to scrutiny may be offered at this point. The first is that the Act itself appears to have had little impact on the incidence of corporate rescue, at least in its first year of operation. Levels of corporate rescue were very low before the coming into force of the Act and remain as low after it, with around only 4 per cent of all companies in the entire sample recording a rescue outcome. *Business* rescue, on the other hand, seems a more realistic expectation from insolvency procedures, although it would appear that the *choice* of procedure may not be critical to the business rescue outcome, with administrative receivership seemingly as successful in this regard as administration.

The emergence of the pre-pack strategy is intriguing. Its potential for employment preservation could certainly be taken as a positive characteristic, and it would appear that the incidence of pre-packs has been driven upwards by the easier entry routes in administration offered by the Enterprise Act. Moreover, there is at least an argument that, to the extent that the Enterprise Act was as much about offering businesses and their managers (as opposed to companies) a second chance, then the pre-pack is furthering the achievement of that objective. There is certainly something to be said for offering those managers, whose companies fail due to externalities, that second chance: and a going concern sale of the company's business back to them is one way of affording them that opportunity. The recidivism rate, however, might be a matter of some concern, and lead to accusations of a phoenix syndrome arising from the ashes of a phoenix syndrome.

This research will inevitably raise as many questions as it answers, and many of these questions can only be answered by debates into legislative policy, rather than whether the means selected to achieve the end are appropriate. Overall, this makes for a fascinating few years ahead.

4

Comment and Summary

PHILIPPE THÉRY

THE PRECEDING CHAPTERS by Louise Gullifer and Sandra Frisby give the French jurist the opportunity to reflect on the similarities and differences between English and French law.

It is of course self-evident, as regards similarities, that bankruptcy law has limitations that are the same everywhere, and that these influence the legislation in both countries. Insolvency proceedings are an exercise *par excellence* in allocating scarce resources, to use the economist's expression, or, put more simply, sharing a biscuit out between many guests. In other words, in insolvency proceedings there is always the conundrum of satisfying every creditor, all of whose interests are, in their own ways, legitimate. They could all claim that the business would not have existed, or would not have been able to develop, without them. This not only explains the conflicts among the various categories of creditor, but also justifies the idea of a community of interests, which is the keystone of any insolvency proceedings. The analogy of *lex rhodia de jactu*, made by legal historians, is eloquent: where goods were thrown from the deck into the sea to save a ship foundering in a storm, the loss was not borne solely by the owner of the jettisoned goods but shared between the owners of the entire cargo, since the sacrifice of goods had benefited all of them.

Well, of course the ship must be saved and, taking a more farsighted view view, *lex rhodia* prefigures our methods of saving a business. Reports have shown that in France as well as England a business is seen as value that should not be lost where this can be avoided, *even at the cost of sacrifices made by the creditors*.¹ Thus, in both countries, the legislature has laid down a hierarchy of the objectives of insolvency proceedings, in which saving the business ranks first. However, care should be taken to construe this aim in its current context. It is today's concerns relating to the general

¹ Corinne Saint Alary-Houin, *Procédures collectives: le rôle de la jurisprudence dans l'évolution du droit des faillites vers la sauvegarde des entreprises*, Bicentenaire du code de commerce, 1807–2007 (Paris, Dalloz, 2007).

interest, be it economic or social, that have placed the emphasis on saving the business.

Another striking feature is the weight placed on selling the business. The Act of 25 January 1985 saw it as a form of recovery—the assignment plan—which is quite true, since the economic activity would survive even if the legal entity disappeared. However, for the creditors linked to this entity it was a form of liquidation, and the 1985 Act gave it the effects of liquidation.² The 2005 Act provided for assignment as one method of liquidation, thus returning to the solution laid down by the Act of 13 July 1967, which organised the *cession à forfait* (assignment for a fixed price) as a liquidation method.³ However, this requalification did not do away with the hybrid nature of the assignment, and, like the 1985 Act acknowledging that the liquidating finality of an assignment qualified as a recovery means, the 2005 Act, while ranking assignment after liquidation, saw it as a means of saving the business.⁴ The recourse to *pre-packs* described by Dr Frisby is a good illustration of the idea that any business in difficulty will, *de facto*, find itself on the market. It also trains the spotlight on the practices that develop from the statutory provisions, undermining or, sometimes, contradicting them, and which can distort the perception of insolvency proceedings. Yves Guyon thus noted that the statistics for insolvency procedures did not take account of the fact that businesses that could be saved were often saved before the opening of the proceedings, due to prior intervention by one or other safeguard committee under the authority of the Ministry of Finance.

The final aspect for which a more detailed comparison could be made is the security the business can offer its creditors. Louise Gullifer has highlighted the increasing use of accounts receivable. The same thing has been observed in French law, since the introduction of the debt assignment by means of filling in a special form (the so-called ‘Daily’ assignment, named after the member of the French parliament responsible for the bill)⁵. It is a simplified way of shunting the company’s receivables over to the bank, which could be used for the transfer of a group of debts, including future receivables. After some hesitation, the Cour de Cassation agreed that this was an effective tool, even after insolvency proceedings had been

² This was reflected in art 1844-7-7 of the French Civil Code: in the same way as the liquidation judgment, the decision ordering total assignment of the business led to the company being dissolved.

³ These provisions gave the legal basis to the practice of company takeovers until the 1985 Act, the purpose of which was to make them ‘more ethical’.

⁴ Art L642-1 is unambiguous: ‘The reason for selling the business shall be to maintain activities that can continue autonomously, keep all or a proportion of the jobs arising from them, and pay off debts.’

⁵ Arts L313–23 of the Monetary and Financial Code. The *bordereau* is a written form, mentions of which are described in the aforesaid provision. A model of the form can be found in Décret no 81-8621 du 9 septembre 1981, Annex I (http://www.legifrance.gouv.fr:80/jopdf/common/jo_pdf.jsp?numJO=0&dateJO=19810919&pageDebut=02504&pageFin=&pageCo)

opened.⁶ This use of accounts receivable as security adds the finishing touch to the image of a businessman who owns nothing: he rents the plant and buildings that he uses, or he leases them; his assets belong to the seller, who retains ownership; and his accounts receivable are assigned to the bank that is financing him.

However, there remain significant differences between the bankruptcy laws of the two countries: in French law, insolvency proceedings are public and the interested parties attempting to avoid them run the risk of seeing their agreements struck down, if only because the *Cour de Cassation* recognises the debtor's right to demand that the statutory provisions be complied with. The commercial court plays a central role, and any initiative that the interested parties might take will be under its supervision. Private arrangements such as pre-packs would no doubt be possible, but would have to remain purely private; at any rate, they would not be imposable on the court once the insolvency proceedings have opened. It would not, therefore, be possible to start proceedings solely for the purpose of getting them executed.

Furthermore, a creditor, in French law, could never have benefited from a situation like that of the beneficiary of a floating charge. His situation is so extraordinary that it seems to a French lawyer that the English bankruptcy Act has been designed to thwart floating charge holders.⁷ The difference is all the more striking since in French law, until recently, a creditor holding a secured claim had no special procedure at his disposal with which to call on the security he had the benefit of. The procedures to force execution—ie seizures—were the same regardless of whether the creditor was secured or not.⁸

The characteristic of French bankruptcy law has always been to operate using categories. Although every secured creditor was protected by the Act of 1967, they all received the same treatment and none of them benefited

⁶ Com 7 December 2004, Bull IV, n 213.

⁷ The 'floating charge' is unknown in French law. The best that can be done is to draw comparisons, which would merely serve to highlight the difference between the two systems. General privileges are the closest thing to the floating charge that French law can offer. The purpose of this priority right is to allow its exercise on all assets (or more often, all moveable assets) at the time the company is sold. The debtor thus remains free to dispose of his assets and the priority will be applied to those which he acquires. However, such security can only exist in law. In terms of conventional security, that resembling a floating charge most closely is security covering a group of assets of the same type, eg shares, oil or crops, that the debtor is free to dispose of. The security will also comprise the assets acquired in replacement (inventory, trade receivables). These do not have the all-encompassing nature of the floating charge.

⁸ The only exception was the creditor's possibility to ask the judge to award him the pledge as payment (formerly art 2078 of the Civil Code). Since the ordinance of 23 March 2006, in addition to the traditional seizure enabling him to sell the asset in order to exercise his priority, the creditor has also been able to conclude a *commissoria lex*—he will become owner of the asset where the debtor does not pay at the due date, or request the judge to award him ownership of the asset serving as security. However, these procedures are blocked in the event of insolvency proceedings.

from a position as advantageous as that of the floating charge holder vis-à-vis the other creditors. The treatment of the remuneration of the professionals dealing with the insolvency procedure is another example. Although their priority payment is based on the idea that costs must be shared only by those benefiting from the procedures, to a French jurist it seems natural that the costs should always be treated the same, whatever the outcome of the procedure.

Finally, no French jurist would understand that the receiver appointed by the beneficiary of the floating charge should owe duties solely to the latter. The French provisions on liability are too general for this solution to be possible,⁹ and if a French judge had been confronted with a similar issue, he would without a doubt have punished a receiver for damaging the creditors' interests when he could have avoided it.

⁹ 'Any person causing any wrong whatsoever to another shall be bound to remedy that wrong': art 1382 of the Civil Code.

Strategic Insolvency Migration and Community Law

WOLF-GEORG RINGE*

I. INTRODUCTION

STRATEGIC CROSS-BORDER movements within the European Union have been a matter of much debate in the context of company law in recent years, but now the discussion has reached a new level. Whereas the last years revealed a competition for the most flexible and business-friendly corporate law regime within the EU,¹ the *dernier cri* of cross-border migration in Europe is to migrate across the border in order to profit from another insolvency law regime, a phenomenon referred to as ‘forum shopping’.

Unlike company law, the situation with insolvency law is more complicated, since EU legislation provides for an instrument that deals with exactly this matter: the European Insolvency Regulation.² Rather than harmonising the substantial insolvency law of the Member States, the Regulation confines itself to unifying national rules on jurisdiction and conflict of law for insolvency matters.³ This Community instrument takes a firm stand within the debate of forum shopping: ‘It is necessary for the proper functioning of

* I am grateful to John Armour, Michelle Harner, Paschalis Paschalidis, Philipp Reuss, Oren Sussman and Charlotte Willemer for their helpful comments on earlier versions of this chapter.

¹ See on this eg WH Roth, ‘From Centros to Ueberseering: Free Movement of Companies, Private International Law, and Community Law’ (2003) 52 *ICLQ* 177; J Rickford, ‘Current Developments in European Law on the Restructuring of Companies: An Introduction’ (2004) 15 *European Business Law Review* 1225; J Armour, ‘Who Should Make Corporate Law? EC Legislation versus Regulatory Competition’ (2005) 58 *Current Legal Problems* 369; WG Ringe, ‘No Freedom of Emigration for Companies?’ (2005) 16 *European Business Law Review* 621; M Siems, ‘SEVIC: Beyond Cross-Border Mergers’ (2007) 8 *European Business Organization Law Review* 307.

² Council Regulation (EC) no 1346/2000 of 29 May 2000 on insolvency proceedings, [2000] OJ L160/1. Hereafter the ‘Regulation’.

³ Cf Recital 11.

the internal market to avoid . . . forum shopping.’⁴ The purpose of this chapter is to question this hostile attitude that the Regulation has towards forum shopping. It will be argued that forum shopping can have beneficial effects both for the company and for its creditors. Furthermore, the validity of the ‘centre of main interests’ (COMI) approach of the Regulation under the fundamental freedoms of the Treaty is questioned; it is suggested that the current regime needs to be amended.

This chapter is structured as follows: first, a definition of the idea of forum shopping will be analysed (section II). Recent examples that have been become public, as well as legislators’ reactions will be discussed (section III). Then I will analyse the motivations behind forum shopping (section IV) and discuss its desirability from an economic perspective (section V). Finally, I will put the concept to a compatibility test with primary EU law, notably the fundamental freedoms of the Treaty.

II. WHAT IS FORUM SHOPPING?

At its simplest, forum shopping means little more than identifying the optimal jurisdiction for a certain transaction—in the context of insolvency certainly for the purpose of the restructuring or insolvency of a given company—and taking measures so that the law of that jurisdiction is applied. Recital 4 of the Regulation defines forum shopping as the practice whereby debtors ‘transfer assets or judicial proceedings from one Member State to another, seeking to obtain a more favourable legal position’. As under the Regulation both the forum and the applicable law (the *lex forum concursus*) depend on the COMI, successful forum shopping in the context of insolvency law will depend upon the debtor’s ability to move this very COMI from one jurisdiction into another. If this is successfully achieved, both the forum for the main insolvency proceedings (Article 3 of the Regulation) and the applicable insolvency law (Article 4 of the Regulation) will be those of the new COMI state. Article 3(1) contains a presumption according to which the COMI is situated at the registered office of a company unless the contrary can be proven.

Other variations of forum shopping can occur in different legal contexts. There is an ongoing debate on forum shopping in company law, where companies seek to move from one jurisdiction to another in order to benefit from a more favourable company law regime.⁵ Moreover, the simple allocation of jurisdiction in international legal disputes of a civil or commercial nature, which is governed by the Brussels I Regulation,⁶ can be

⁴ Recital 4 of the Regulation.

⁵ See on this the references given in n 1.

⁶ Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters, [2001] OJ L12/1.

manipulated by the specific choice of a forum that best suits the plaintiff's needs.⁷ Here, case-law shows that different motivations can play a major role in the selection of the forum, eg if the plaintiff wishes to delay the legal dispute and therefore chooses a place of jurisdiction known for its lengthy court procedures.⁸ Moreover, forum shopping is an issue in many other disciplines of law, eg patent litigation⁹ or family law.¹⁰

In all disciplines, one of the key questions is always to what extent this behaviour should be allowed. Which situation amounts to an abuse, and which is economically beneficial? Which behaviour is possibly even mandated by other provisions of law, especially higher-level principles stemming, for example, from the EC Treaty?

III. RECENT EXAMPLES AND REACTIONS

In insolvency law, a growing number of cases of forum shopping have occurred in recent years, prompting reactions from legislators, courts and academics. For a better understanding, the problem is illustrated first by recent examples; typical responses to the problems will then be discussed.

(a) Practical Examples

Two major types of cases can be distinguished: forum shopping in the context of groups of companies and a veritable migration from one jurisdiction to another.

(i) Groups of Companies

The first category of cases where forum shopping becomes relevant is cases that deal with insolvency of company groups. The notorious case of *Daisytek* is the best example to illustrate the conflict.¹¹

Daisytek-ISA Ltd was an English incorporated subsidiary of the US *Daisytek International Corp* and the holding company of 15 other

⁷ This topic is excellently covered by the contributions contained in P de Vareilles-Sommières (ed), *Forum Shopping in the European Judicial Area* (Oxford, Hart Publishing, 2007).

⁸ This may be even more the case when the plaintiff is a 'natural defendant', as in the 'Italian torpedo' cases. See eg case 144/86 *Gubisch Maschinenfabrik KG v Giulio Palumbo* [1987] ECR 4861, case C-159/02 *Turner v Grovit* [2004] ECR I-3565, case C-116/02 *Erich Gasser GmbH v MISAT Srl* [2003] ECR I-14693; cf F Blobel and P Späth, 'The Tale of Multilateral Trust and The European Law of Civil Procedure' (2005) 30 *EL Rev* 528.

⁹ KA Moore, 'Forum Shopping in Patent Cases: Does Geographic Choice Affect Innovation?' (2001) 79 *North Carolina Law Review* 889.

¹⁰ See on this M Jänterä-Jareborg, 'Unification of International Family Law in Europe—A Critical Perspective' in K Boele-Woelki (ed), *Perspectives for the Unification and Harmonisation of Family Law in Europe* (Antwerpen/Oxford/New York, Intersentia, 2003) 194, 207ff.

companies incorporated in various European jurisdictions, most of them registered in France and Germany. Following the filing by *Daisytek International Corp* for reorganisation under Chapter 11 of the US Bankruptcy Code, *Daisytek-ISA Ltd* and most of its European group companies petitioned the English court for administration orders in respect of each of them. This petition required the judge to consider whether the application of the Regulation meant that the English court had jurisdiction to open main proceedings and make an administration order in respect of the European subsidiaries. For this to be possible the court would need to conclude that the COMI of the subsidiaries was located in England, despite the presumption laid down in Article 3(1) of the Regulation, according to which the COMI would be presumed to be in each individual Member State of the respective companies. To cut to the chase: the question was whether the COMI of a subsidiary could be at the seat of the parent company or, in other words, whether the insolvency procedure can be initiated for the whole group at the parent company's seat.

The High Court in Leeds embraced a commercial approach to give effect to the Regulation.¹² McGonigal J found that the majority of the administration of the European subsidiaries was conducted from the English head office. Most creditors and other third parties would therefore get into contact with the English parent company directly. Accordingly, the court found the subsidiaries' COMIs to be situated in England.¹³

This decision has provoked very different echoes. Some—mostly English—commentators hailed the case as the cornerstone on the way to a comprehensive insolvency law for groups of companies within Europe.¹⁴ Other—mostly continental—commentators reacted with astonishment and anger. They felt that English courts would be willing to intentionally attract insolvency cases into their territory,¹⁵ and that this approach undermined the system of mutual trust on which the Regulation is based.¹⁶

Despite its courageous interpretation of the Regulation, the *Daisytek* case has set the tone and has been a point of orientation for many other courts over the following years, especially in England, Germany and Italy.¹⁷ Apart

¹¹ *Re Daisytek-ISA Ltd* [2003] BCC 562.

¹² [2003] BCC 562, 564 ff.

¹³ For comments on this case, see K Dawson, 'The Jurisdiction of the English Courts under the EC Regulation on Insolvency Proceedings', [2003] *Insolvency Lawyer* 226; E Klempka, 'The Centre of Main Interest and the Administration of Daisytek' (2004) 1 *International Corporate Rescue* 27.

¹⁴ *Ibid.*

¹⁵ This is the main argument put forward by P Mankowski in his case note in [2003] *Entscheidungen zum Wirtschaftsrecht* 767.

¹⁶ See C Paulus [2003] *Entscheidungen zum Wirtschaftsrecht* 709.

¹⁷ The most remarkable of these cases include *Re Crisscross Telecommunications Group* (unreported, 20 May 2003, Ch D), see G Flannery and N Nathanson, 'Registration and Publication of Judgments Opening Insolvency Proceedings under the EC Regulation (with Reference to the Crisscross Communications Case)' (2005) 21 *Insolvency Law and Practice* 57; *Re Collins &*

from different doctrinal approaches to the law of groups of companies or to insolvency law in general, one motivation for the generous interpretation of the notion of COMI could arguably be a fight for shares in the lucrative market for insolvencies, particularly for big groups of companies.¹⁸

(ii) Migration of Companies

So far, a category has been discussed that deals with forum shopping based on the hope that the court which was first seised would open insolvency proceedings according to a corresponding interpretation of the rules of jurisdiction. In other words, the applicant tries to convince the court with legal arguments or relies on a certain interpretation of legal terms in order to open insolvency proceedings, thereby not changing any factual coordinates.

In recent years, however, a growing tendency could be witnessed that tries to change the appropriate jurisdiction by physically moving the given factors for the opening of insolvency proceedings into another jurisdiction. Most prominently, various companies have tried to move their COMI from one jurisdiction to another so as to profit from the insolvency law most suited to their purposes.

The three German companies *Schefenacker*, *Deutsche Nickel* and *Hans Brochier* are prime examples of migration to the UK for this reason. These companies, all in financial trouble, tried to move parts of their operational structure to the UK in order to profit from English insolvency law that they considered to be more helpful for their purposes than German insolvency law.

(1) *Schefenacker*¹⁹ German automotive parts manufacturer Schefenacker AG was a German incorporated group with a €930m turnover and 7,900

Aikman Corp Group [2005] EWHC 1754 (Ch) = [2006] BCC 606, see case note by A Deacock in (2006) 3 *International Corporate Rescue* 88; Amtsgericht München, decision of 4 May 2004 (1501 IE 1276/04), reported in [2004] *Neue Zeitschrift für das Recht der Insolvenz und Sanierung* (NZI) 450 (*Hettlage*); Amtsgericht Offenburg, decision of 2 August 2004 (2 IN 133/04), reported in [2004] NZI 673; Tribunale Rome, decision of 26 November 2003, [2004] *Rivista di Diritto Internazionale Privato e Processuale* 690; Tribunale Parma, decision of 19 February 2004, [2004] *Rivista di Diritto Internazionale Privato e Processuale* 693. For further references, see B Wessels, *International Insolvency Law* (Kluwer, Deventer, 2006) para 10595. Specifically for Italy, see FM Mucciarelli, 'The Transfer of the Registered Office and Forum-Shopping in International Insolvency Cases: An Important Decision from Italy' [2005] *European Company and Financial Law Review* 512.

¹⁸ This last view is most prominently taken by P Mankowski; out of his numerous articles and case notes on this aspect, see only [2003] *Entscheidungen zum Wirtschaftsrecht* 1239, [2004] NZI 450 and [2004] NZI 418.

¹⁹ See on this case 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 *International Corporate Rescue* 171, 174.

employees in 33 locations worldwide, founded in Esslingen (near Stuttgart), Germany in 1935. Its financial problems began in 2002, when the company acquired the British mirror manufacturer Britax, an acquisition which turned out to be an overambitious transaction for the medium-sized business. Beginning in August 2006, Schefenacker AG grew increasingly concerned with both the operational performance of the company and its subsidiaries and the sustainability of its capital structure. The company was attracted by the possibility of migrating to the UK to take advantage of English insolvency procedures and, importantly, the ability to push through a debt-for-equity swap using English insolvency provisions. Over the next months, the shareholders and creditors discussed potential restructuring scenarios that culminated in February 2007 in a binding term sheet which provided immediate necessary short-term liquidity to Schefenacker and its subsidiaries and formed the basis for the proposal for a company voluntary arrangement (CVA) as an alternative to liquidation. To this end, Schefenacker had to move its COMI to England in order to profit from English insolvency law.

The restructuring plan for Schefenacker provided the following:

- (a) In a first step, Schefenacker AG became a German limited partnership, Schefenacker GmbH & Co KG, under the German Transformation Act (Umwandlungsgesetz), with newly set up Schefenacker plc as one of its general partners.
- (b) Then, the other general partner and limited partner of Schefenacker GmbH & Co KG would either withdraw from the partnership or transfer their interests in the partnership to Schefenacker plc. As a matter of German law, this would result in (i) Schefenacker GmbH & Co KG ceasing to exist; and (ii) the assets and liabilities of Schefenacker GmbH & Co KG being transferred by operation of German law to Schefenacker plc as the remaining general partner. This is the consequence of section 738(1) of the German Civil Code, providing the principle of *Anwachsung* in the case where one of the partners withdraws from the partnership.²⁰

The plan was implemented as such, and on 9 February 2007, Schefenacker plc accordingly assumed all the assets and liabilities (including the bonds and obligations under the indenture) of Schefenacker AG. The German rules of universal succession were thus used to effect a cross-border merger. As a result, the previously German company ended up as an English limited company. Crucially, the COMI of Schefenacker also had to move to the UK

²⁰ On this principle in more detail, B Früchtel, 'Die Anwachsung gem § 738 I 1 BGB—Unbeachteter Eckpfeiler und gestaltbares Instrument des Personengesellschaftsrechts' [2007] *Neue Zeitschrift für Gesellschaftsrecht* 368.

to fall within the Insolvency Regulation requirements for main proceedings. So far, the restructuring process has been a success.²¹

(2) *Deutsche Nickel* Deutsche Nickel AG, a maker of nickel wire and bar, is another example of a traditional German company.²² In 2004 the company experienced severe financial difficulties as a result of high losses incurred in the coin business due to a considerable drop in demand for new euro coins following the completion of the introduction of the euro. The subsequent overcapacity in the market led to a fierce price war. A first attempt to reorganise the company under German law, more specifically under the German *Schuldverschreibungsgesetz* 1899,²³ failed because the plan did not receive the appropriate rate of approval as required by the law.²⁴ Under German law, an approval of 95 per cent of the bondholders was required. This made the stakeholders try a different solution: again, all shares in Deutsche Nickel AG were sold to a newly set up English company, DNICK Ltd. Following this, the legal form of Deutsche Nickel AG was changed to a limited partnership under German law (*Kommanditgesellschaft*).²⁵ DNICK Ltd became general partner, and another English vehicle, EuroCoin Ltd, limited partner. Again taking advantage of the German rules of universal succession, EuroCoin Ltd withdrew from the limited partnership, and all assets and liabilities of the former German stock corporation accrued to DNICK Ltd. After some further adjustments to the group structure, DNICK Ltd filed for insolvency at the High Court in London, and an administration procedure was commenced on 29 April 2005.²⁶ Within this procedure, the creditors of DNICK Ltd and EU Coin Ltd agreed in a creditors' meeting held on 29 June 2005 in Frankfurt to accept a CVA under English law. Unlike German law, an English CVA only requires support of 75 per cent of the creditors, which the company finally obtained. The transformation was an overall success—not least because it was fully supported by its creditors.²⁷

²¹ Schefenacker, press release 2 May 2007, <http://www.visiocorp.com/pages/news/schefenacker-successfully-concludes-refinancing.php> (accessed 28 March 2008).

²² On this case, see R Hickmott, 'Forum Shopping Is Dead: Long Live Migration!' (2007) 5 *Journal of International Banking and Financial Law* 272; H Vallendar, 'Gefahren für den Insolvenzstandort Deutschland' [2007] *NZf* 129, 131ff; Tashiro and Beissenhirtz, above n 19.

²³ 'Gesetz betreffend die gemeinsamen Rechte der Besitzer von Schuldverschreibungen vom 4 Dezember 1899' (law relating to the joint entitlements of securities owners of 4 December 1899), [1899] *RGBl* 691.

²⁴ Tashiro and Beissenhirtz, above n 19. Cf A Aarons and K Matussek, 'Companies Take a Radical Step in Reconstructing Amid Bankruptcy: Moving Abroad', *International Herald Tribune* 18 July 2007, <http://www.iht.com/articles/2007/07/17/business/bxquit.php> (accessed 28 March 2008).

²⁵ This became effective on 10 March 2005.

²⁶ Court Case no 2771/2005.

²⁷ DNICK Holding plc, Annual Report 2005, available at http://www.dnickholding.com/pdf/Group_Annual_Report_2005.pdf (accessed 28 March 2008) 27.

(3) *Hans Brochier* After illustrating two successful examples, however, difficulties have to be highlighted that may be encountered along the way. One case involved a specialist German construction business that traded primarily from Nuremberg, Hans Brochier GmbH & Co KG.²⁸

Presumably in an effort to replicate the success of the Deutsche Nickel/Schefenacker model, Hans Brochier followed the magic recipe and converted its assets and liabilities into Hans Brochier Holdings Ltd, incorporated in England. Nevertheless, after some confusion about the competent court and the procedure, a German insolvency procedure was finally commenced and the English procedures were annulled.

On 4 August 2006, the directors appointed English administrators to the company on an out-of-court basis. In doing this, they stated that the company's COMI was in England, largely on the basis that this was where its registered office was located. On the same day, only 45 minutes later, German company employees applied to the Local Court in Nuremberg. The German court, unaware of the earlier order of the English court, decided on the evidence before it that the company's COMI was in Germany. Accordingly, it appointed a preliminary German insolvency practitioner. When the existence of the parallel proceedings came to light, it was clear that the English administrators were appointed first and, as such, any attempt to overturn their appointment would have to be made to the English court.

Following the Regulation's logic, the English opening of insolvency procedures should have blocked the German proceedings; at the least, the erroneously opened proceedings should have been stopped or converted into a secondary proceeding.²⁹ However, the Nuremberg court did not do anything of the sort, but instead a few days later rejected the validity of the English proceedings on the grounds of a violation of *ordre public*.³⁰ The High Court, having made up its mind and having received new evidence on the situation, accepted this point of view and declared its own decision to open main proceedings in England as invalid.³¹ Furthermore, following the

²⁸ On the factual side of this case, see R Rose, 'Main and Territorial Proceedings under the EC Regulation—The Matter of Hans Brochier Holdings Limited (in administration) (unreported) Mr Justice Warren, 15 August 2006' (2006) 22 *Insolvency Law and Practice Journal* 225; EZ Geva, 'National Policy Objectives from an EU Perspective: UK Corporate Rescue and the European Insolvency Regulation' (2007) 8 *European Business Organization Law Review* 605, 610ff; A Ballmann, 'Der High Court of Justice erschwert die Flucht deutscher Unternehmen ins englische Insolvenzrecht—Der Fall Hans Brochier—Hintergründe und Folgen' [2007] *Betriebs-Berater* 1121; D Andres and A Grund, 'Die Flucht vor deutschen Insolvenzgerichten nach England—Die Entscheidungen in dem Insolvenzverfahren Hans Brochier Holdings Ltd' [2007] *NZI* 137.

²⁹ Cf Art 16 (1) of the Regulation.

³⁰ Amtsgericht Nuremberg, decision of 15 August 2006 (8004 IN 1326-1331/06), [2007] *NZI* 185. For a critical assessment, see Tashiro and Beissenhirtz, above n 24, 174.

³¹ *Hans Brochier Holdings Ltd v Exner* [2006] EWHC 2594 (Ch) = [2007] BCC 127 = [2007] *NZI* 187.

management's attempt to open at least secondary proceedings in England according to Article 3(3) of the Regulation, the High Court rejected even this request, declaring that the applicant did not even have an 'establishment' in the sense of Article 3(3) of the Regulation in England.³² Although the company's registered office was in England, its link with this country was fairly tenuous and not even strong enough to satisfy the definition of 'establishment' for the purposes of the regulation. It appeared that although there had been a place of operations in the UK, there was little by way of genuine economic activity took place in the UK.

Important lessons can be learnt from this. First, a successful migration to another insolvency jurisdiction requires the debtor to make sure that not only the registered office is transferred, but more importantly that the COMI in the meaning of the company's 'head office' is equally transferred. It seems that courts are not willing to accept the presumption laid down in Article 3(1) of the Regulation, but are more inclined to rebut the presumption.³³

(4) *Excursus: Eurofood* Some months before *Hans Brochier*, the European Court of Justice had handed down its seminal judgment in *Eurofood*.³⁴ Although this case did not concern a forum-shopping case *strictu sensu*, it is worth mentioning here because it gave some further guidelines as to the interpretation of the COMI.

Analysing a group insolvency situation, the court found that the presumption in Article 3 of the Regulation can only be rebutted

if factors which are both objective and ascertainable by third parties enable it to be established that an actual situation exists which is different from that which locating at that registered office is deemed to reflect.³⁵

Thus, the Court raised the threshold for departing from the presumption. However, it then went on to give the example of a company not carrying on business in the territory of a Member State in which it has its registered office ('letterbox company') as a situation where the presumption would most likely be rebutted.³⁶

It is submitted that this judgment solves only part of the problem, if at all.³⁷ It has become more difficult to easily shift the COMI within a corporate group and to argue for a 'group insolvency' procedure at the COMI

³² High Court of Justice London, Order of 8 December 2006, 6211/06, [2007] NZI 187–8.

³³ See eg the case *Enron Directo SA* (decision of Lightman J, High Court, Chancery Division, of 4 July 2002), unreported, but a summary can be found at IF Fletcher, *Insolvency in Private International Law* (2nd edn, Oxford University Press, 2005) para 7.61.

³⁴ Case C-341/04 *Eurofood IFSC Ltd* [2006] ECR I-3813.

³⁵ *Ibid*, para 34.

³⁶ *Ibid*, para 35.

³⁷ In a very critical account, see E Grier, 'Eurofood IFSC Ltd—An End to Forum Shopping?' [2006] *Commercial Law Practitioner* 161, 165ff; T Bachner, 'The Battle over Jurisdiction in European Insolvency Law' [2006] *European Company and Financial Law Review* 310, 327.

of the group's parent company, comprising all subsidiaries. However, as the case concerned did not involve migration, no direct implications can be drawn from it for the migration question. Two points seem to emerge from this. On the one hand, the case has underlined the importance of the 'presumption' and made it more difficult to rebut it. As far as the registered office has gained more importance as a criterion, this has to be welcomed. On the other hand, on insisting on the 'objective and ascertainable' criteria, the Court has underlined the factual elements of the COMI, thereby rejecting the 'mind of management' idea and seemingly interpreting the COMI almost as a 'de facto' *head office*.³⁸ The latter aspect came into relevance in *Hans Brochier*: given the ECJ's more fact-based interpretation of the COMI, the courts found that the company's COMI was in Germany—despite being registered in England.³⁹ Here we see the other effect of *Eurofood*: the insistence on 'objective and ascertainable' criteria makes it more difficult to shift the COMI from one Member State to another, because the connecting factor takes into account more factual and not only legal criteria, which need to be moved across the border.⁴⁰

These two sides of *Eurofood* are both important for the forum-shopping question, though not entirely clear in their long-term effects. The impact of the case remains to be seen; for now, no definite solution to the migration problem is recognisable.⁴¹ Tellingly, the confusion around *Hans Brochier* arose after *Eurofood*—which should have answered all the questions.

(iii) Forum Shopping between Filing for Insolvency and Opening of the Proceedings

A more delicate problem concerns a move of the debtor's COMI between the first filing for insolvency and the moment when the proceedings were actually opened. Two main cases can be noted, both of them concerning individuals rather than companies.

The UK case *Shierson v Vlieland Boddy*⁴² shows that forum shopping can also be an issue in individual insolvency law. In this case, the debtor, a natural person, moved from the UK to Spain after failing to obtain an English individual voluntary arrangement premised on an English COMI for several months. Later, a bankruptcy petition was presented at the UK High Court. The debtor argued that his COMI had changed to Spain and that the UK had therefore no jurisdiction to hear the case. Chadwick LJ

³⁸ This expression is well known from the company law debate and was the criterion for the applicable law under the 'real seat' theory.

³⁹ *Hans Brochier Holdings Ltd v Exner* [2007] BCC 127, 133 para 28.

⁴⁰ This is best illustrated by *Hans Brochier* itself. Cf F Frind, 'Forum Shopping—Made in Germany?' [2008] *Zeitschrift für das gesamte Insolvenzrecht (ZInsO)* 261, 262.

⁴¹ Cf Grier, above n 37.

⁴² [2005] EWCA Civ 974, [2005] 1 WLR 3966.

held that the facts on the basis of which the COMI was to be determined included 'historical facts', including what a debtor 'would be perceived to be doing by an objective observer'. He further held that there was no 'principle of immutability'. A debtor was free to locate his home and business, and it is inherent in that freedom that it can be exercised in the debtor's own interest. In conclusion, the court held that the debtor's COMI had changed because he had taken up residence in Spain. Commentators observe that the case demonstrates that the regulation allows debtors to change the COMI and thus to change the law regulating insolvency proceedings. This leads to the consequence that debtors, by adjusting the management of their affairs, are able to select a state whose anti-avoidance provisions are considered more favourable.⁴³

A different approach was taken by the ECJ. In *Staubitz-Schreiber*,⁴⁴ the applicant was resident in Germany where she requested the opening of insolvency proceedings regarding her assets before the competent court. A few months later, she moved to Spain in order to live and work there. Subsequently, the German court refused to open the insolvency proceedings on the ground that there were no assets. The appeal was dismissed on the ground that the German courts did not have jurisdiction to open insolvency proceedings in accordance with Article 3(1) of the Regulation, since the applicant's COMI was situated in Spain. Ultimately, the German Federal Supreme Court (Bundesgerichtshof) referred the case to the ECJ,⁴⁵ asking essentially if the fact that the debtor moves her COMI to another Member State after filing for insolvency but before the proceedings are opened is relevant to the question of jurisdiction.

The ECJ pointed out that a transfer from one jurisdiction to another 'would be contrary to the objectives pursued by the Regulation'.⁴⁶ It explicitly referred to recital 4 of the Regulation and elaborated that one of the aims of the Regulation was to avoid incentives for parties to forum-shop. Another argument used by the ECJ was that recitals 8 and 2 of the Regulation call for efficient and effective cross-border proceedings, and that the possibility to move to another jurisdiction would result in the contrary, ie an extension of the insolvency procedure and the need for creditors to get hold of their debtor. Thus, the objectives pinned down in recitals 2 and 8 would be contravened. Ultimately, the ECJ underlined that retaining the jurisdiction of the first court that is seised with the matter ensures greater judicial certainty for creditors, because when assessing the

⁴³ G Mitchell and R Brent, 'Establishing Jurisdiction in Insolvency Cases' (2005) 155 *New Law Journal* 1819, 1821. Cf G Moss, 'A Very Peculiar "Establishment"' [2006] *Insolvency Intelligence* 20, 23–4.

⁴⁴ Case C–1/04 *Susanne Staubitz-Schreiber* [2006] ECR I–701.

⁴⁵ Bundesgerichtshof 27 November 2003 (IX ZB 418/02), reported in [2004] *NZI* 139 with case note O Liersch. See on this MP Weller, 'Forum Shopping im Internationalen Insolvenzrecht?' [2004] *IPRax* 412, 416.

⁴⁶ *Staubitz-Schreiber*, above n 44, para 24.

risk that is inherent with every lending of money, creditors will take into account the risk of retrieving their money according to the insolvency law regime that is applicable to the debtor at the moment the lending contract is concluded. Therefore, the ECJ concluded, the first court seised maintains jurisdiction even if the COMI is subsequently moved to another Member State—a legal phenomenon usually referred to as *perpetuatio fori*.

The decision was welcomed by many commentators in Germany,⁴⁷ but also in the UK⁴⁸ and France.⁴⁹ Although no express reference is made, this conclusion accords with the intention finding of the Virgós-Schmit Report,⁵⁰ which states:

[T]he relevant moment to establish international jurisdiction is when the application to open insolvency proceedings is filed . . . [because] [t]his is the only reference date that avoids incentives for forum shopping that the Insolvency Regulation expressly tries to eliminate.⁵¹

(iv) *Outlook*

Migration has and will become even easier in the future. The European Merger Directive⁵² was finally adopted in 2005 and had to be implemented into national law by 15 December 2007.⁵³ This will enable companies to migrate between jurisdictions without resorting to complicated structures such as the described rules of universal succession of German partnership law.

The Merger Directive will need to fulfil the job that the proposed 14th

⁴⁷ See the case note by P Mankowski in [2006] *NZI* 154; B Knof, 'Europäisches Insolvenzrecht und Schuldbefreiungs-Tourismus' [2005] *Zeitschrift für das gesamte Insolvenzrecht* 1017, 1023 f; B Brenner, 'Zur Erhaltung der internationalen Zuständigkeit nach Einleitung eines vorläufigen Insolvenzverfahrens' [2005] *Zeitschrift für Wirtschaftsrecht (ZIP)* 1646, 1647; B Knof and S Mock, 'Zur perpetuatio fori bei Sitzverlegung nach Stellung eines Insolvenzantrags' [2006] *ZIP* 189. Cf P Gottwald, *Insolvenzrechts-Handbuch* (3rd edn, CH Beck, Munich, 2006) § 129, para 17.

⁴⁸ D Petkovich, 'The Correct Time to Determine the Debtor's COMI—Case Note and Commentary on *Staubitz-Schreiber* (ECJ) and *Vlieland-Boddy* (UKCA)' (2006) 22 *Insolvency Law and Practice* 76; H Tschauer and C Herweg, 'EC Regulation on Insolvency Proceedings—Recent Decisions on Shifting and Changing the COMI' (2006) 3 *International Corporate Rescue* 117.

⁴⁹ F Kauff-Gazin and L Idot, 'Centre des intérêts principaux du débiteur' [2006] *Revue Europe*, comm 99.

⁵⁰ M Virgós and E Schmit, *Report on the Convention on Insolvency Proceedings*, eg published as annex 2 in G Moss and others (eds), *The EC Regulation on Insolvency Proceedings—A Commentary and Annotated Guide* (Oxford University Press, 2002).

⁵¹ M Virgós and F Garcimartín, *The European Insolvency Regulation: Law & Practice* (The Hague, Kluwer Law International, 2004) 49–50.

⁵² Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies, [2005] OJ L310/1.

⁵³ The UK implemented the directive by means of the Companies (Cross-Border Mergers) Regulations 2007 (SI 2974/2007), Germany by means of the second amendment to the 'Umwandlungsgesetz' (Zweites Gesetz zur Änderung des Umwandlungsgesetzes vom 19 April 2007, [2007] BGBl I 542).

directive of the transfer of the seat was supposed to cover. Since the latter project was eventually dropped in 2007,⁵⁴ companies wishing to transfer the registered office from one Member State to another will have to set up a shell company in the destination Member State and then to effect a cross-border merger onto this shell company under the 10th directive. The other solution could be to use the provisions on the cross-border transfer of the registered office which are provided by the European Company Statute (SE).⁵⁵ By these means, companies can migrate within the EU most conveniently by shifting the registered office from one Member State into another without being dissolved or having to re-register.

These two instruments, the Merger Directive and the SE Regulation, could provide viable options to migrate from both a COMI and a corporate perspective. Both a merger and a transfer of the registered office may be time consuming and costly in a restructuring scenario, but commercial factors will be weighed up and the lawyers will adapt to the business needs using the best legal tools available, which may well include these two.

(b) Legislative and Judicial Responses

The problem of forum shopping, illustrated by the examples above, is not new. The legislature has long been trying to regulate the possibility of a company's emigration soon before insolvency. Over the years, different attempts have been made, in particular in Europe, some of which have attempted to resolve conflicts of law, while others have attempted to harmonise insolvency law itself.⁵⁶

The EU Insolvency Regulation was eventually adopted in 2000. The Regulation did not fully resolve the problem of forum shopping. To be sure, we can see from its materials and recitals that one of its aims is to prevent any distortion of competition in the field of insolvency, which is conceived as damaging to the internal market.⁵⁷ In fact, the need to

⁵⁴ This directive proposal has had a turbulent past: preparatory works had been in the pipeline since the mid-1990s, flowing into a pre-proposal of 1997: Commission Proposal for a Fourteenth European Parliament and Council Directive on the transfer of the registered office of a company from one Member State to another with a Change of Applicable Law (Doc No XV/D2/6002/97-EN REV.2). See on this draft RR Drury, 'Migrating Companies' (1999) 24 *EL Rev* 354, 362ff. After this day, however, there was no activity for many years—until the Commission reopened the initiative in February 2004, only to announce in October 2007 that it would not proceed with the directive (speech by Commissioner McCreedy at the European Parliament's Legal Affairs Committee, 3 October 2007, Speech/07/592).

⁵⁵ See Art 8 of the SE Regulation. Cf WG Ringe, 'The European Company Statute in the Context of Freedom of Establishment' (2007) 7 *Journal of Corporate Law Studies* 185.

⁵⁶ For a detailed account, see PJ Omar, *European Insolvency Law* (Aldershot, Ashgate, 2004) 49–86.

⁵⁷ See recital 4 of the Regulation; cf G Moss et al (eds), *The EC Regulation on Insolvency Proceedings—A Commentary and Annotated Guide* (Oxford University Press, 2002) 8.100; B Wessels, 'Realisation of the EU Insolvency Regulation in Germany, France and The Netherlands'

co-operate internationally against the possibility of forum shopping is even taken to be a justification for enacting a European-wide instrument instead of national legislation.⁵⁸ In other words, from the EU's point of view, only a measure that co-ordinates proceedings at the supranational level can have the impact necessary to harmonise the objectives of a level playing field by removing unequal domestic barriers to the exercise of rights.

However, it has to be taken into account that the Regulation confines itself to harmonising jurisdiction or conflict-of-law elements of insolvency law and refrains from harmonising substantive law, mostly due to proportionality questions.⁵⁹ Therefore, this question can be asked: can mere co-ordination of jurisdiction issues without substantive harmonisation of domestic rules be truly effective?

In essence, the substantial text of the Regulation itself is silent about the possibility of forum shopping. This can be underlined by comparison with one of its predecessors, the draft Convention from 1980,⁶⁰ which still contained provisions on migration soon before insolvency.⁶¹ In contrast to the draft Convention, the Regulation contains no direct rule against forum shopping; hence, the matter is clearly left to national law.⁶² However, the rule of the COMI itself is a tool that is in a way designed to prevent manipulation.⁶³ One of its purposes can be seen in the fact that it is usually more difficult to move a COMI across a border than, for example, the registered office.⁶⁴ Given that a company typically has strong ties to its home country, it will often be difficult to move the factual criteria that make up the company's 'centre' into another country.⁶⁵ Recital 13 defines the COMI as the place 'where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties'. The present tense ('conducts') and the requirement of the 'regular basis' impose conditions on the COMI that are difficult to fulfil when the debtor wants to move its COMI on a short-term basis.⁶⁶ This interpretation, in combination

(2004) 15 *European Business Law Review* 73, 83; H Vallendar, 'Gefahren für den Insolvenzstandort Deutschland' [2007] *NZI* 129, 130.

⁵⁸ This follows from recitals 4 and 5 together.

⁵⁹ See recital 6 of the Regulation. Cf Omar, above n 56, 92.

⁶⁰ Draft EEC Convention on Bankruptcy, Winding-up, Arrangements, Compositions and Similar Proceedings, published in EC Bull Supp 2/82.

⁶¹ See Arts 6ff in the Draft Convention of 1980.

⁶² HC Duursma-Kepplinger, 'Commentary to Article 3', in HC Duursma-Kepplinger et al, *Europäische Insolvenzverordnung—Kommentar* (Vienna, New York, Springer, 2002) para 17.

⁶³ S Shandro and B Jones, 'Bankruptcy Jurisdiction in the US and Europe: Reconsideration Needed!' [2005] *Insolvency Intelligence* 128, 131–2; P Kindler, 'Internationales Insolvenzrecht' in K Rebmann et al, *Münchener Kommentar zum Bürgerlichen Gesetzbuch* (4th edn, Munich, CH Beck, 2006) vol 11, para 205.

⁶⁴ Kindler, above n 63; Duursma-Kepplinger, above n 62, introduction to Art 3, paras 11, 13. Cf Vallender, above n 57, 130.

⁶⁵ HC Duursma-Kepplinger, 'Aktuelle Entwicklungen in Bezug auf die Auslegung der Vorschriften über die internationale Eröffnungszuständigkeit nach der Europäischen Insolvenzverordnung' [2006] *Deutsche Zeitschrift für Wirtschafts- und Insolvenzrecht* 177, 179.

⁶⁶ Virgós and Garcimartín, above n 51, 51.

with the courts' willingness to easily rebut the presumption contained in Article 3 of the Regulation, amounts to a de facto interpretation of the COMI as the 'head office' of the company. Moreover, this whole tendency is reinforced by the clear position against forum shopping laid down in recital 4, which has already been mentioned.

This hostile tendency towards forum shopping is paralleled by efforts of national legislators and courts to find ways to oppose pre-insolvency migrations.⁶⁷ French insolvency law, for instance, does not recognise a transfer of the COMI if this change took place within six months before the application of insolvency proceedings.⁶⁸ Similar provisions are in force in Spain⁶⁹ and in Italy.⁷⁰ Whereas German law does not provide for an equivalent rule, courts have been suspicious about migration shortly before insolvency. In a case from 1996, the Federal Supreme Court said in an *obiter dictum* that, at the least, an application for insolvency within three weeks after the migration would constitute an abusive behaviour.⁷¹ English domestic law is interpreted in such a way that a person who has carried on business in England is treated as continuing the business for the purposes of bankruptcy jurisdiction until he has made arrangements to settle his business debts.⁷² Similarly, in *TXU*,⁷³ an English registrar implicitly stated that forum shopping could undermine creditors' rights and that he might not have granted the order sought in the event the debtor's recent cross-border migration had caused prejudice to foreign creditors. And last but not least, the ECJ itself has raised the threshold for an insolvency forum shopping in its two judgments in *Eurofood* and *Staubitz-Schreiber*.⁷⁴ Forum shopping has become more difficult after these two judgments, as we can see from *Hans Brochier*.⁷⁵

Moreover, academic literature⁷⁶ has elaborated solutions on how to

⁶⁷ It is a matter of current debate whether national rules preventing forum shopping can apply alongside the Insolvency Regulation; cf J Haubold, 'Tagung zur Europäischen Insolvenzverordnung an der Europäischen Rechtsakademie (ERA) in Trier' [2004] *Europäische Zeitschrift für Wirtschaftsrecht* 230.

⁶⁸ G Jazottes and MH Monsié-Bon, 'Premières applications du règlement insolvabilité: la recherche de l'efficacité' [2007] *Revue Europe* no 8, étude 19, para 12; H Vallendar, 'Gefahren für den Insolvenzstandort Deutschland' [2007] *NZI* 129, 130 fn 15, citing B Dostal, 'Französisches Internationales Insolvenzrecht' [1998] *ZIP* 969, 970. In the same way Duursma-Kepplinger, above n 62.

⁶⁹ J Marshall (ed), *European Cross Border Insolvency* (London, Sweet & Maxwell, 2004; loose-leaf) para 1.007.

⁷⁰ See on this F Frind, 'Forum PINning?' [2008] *ZInsO* 363, 365.

⁷¹ Bundesgerichtshof, judgment of 20 March 1996, X ARZ 90/96, reported in (1996) 132 BGHZ 195.

⁷² *Re A Debtor* (No 784 of 1991) [1992] Ch 554; *Theophile v Solicitor-General* [1950] AC 186 (HL); Cf Moss et al, above n 57, para 8.44.

⁷³ *Re TXU Europe German Finance BV* [2005] BCC 90 para 19.

⁷⁴ Case C-341/04 *Eurofood IFSC Ltd* [2006] ECR I-3813; case C-1/04 *Susanne Staubitz-Schreiber* [2006] ECR I-701. Cf Bachner, above n 38, 310; Frind, above n 40, 262.

⁷⁵ *Hans Brochier Holdings Ltd v Exner* [2007] BCC 127, 131ff.

⁷⁶ For a critical example from the US, see L LoPucki, 'Global and Out of Control?' (2005) 79 *American Bankruptcy Law Journal* 79, 97ff.

tackle the migration problem. Some authors suggest that, in extreme cases, decisions could be rejected on the grounds of *ordre public*.⁷⁷ Others claim an extremely broad interpretation of Article 4 of the Regulation in order to prevent companies from forum shopping.⁷⁸ Still others advocate for a criterion of ‘permanence’ for the interpretation of the COMI.⁷⁹ And finally, some authors even suggest amending the Regulation in order to make it unambiguously clear that forum shopping is not allowed under the Regulation.⁸⁰ However, most contributions treat forum shopping as undesirable without further reasoning.⁸¹

(c) Summary

This overview has shown that business has turned out to be very resourceful in finding cross-border migration tools. The German *Anwachsung* is one example, but new cross-border instruments are already being provided.

Although at least two successful cases can be reported, companies face obstacles to their desire to migrate for insolvency purposes from various sides. The European Union as well as national legislators try to limit pre-insolvency migration to a certain extent. The construction and interpretation of the COMI approach itself is designed to hamper forum shopping; furthermore, several national rules impose barriers to pre-insolvency migration. The courts have struggled to find an optimal perspective on this problem. It emerges that courts are generally willing to accept a pre-insolvency migration under the Regulation, provided that the entire COMI has been moved (which was not the case in *Hans Brochier*). However, a migration *after* the debtor had filed for insolvency was not accepted; the court saw it as abusive to move the COMI only for the purpose of insolvency.⁸²

Apart from this development, it is worth remembering that the COMI requirement itself makes it more burdensome to effectively migrate to another Member State, because the presumption in Article 3 of the Regulation is treated as easily rebuttable by the national courts, and the COMI is de facto interpreted as the company’s head office. Even after *Eurofood*—which can be considered a step in the right direction insofar as

⁷⁷ Duursma-Kepplinger, above n 62, para 17. However, this approach is questionable after *Eurofood*, above n 74, paras 38ff. In a similar vein, J Rotstegge, ‘Zuständigkeitsfragen bei der Insolvenz in- und ausländischer Konzerngesellschaften’ [2008] ZIP 955, 961.

⁷⁸ P Kindler, above n 63, vol 11 paras 203ff.

⁷⁹ Jazottes and Monsèrié-Bon, above n 68; Frind, above n 70. Cf Weller, above n 45, 416.

⁸⁰ G Moss and C Paulus, ‘The European Insolvency Regulation—The Case for Urgent Reform’ [2006] *Insolvency Intelligence* 1, 3.

⁸¹ Eg Weller, above n 45.

⁸² Case C-1/04 *Susanne Staubitz-Schreiber* [2006] ECR I-701 para 25. Cf GA Colomer, Opinion of 6 September 2005, para 75.

the importance of the registered office is strengthened—the COMI standard remains ambiguous.

IV. WHY DO COMPANIES MIGRATE?

When analysing the discussed cases, it emerges that companies or individual debtors always have similar motivations to migrate. In the scope of the cases that are of interest here, companies changed their COMI in order to profit from a more favourable insolvency law that they considered to be more useful for the attainment of their objectives. Given the high cost of a cross-border migration, it is worth examining these differences between legal systems that seem to be incentive enough for insolvency debtors.

To start with, it is worth recapitulating that the EC Insolvency Regulation did not make any attempt to harmonise substantive insolvency laws within the EC. Quite apart from the political impossibility of such an undertaking, its beneficial effects would still be uncertain. Instead, the Regulation only provides for a harmonised set of rules for international insolvency procedure and for conflict-of-law rules.⁸³

Insolvency regimes represent the balancing of several objectives, which include on the one hand protecting the rights of creditors, essential to the mobilisation of capital, while safeguarding the interests of shareholders and customers, and on the other hand avoiding the premature liquidation of viable enterprises. In most countries the framework for dealing with insolvency has evolved over time as the balance of political power between various interests has changed and the economy's structure has been transformed. This is the reason why substantial insolvency laws differ extremely in the way they protect the different stakeholders and constituencies, even among European countries.⁸⁴

The differences among insolvency jurisdictions have been the subject of exhaustive empirical research.⁸⁵ To name only a few major differences: as we have seen, the *Deutsche Nickel* case showed considerable differences in the possibility of undertaking a debt–equity swap, which requires a greater approval quota in Germany than in the UK and thus makes a restructuring in the UK attractive. On the other hand, for instance, Germany and Austria provide for *Insolvenzgeld* funding by the state for the workers' salaries during the first months of an insolvency, a feature unknown to most other

⁸³ See recital 11 of the Regulation.

⁸⁴ Cf in much detail S Dahiya and L Klapper, 'Who Survives? A Cross-country Comparison' (2007) 3 *Journal of Financial Stability* 261.

⁸⁵ See eg SA Davydenko and JR Franks, 'Do Bankruptcy Codes Matter? A Study of Defaults in France, Germany, and the UK' (2008) 63 *Journal of Finance* 565.

jurisdictions.⁸⁶ French insolvency law is known to have a comparably high protection for employees in comparison to other jurisdictions. As a matter of public policy, France decided that unpaid wages claims should have super-preference over other claims.⁸⁷ The underlying argument is that there is no reason why secured creditors should rank ahead of employees in an insolvency situation. Hence, French law protects employees who do not have the opportunity of diversifying or hedging the risk of being involved with a particular employer, whereas financial institutions have the capacity and opportunity to assess such risks.⁸⁸ The United Kingdom was generally perceived to have implemented the Acquired Rights Directive⁸⁹ in the strictest way possible so that the Transfer of Undertakings (Protection of Employment) Regulations (TUPE) 1981⁹⁰ (which implemented the Directive) triggered almost all outsourcings within the United Kingdom. This aspect was considered to be a disadvantage of English insolvency law⁹¹—compared to the arguably more employer-friendly system in the Netherlands⁹²—and was only reversed in 2006.⁹³

The most significant differences appear when it comes to the role of creditors as compared to the role of the insolvency courts. In France, the state imposes court-administered procedures with the explicit objective of preserving the firm as a going concern and maintaining employment.⁹⁴ Under the traditional insolvency procedure, French courts are given control of the insolvency process, whereas the role of creditors is reduced to an advisory function, and their approval is not required by the court in deter-

⁸⁶ Ss 183ff Sozialgesetzbuch VIII. See on this instrument G Schaub, 'Insolvenzgeld' [1999] *NZI* 215.

⁸⁷ Arts L622-17 and 641-13-III of the Commercial Code.

⁸⁸ See E Yemin and AS Bronstein, *The Protection of Workers' Claims in the Event of the Employer's Insolvency* (International Labour Organisation, Geneva 1991) 29ff; GW Johnson, *Insolvency and Social Protection: Employee Entitlements in the Event of Employer Insolvency* (OECD Report on Fifth Forum for Asian Insolvency Reform (FAIR), 27–8 April 2006, Beijing, China) 16; W Huaiyu, *An International Comparison of Insolvency Laws* (OECD Report on Fifth Forum for Asian Insolvency Reform (FAIR), 27–8 April 2006, Beijing, China) 12. Cf F Tolmie, *Corporate & Personal Insolvency Law* (2nd edn, Routledge Cavendish, London, 2003) 69–70.

⁸⁹ Council Directive 2001/23/EC of 12 March 2001 on the approximation of the laws of the Member States relating to the safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses, [2001] OJ L82/16.

⁹⁰ SI 1981/1784, as amended.

⁹¹ S Frisby, 'TUPE or not TUPE. Employee Protection, Corporate Rescue and One Unholy Mess' (2000) 4 *Company Financial and Insolvency Law Review* 249.

⁹² On this, see A Jacobs, *Labour Law in the Netherlands* (Kluwer Law International, The Hague, London, New York, 2004) 91–2.

⁹³ The Transfer of Undertakings (Protection of Employment) Regulations 2006, SI 2006/246. On the reform discussion, see J Armour and S Deakin, 'Insolvency and Employment Protection: The Mixed Effects of the Acquired Rights Directive' (2003) 22 *International Review of Law and Economics* 443.

⁹⁴ Even after the 2005 reform, the main aim of insolvency law is to save the firm as an ongoing concern. See P Théry 'The Evolution of Insolvency Law in France', above ch 1.

mining a reorganisation plan.⁹⁵ By contrast, English insolvency law grants much more power to the creditors, especially to secured creditors and those holding floating charges.⁹⁶ Arguably, Germany provides an intermediate level of creditor protection, where collective court-administered procedures are imposed on the parties in insolvency, but creditors retain significant control over the restructuring process and their agreement is required to approve any reorganisation plan. The differences across these countries have even led to the creation of the famous so-called ‘creditors’ rights scores’ of *La Porta et al*,⁹⁷ which range from a minimum of zero for France, to three for Germany, and to a maximum of four for the UK.

Given this broad variety of differences (which could be continued), the reasons for debtors wishing to change their insolvency law can be manifold. Not all of these differences will motivate companies to undertake the huge task of transferring their COMI to another jurisdiction and to bear the enormous cost that this entails. Therefore, what were the real motivations for migrating companies?

As we have seen, *Deutsche Nickel* clearly stated that the majority requirement for a debt–equity swap of only 75 per cent in the UK was one of the factors that induced it to effect the cross-border migration.⁹⁸ Similar considerations played a role in the *Schefenacker* case.⁹⁹ Another issue was that German law also requires courts to name outside advisers to oversee insolvent companies, whereas in the UK a company can choose its own administrator.¹⁰⁰ This is considered to be more favourable for the reorganisation process. Furthermore, the attractiveness of the CVA under English law always plays an important role.¹⁰¹ In general, as *Schefenacker*’s legal advisor stated, English insolvency law is more predictable and more flexible.¹⁰² Finally, I believe that the psychological side of the matter should not be underestimated: in the *Schefenacker* case, for instance, it is reported that about 90 per cent of the creditors were from the UK or the US. Hence, choosing a UK reorganisation gave the stakeholders comfort that a familiar restructuring environment would be available.¹⁰³

⁹⁵ However, in 2006, the French legislator introduced a new Chapter 11-style *procédure de sauvegarde*, putting more emphasis on the creditors’ needs.

⁹⁶ However, the Enterprise Act 2002 has somehow reduced their primary status. Cf eg R Stevens, ‘Security after the Enterprise Act’, in J Getzler and J Payne (eds), *Company Charges: Spectrum and Beyond* (Oxford University Press, 2006) 153.

⁹⁷ R La Porta et al, ‘Law and Finance’ (1998) 106 *Journal of Political Economy* 1113.

⁹⁸ I Scholz, the company’s lawyer, according to A Aarons and K Matussek, ‘Schefenacker, Seeking Bankruptcy, Flees Germany for UK Courts’, <http://www.bloomberg.com/apps/news?pid=20601109&refer=home&sid=aoOp2euiFKzI> (accessed 28 March 2008). Cf on this Ballmann, above n 28, 1125.

⁹⁹ Aarons and Matussek, above n 98.

¹⁰⁰ *Ibid.*

¹⁰¹ DNick Holding plc, Annual Report 2005, 36.

¹⁰² S Taylor, according to I Simensen, ‘Schefenacker Restructuring Holds Up Mirror to Cross-border Differences’ *Financial Times* 11 October 2007.

¹⁰³ *Ibid.*

The situation is similar for insolvent individuals. Here, we see a growing tendency of cross-border migration before insolvency similar to that of companies. French insolvency law seems to be the object of desire: for instance, French insolvency law allows for a discharge of residual debt within 18 months, whereas German law mandates a period of at least six years.¹⁰⁴

From this overview, it becomes clear that ‘insolvency law matters’.¹⁰⁵ The disparities between European insolvency laws, which are now complemented with unified rules on jurisdiction and conflict of laws, give an even greater incentive to choose between these legal systems and ultimately cause the problem of forum shopping. After this evaluation, it is now possible to turn to the question whether forum shopping brings about beneficial elements or not.

V. IS FORUM SHOPPING GOOD OR BAD?

After discussing the actual developments and the increasing presence of pre-insolvency migration, we now turn to the question whether ‘forum shopping’ in insolvency is generally speaking a beneficial and thus desirable thing. Thereby, we can resort to previous work done in particular by Horst Eidenmüller in this area.¹⁰⁶

(a) Forum Shopping and Efficiency

In order to answer this question, we first have to define what ‘good’ or ‘bad’ means in the context of insolvency. There is an ongoing debate on the objectives of insolvency law that has gained even more importance since the beginning of the 1980s.¹⁰⁷ Whatever goal policymakers pursue in constructing a ‘good’ insolvency law—be it the primacy of creditor wealth

¹⁰⁴ M Creutz, ‘Schneller Schuldenerlass im Ausland’ *Handelsblatt* (Düsseldorf) 21 March 2007, 18; T Sigmund, ‘Zum Nachteil der Gläubiger’ *Handelsblatt* (Düsseldorf) 21 March 2007, 18.

¹⁰⁵ Referring to the famous debate on ‘Does Law Matter?’ See on this the contributions to the ‘Norms & Corporate Law’ symposium in (2001) *University of Pennsylvania Law Review* 1607ff; eg JC Coffee, ‘Do Norms Matter? A Cross-Country Evaluation’ (2001) 149 *University of Pennsylvania Law Review* 2151.

¹⁰⁶ H Eidenmüller, ‘Free Choice in International Company Insolvency Law in Europe’ (2005) 6 *European Business Organization Law Review* 423; H Eidenmüller, ‘Wettbewerb der Insolvenzrechte?’ [2006] *Zeitschrift für Unternehmens- und Gesellschaftsrecht* (ZGR) 467; H Eidenmüller, ‘Der Markt für internationale Konzerninsolvenzen: Zuständigkeitskonflikte unter der EuInsVO’ [2004] *Neue Juristische Wochenschrift* 3455.

¹⁰⁷ For a good account of this debate, see J Amour, ‘The Law and Economics of Corporate Insolvency: A Review’ in J McCahery, F Verstijlen and R Vriesendorp (eds), *Comparative and International Perspectives on Bankruptcy Law Reform in the Netherlands* (The Hague, Boom Juridische Uitgevers, 2001) ch. 3.

maximisation,¹⁰⁸ the promotion of interests of all stakeholders¹⁰⁹ or a 'community interest' aspect for insolvency law¹¹⁰—they will always wish to further this goal in the most efficient way possible.¹¹¹ Therefore, law and economics scholars have introduced the notion of 'efficient bankruptcy law'. I take efficiency to mean a speedy process designed to allocate the available resources to their best use. Economically speaking, it is the duty of an effective insolvency law system to transfer assets that are no longer productive back into productivity.¹¹² This may include either traditional liquidation or different reorganisation procedures. Any inefficient procedure will result in high exit costs.

Furthermore, economists take the view that the overall goal of efficiency in insolvency procedure leads to the consequence that the ultimate function of insolvency law is to minimise the costs of debt finance.¹¹³ This is because the costs of financial distress or of any insolvency procedure are considered to be a by-product of debt finance. The higher the costs of insolvency, the higher the costs of financial debt. In other words: lenders will factor the possible costs of insolvency into the interest rates at which they are willing to lend money.

If we transpose this theoretical foundation to our question of forum shopping, the problem becomes more concrete: is forum shopping in insolvency law a means that makes an insolvency more 'efficient' in the way described above? Does it reduce the costs of debt finance, or does it increase them?

Various factors can be taken into account.¹¹⁴ Among the most popular

¹⁰⁸ This view was taken most prominently by Thomas Jackson and Douglas Baird, see eg T Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain', (1982) 91 *Yale Law Journal* 857; T Jackson, 'Avoiding Powers in Bankruptcy', (1984) 36 *Stanford Law Review* 725; D Baird and T Jackson, 'Corporate Reorganisations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy', (1984) 51 *University of Chicago Law Review* 97.

¹⁰⁹ See DR Korobkin, 'Contractarianism and the Normative Foundations of Bankruptcy Law', (1993) 71 *Texas Law Review* 541.

¹¹⁰ K Gross, *Failure and Forgiveness: Rebalancing the Bankruptcy System* (New Haven, Yale University Press, 1997).

¹¹¹ The Regulation follows the same idea. Recital 2 goes as follows: 'The proper functioning of the internal market requires that cross-border insolvency proceedings should operate efficiently and effectively', and recital 8 mentions the 'aim of improving the efficiency and effectiveness of insolvency proceedings having cross-border effects'.

¹¹² C Paulus, 'Die EuInsVO—wo geht die Reise hin?' [2008] *NZI* 1, 5. D Hahn, 'Concentrated Ownership and Control of Corporate Reorganisations' (2004) 4 *Journal of Corporate Law Studies* 117, 127, suggests that three primary factors affect the efficiency and fairness of corporate reorganisation regimes: '(a) the ownership structure of corporate debtors and its effect on the extent of independent judgment the debtor's management is capable of exercising, (b) the effect of the respective regimes on the firm's decision-making concerning the commencement of bankruptcy, and (c) the professional qualification of the person controlling the reorganisation case.'

¹¹³ A Schwartz, 'A Contract Theory Approach to Bankruptcy' (1998) 107 *Yale Law Journal* 1807.

¹¹⁴ See on this H Eidenmüller, 'Free Choice in International Company Insolvency Law in Europe', above n 106, 434ff; P Kuipers and M Roelofs, 'Judicial Comity and Chauvinism: The Need to Go Forum Shopping in Insolvency Matters' (2004) 1 *International Corporate Rescue* 319.

arguments against the admissibility of forum shopping is the idea that it works to the detriment of the lawful rights of creditors or other parties. Economically speaking, creditors would be unable to foresee the insolvency law regime that becomes applicable and would therefore need to factor the uncertainty costs into their credit costs, creating an overall welfare loss.¹¹⁵ This uncertainty undermines the position of business financing by making lenders more cautious about contracting with parties whose asset bases may be volatile in this way.¹¹⁶ However, one might argue, a debtor is at all times free to move within the internal market (and even beyond) and is no longer bound by national boundaries. A company's migration does not necessarily have to take place in the vicinity of insolvency. I would argue therefore that a creditor is never able to predict which insolvency law his claim will be subject to—as long as the internal market consists of different substantive insolvency regimes. At the least, it is the creditor's responsibility to take protection against this type of risk as it is against every other type of business risk. Accordingly, practitioners report that creditors have begun to include 'anti-migration' covenants and warranties in their lending agreements to ensure that they are not faced with a potentially less favourable legal regime in the event of insolvency.¹¹⁷

Another argument that is discussed in the literature is that legal rules contained in both company and insolvency laws which a company is subject to might become separated by pre-insolvency forum shopping.¹¹⁸ Thereby, the argument goes, insolvency costs will rise, since conflicts-of-law problems will arise, making it more difficult to obtain an efficient restructuring procedure. Again, I am sceptical about this argument. The cases discussed above have shown that migrating companies move to another jurisdiction, thereby changing their legal form to that of the destination state. Deutsche Nickel became an English Limited, Schefenacker an English plc. These examples illustrate that company and insolvency indeed coincided despite a forum-shopping procedure.

Other arguments can be given that show potential benefits of forum shopping. Taken from the (similar) US debate, it has been argued that forum shopping enables companies to choose a bankruptcy forum where the judge is predictable, fast and competent in handling the reorganisation of the firm.¹¹⁹ Furthermore, an increased amount of forum shopping in

¹¹⁵ H Eidenmüller, 'Wettbewerb der Insolvenzrechte?' [2006] ZGR 467, 478. Cf for a similar argument the ECJ in the case *Staubitz-Schreiber*, above n 82, para 27.

¹¹⁶ Omar, above n 56, 50.

¹¹⁷ I Fletcher, *The Law of Insolvency* (London, Sweet & Maxwell, 2002) 852; Eidenmüller, above n 115, 479.

¹¹⁸ Eidenmüller, above n 115, 478.

¹¹⁹ KM Ayotte and DA Skeel, 'Why Do Distressed Companies Choose Delaware? An Empirical Analysis of Venue Choice in Bankruptcy', Columbia Business School and University of Pennsylvania Law School Working Paper 2004.

Europe could lead to arbitrage amongst EU Member States to offer optimal insolvency law regimes.¹²⁰

Ultimately, the question will lead to a debate similar to the one that has been led over decades and that is still ongoing: the debate, well known from US corporate law, is on whether regulatory competition is beneficial, whether it inter alia implies a 'race to the bottom' towards lower protection standards or rather a 'race to the top'.¹²¹ In general, while the claim that Delaware company law is efficient remains much disputed,¹²² it is generally agreed that regulatory competition need not, necessarily, imply a degradation of standards.

(b) The Role of the Creditors

As often, there is no clear-cut overall answer to the question. From the theoretical viewpoint, many different outcomes are being discussed. One aspect has hitherto always been neglected: in most cases, the creditors consented to the debtor's 'migration' before insolvency proceedings were opened.

(i) Creditors as Initiators of Forum Shopping

As in the *Schefenacker* case,¹²³ it was largely the creditors' initiative to move the company to the UK, partly due to the perceived flexibility and sophistication of English insolvency law (particularly the way in which restructuring proposals can be implemented) and partly due to English and US creditors' preference for managing their interests through the gateway of London.¹²⁴ If the creditors support the migration of the company into another jurisdiction, especially if they even initiate the migration, this can and must be taken to be a remarkable indication of a more efficient insol-

¹²⁰ L Enriques and M Gelter, 'Regulatory Competition in European Company Law and Creditor Protection' (2006) 7 *European Business Organization Law Review* 417, 447–8.

¹²¹ See eg sceptically W Cary, 'Federalism and Corporate Law: Reflections Upon Delaware' (1974) 83 *Yale Law Journal* 663; speaking of a 'race to the top': R Winter, 'State Law, Shareholder Protection and the Theory of Corporation' (1977) 6 *Journal of Legal Studies* 251; D Fischel, 'The 'Race to the Bottom' Revisited: Reflections on Recent Developments in Delaware's Corporation Law' (1982) *Northwestern University Law Review* 913, 916, 920. See also F Easterbrook, 'The Economics of Federalism' (1983) 26 *Journal of Law and Economics* 23, 28 and F Easterbrook and D Fischel, 'Voting in Corporate Law' (1983) 26 *Journal of Law and Economics* 395. A more recent account with Z Fluck and C Mayer, 'Race to the Top or Bottom? Corporate Governance, Freedom of Reincorporation and Competition in Law' (2005) 1 *Annals of Finance* 349.

¹²² L Bebchuck and A Ferrell, 'Federalism and Takeover Law: The Race to Protect Managers from Takeovers' (1999) 99 *Columbia Law Review* 1168.

¹²³ Discussed above pp 75ff.

¹²⁴ G Tett and I Simensen, 'Schefenacker Considers Move to London' *Financial Times* 16 October 2006; Simensen, above n 102.

veny procedure. At least for institutional lenders who are experienced in big restructuring processes, this can be seen to be a clear benefit of pre-insolvency migration.¹²⁵ This is all the more true as most critical assessments concerning forum shopping in the vicinity of insolvency warn against the danger that forum shopping could have on the position of creditors.

Legally speaking, this leads us back to the tenet of *volenti non fit iniuria*.¹²⁶ Those who agree to a certain conduct do not suffer any injustice from it. If creditors agree or even further the debtor's migration, they will expect a more favourable insolvency proceeding in the new jurisdiction. If this is the case, we can presume that the 'forum shopping' of the debtor is beneficial and efficient, as it will most certainly reduce the side costs of the insolvency.

At least in these situations, ie when the creditors have consented to the migration, we have a strong indicator that the migration will entail beneficial effects. We can take these types of cases aside and concentrate on other situations, more precisely on situations in which the debtor moves abroad *without* the consent of the shareholders or most of the shareholders. Equally, we must consider what happens when certain creditors (eg large banks) vote in favour of a migration even when other creditors oppose it (eg unsecured, typically involuntary creditors).

(ii) *Creditor Protection*

In all three major forum-shopping cases discussed above, the migrating company actually acted with the consent of its creditors. If we look at the legal grounds on which the migration took place, it becomes clear that it is largely impossible to effect the migration without the creditors' consent,¹²⁷ or that at least strong safeguards are in place.

First, with regard to the *Anwachungs* model under German company law, as explained, under German law the company has to convert from a GmbH (or even AG) to a partnership.¹²⁸ Sections 204 and 22 of the Umwandlungsgesetz thereby provide for a creditor-protection regime: within six months from the day on which the change of the legal form has been entered into the commercial register, creditors can claim a security deposit for the claims against the company if they can credibly show that the change of the legal person will affect the performance of the claim.¹²⁹

¹²⁵ Eidenmüller, above n 115, 476.

¹²⁶ See on this principle A Ohly, *Volenti non fit iniuria—Die Einwilligung im Privatrecht* (Tübingen, Mohr Siebeck, 2002); R Zimmermann, *The Law of Obligations—Roman Foundations of the Civilian Tradition* (Oxford University Press, 1990) 450, 1013.

¹²⁷ Cf the statement of Mr Registrar Baister in *Re TXU Europe German Finance BV* [2005] BCC 90 para 19.

¹²⁸ This is governed by ss 190ff and 228ff of the German Umwandlungsgesetz.

¹²⁹ Emphasising the concrete nature of the danger that has to be shown: Bundesgerichtshof, judgment of 24 April 2002, [2002] NJW 2168, 2169. See in more detail S Simon, 'Gläubigerschutz im Umwandlungsrecht' [2004] *Der Konzern* 191, 194–5; M Fischer, 'Formwechsel

This is accompanied by the possible damages regime under sections 205 and 206 of the Umwandlungsgesetz. In the second step, the general partner of the partnership withdraws from the partnership, triggering the persisting liability for claims existing before the general partner withdrew.¹³⁰ We see that in this case, both steps contain measures of creditor protection, both of which are mandatory. This model has been used in practice, eg in the *Schefenacker* case.¹³¹ The *Deutsche Nickel* case was slightly different (see above), as the shares were sold to the newly created English company. As it happened, and from a realistic perspective this will always be the case, under normal circumstances the shares in such a company are all pledged to creditors, who therefore have to consent to the sale. Moreover, sections 22, 204, 205 and 206 of the Umwandlungsgesetz would apply in the *Deutsche Nickel* case as well.

Beyond the *Anwachungs* model, the regime for the now implemented cross-border merger directive is even more restrictive. The new section 122j of the Umwandlungsgesetz (based on Article 4 of the cross-border merger directive) provides for an ex-ante creditor protection system. Here, creditors already profit from the right to a security deposit after the ‘common draft terms’ of the merger according to Article 5 of the cross-border merger directive have been published, ie long before the merger is actually accomplished.¹³² And finally, in the case of a cross-border transfer of the seat—which is, for now, only available via the SE—here again, the legislator emphasises the need for adequate creditor protection (see Article 8(7) of the SE Regulation).¹³³ Similarly, the proposed directive on the transfer of the registered office offered creditor protection in Article 8(1), according to which

Creditors and holders of other rights in respect of a company which predate publication of the transfer proposal shall be entitled to require the company to provide adequate security on their behalf.¹³⁴

We see in these examples that the respective legislator secures creditor protection in every particular situation of a cross-border restructuring. But this is not everything: the specific creditor protection measures are always

zwischen GmbH und GmbH & Co KG’ [1995] *Betriebs-Berater* 2173, 2175ff; H Kallmeyer, ‘Gläubigerschutz bei Umwandlung beteiligungsidentischer GmbH & Co KG’ [2000] *GmbH-Rundschau* 541.

¹³⁰ Based on s 128 Handelsgesetzbuch, see KJ Hopt ‘§ 128’ in KJ Hopt and H Merkt, *Baumbach/Hopt—HGB* (33rd ed, Munich, CH Beck, 2008) paras 28ff.

¹³¹ See above pp 75ff.

¹³² Critical on this provision B Grunewald, ‘Der Gläubigerschutz bei grenzüberschreitenden Verschmelzungen nach dem Entwurf eines zweiten Gesetzes zur Änderung des UmwG’ [2007] *Der Konzern* 106; M Passarge and M Stark, ‘Gläubigerschutz bei grenzüberschreitenden Verschmelzungen nach dem Zweiten Gesetz zur Änderung des Umwandlungsgesetzes’ [2007] *GmbH-Rundschau* 803, 804ff.

¹³³ On creditor protection and SE migration, see Ringe, above n 55.

¹³⁴ Art 8 of the 1997 Proposal—see above n 54.

accompanied by the applicability of tort law. In the case where the whole operation in question harms the financial situation of the creditors, national law will provide for tort remedies.¹³⁵

To be sure, these cases have been exemplified under German law because it happened that the three major cases that were discussed above concerned German companies. But most of the safeguards are based on European law instruments, and therefore will be in place throughout the European Union. Moreover, similar creditor protection regimes will be found in other jurisdictions. For instance, UK courts have shown willingness to scrutinise the protection of creditors of a foreign company before granting an insolvency order.¹³⁶ Another example is the UNCITRAL model law on cross-border insolvency,¹³⁷ which contains various provisions for the benefit of creditors in a cross-border insolvency.¹³⁸ The UK has recently implemented the Model Law by enacting the Cross-Border Insolvency Regulations 2006,¹³⁹ and hence creditor protection is now also ensured in cross-border insolvency cases that do not relate to other EU Member States.

Last but not least, the EU Insolvency Regulation itself contains the means to protect creditors.¹⁴⁰ On the one hand, every creditor is free to oppose the opening decision of the insolvency proceedings in the alleged COMI state by judicial review. In a parallel way, the creditor can try to file for insolvency in the state where he or she believes the real COMI is situated.¹⁴¹ Third, the Insolvency Regulation contains a powerful tool, should a migration have occurred which turns out to be detrimental to the creditors: the ‘secondary proceedings’ according to Article 3(2) of the Regulation.¹⁴² This paragraph provides that if the COMI is situated in a Member State, ‘the courts of another Member State shall have jurisdiction to open insolvency proceedings . . . if [the debtor] possesses an establishment within the territory of that other Member State’. According to Article 28 of the Regulation, secondary proceedings are governed by the law of the Member State where the secondary proceedings are opened. However, the effects of those secondary proceedings ‘shall be restricted to the assets of

¹³⁵ Under German law, the most obvious remedy would be s 826 BGB (intentional damage contrary to public policy).

¹³⁶ *Re TXU Europe German Finance BV* [2005] BCC 90, 94–5.

¹³⁷ United Nations Commission on International Trade Law, Model Law on Cross-Border Insolvency of 30 May 1997. Reproduced in L Sealy and D Milman, *Annotated Guide to Insolvency Legislation 2006/2007*, vol 2 (9th edn, London, Sweet & Maxwell, 2006) 54. A number of leading economies have already adopted this (eg USA, Japan, South Africa, Poland).

¹³⁸ See eg ss 13, 14, 21, 22 of the Model Act.

¹³⁹ Based on s 14 Insolvency Act 2000.

¹⁴⁰ Andres and Grund, above n 28, 142.

¹⁴¹ Admittedly, this solution has become more difficult with *Eurofood*, above n 34, and the ECJ emphasising the principle of mutual trust.

¹⁴² On the possibility of a ‘forum shopping in secondary proceedings’, see Moss et al, above n 57, paras 8.65, 8.168.

the debtor situated in the territory of the latter Member State'. This provision represents an important exception to the principle of universal effect enshrined in Article 3(1).¹⁴³ If one Member State has opened primary proceedings according to Article 3(1), secondary proceedings in another Member State can only be winding-up proceedings (Article 3(3) of the Regulation). These secondary proceedings in the Member State other than the COMI Member State grant creditors situated in this state the possibility to obtain insolvency protection according to their own rules and apart from the main proceedings.

This long list of creditor protection tools—both under national and under Community law—leaves no doubt that adequate and sufficient safeguards are in place that deal with creditor protection and that will even protect 'weak' creditors who are not able to negotiate the terms of their contracts or whose claims are based on involuntary action. Nevertheless, it has to be re-emphasised that cases where these safeguards become necessary will remain the exception, and that in most cases the creditors will most likely consent to the migration.

Drawing these issues together, a cross-border migration is either supported (or even initiated) by the creditors who expect a more efficient restructuring for themselves, or—in the rare case where this might not be the case—we find that the legislator provides creditor protection safeguards, both in specific restructuring law as in the general scope of tort law. If this is true, the initial question of whether pre-insolvency forum shopping is efficient does not need to be answered explicitly, but can be reframed so that the creditors' consent (if it exists) is an indicator for efficiency gains, whereas legislation (both on European and on national levels) provides for safeguards that deal with those situations where creditors do not consent. On this basis, there are no reasons why forum shopping should not be permitted.

This lets us turn to the ultimate question of how the forum-shopping problem responds to the system mandated by primary EC law.

VI. FORUM SHOPPING AND EC LAW

We will now turn from the normative analysis (of whether forum shopping is desirable) to a positive analysis under the current system of EC law. Quite independently from the discussion for and against the benefits of forum shopping, it can be argued that already the current impetus of EC law, namely its fundamental freedoms, mandates the admissibility of forum shopping.

¹⁴³ *Ibid*, para 8.59.

(a) COMI Approach and Fundamental Freedoms*(i) Scope of the Freedom of Establishment*

The issue that needs to be considered first is whether the particular area of insolvency law comes at all within the scope of fundamental freedoms. Most prominently, freedom of establishment (as laid down in Articles 43 and 48 EC Treaty) has turned out to be a helpful tool to facilitate cross-border economic activity in the context of migration.¹⁴⁴ However, some authors suggest that the scope of this fundamental freedom is limited to provisions of company law only.¹⁴⁵ Based on recent case-law, they believe in making a distinction between obstacles to mobility that originate in the scope of company law and other impediments that would not be within the ambit of freedom of establishment. This approach has to be most vigorously contradicted. There is no such confinement of the freedom of establishment to formal rules of 'company law'. Were this the case, Member States could indeed, as Armour puts it, substitute company law creditor-protection rules that impede freedom of establishment by identical rules located in their corporate insolvency law.¹⁴⁶ It follows from this obvious example that no distinction between corporate law and insolvency law can be supported for the assessment of freedom of establishment. Rather, Armour employs a 'functional approach' to the scope of company law, whereby he determines the relevance of the respective provision with regard to company law. Clearly, many rules of insolvency law support or complement company law in a way that can be considered within the functional scope of company law.¹⁴⁷ Moreover, what we need is not only a functional analysis of what constitutes company law, but also a functional analysis of freedom of establishment: Articles 43 and 48 EC do not only apply to obstacles that are of a company law origin.¹⁴⁸ Neither the wording nor the case-law on these provisions suggests that freedom of establishment would apply only to company law. Instead, the EC law perspective is directed more towards the existence of an 'obstacle' to freedom of establishment. All provisions that somehow impede the free choice of establishment of an individual or a company in another Member State could

¹⁴⁴ See on this the references given in n 1 above.

¹⁴⁵ P Ulmer, 'Gläubigerschutz bei Scheinauslandsgesellschaften- Zum Verhältnis zwischen gläubigerschützendem nationalem Gesellschafts-, Delikts- und Insolvenzrecht und der EG-Niederlassungsfreiheit' [2004] *Neue Juristische Wochenschrift* 1201, 1205. In a similar vein, P Kindler, 'Internationales Insolvenzrecht' in Rebmann et al, above n 63, vol 11, para 43.

¹⁴⁶ Armour, above, n 1, 402.

¹⁴⁷ *Ibid*, referring to DA Skeel, 'Rethinking the Line between Corporate Law and Corporate Bankruptcy' (1994) 72 *Texas Law Review* 471; DA Skeel, 'Corporate Anatomy Lessons' (2004) 113 *Yale Law Journal* 1519, 1550ff.

¹⁴⁸ In a similar way Armour, above n 1, 405.

potentially infringe the freedom. This could apply to tax law,¹⁴⁹ social security law¹⁵⁰ or even procedural law.¹⁵¹ The important idea is that EC law does not care about the formal category of the law that restricts its fundamental freedoms.¹⁵²

(ii) *Compatibility with the Freedom of Establishment*

On the basis of the foregoing, it is now possible to assess the validity of the COMI approach of the European Insolvency Regulation with the EC Treaty. It is common belief now that the EC legislator itself, when drafting EC secondary legislation, is bound by the provisions of primary EC law, ie the Treaty.¹⁵³

(1) *Violation of the Home-State Principle* In a series of cases, the ECJ has shaped the scope and the extent of EC corporate law establishment.¹⁵⁴ These well-known cases have created a vast body of literature and need not be reiterated here.¹⁵⁵ Suffice it to state that, based on the home-state

¹⁴⁹ See on this eg case C-9/02 *Hughes de Lasteyrie du Saillant v Ministère de l'Économie, des Finances et de l'Industrie* [2004] ECR I-2409; case C-446/03 *Marks & Spencer plc v David Halsey (HM's Inspector of Taxes)* [2005] ECR I-10837.

¹⁵⁰ Case 79/85 *DHM Segers v Bestuur van de Bedrijfsvereniging voor Bank- en Verzekeringswezen, Groothandel en Vrije Beroepen* [1986] ECR 2375; case C-337/97 *CPM Meeusen v Hoofddirectie van de Informatie Beheer Groep* [1999] ECR I-3289.

¹⁵¹ Case C-43/95 *Data Delecta Aktiebolag and Ronny Forsberg v MSL Dynamics Ltd* [1996] ECR I-4661.

¹⁵² See most recently AG Maduro in his opinion on case C-210/06 *Cartesio Oktató és Szolgáltató bt* of 22 May 2008, para 30. Exemplary for the freedom to provide services: case C-20/92 *Anthony Hubbard v Peter Hamburger* [1993] ECR I-3777 para 19 and summary part 3. From the literature, see G Bitter, 'Niederlassungsfreiheit für Kapitalgesellschaften in Europa: Gläubigerschutz in Gefahr?' in A Tietze et al (eds) *Europäisches Privatrecht—Über die Verknüpfung von nationalem und Gemeinschaftsrecht, Jahrbuch Junger Zivilrechtswissenschaftler 2004* (Stuttgart, Boorberg, 2005) 299, 310ff; H Eidenmüller and G Rehm, 'Niederlassungsfreiheit versus Schutz des inländischen Rechtsverkehrs: Konturen des Europäischen Internationalen Gesellschaftsrechts' [2004] ZGR 159, 166.

¹⁵³ On competence, see case C-376/98 *Germany v European Parliament and Council (Tobacco Advertising)* [2000] ECR I-8419. On substance, see case 15/83 *Denkavit Nederland BV v Hoofddoelproduktschap voor Akkerbouwprodukten* [1984] ECR 2171 para 15; case C-51/93 *Meyhui NV v Schott Zwiesel Glaswerke AG* [1994] ECR I-3879 para 11; case C-114/96 *Criminal Proceedings against Kieffer and Thill* [1997] ECR I-3629 paras 27, 33; case C-284/95 *Safety Hi-Tech Srl v S & T Srl* [1998] ECR I-4301 para 63; case C-341/95 *Gianni Bettati v Safety Hi-Tech Srl* [1998] ECR I-4355 para 61; case C-169/99 *Hans Schwarzkopf GmbH & Co KG v Zentrale zur Bekämpfung unlauteren Wettbewerbs eV* [2001] ECR I-5901 para 37; P Dyrberg, 'Full Free Movement of Companies in the European Community at Last?' (2003) 28 *EL Rev* 528, 537 n 30. For the specific case of the Insolvency Regulation, cf Enriques and Gelter, above n 120, 449; D Haß and C Herweg in D Haß et al (eds), *EU-Insolvenzverordnung* (Munich, CH Beck, 2005) art 4, para 14.

¹⁵⁴ Case C-212/97 *Centros Ltd v Erhvervs- og Selskabsstyrelsen* [1999] ECR I-1459; case C-208/00 *Überseering BV v Nordic Construction Company Baumanagement GmbH* [2002] ECR I-9919; case C-167/01 *Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd* [2003] ECR I-10155.

¹⁵⁵ See only Roth, above n 1; D Zimmer, 'Case Note on Inspire Art' (2004) 41 *CML Rev* 1127; Rickford, above n 1; Siems, above n 1.

principle, every company incorporated in a Member State has to be recognised as such and cannot be made subject to additional regulation in the host Member State. Every obstacle that makes it less attractive to seek establishment in another Member State may violate the freedom of establishment, subject to a possible justification.¹⁵⁶ From this starting point, a certain conflict of the Insolvency Regulation with the Treaty cannot be rejected from the outset.

The concrete test that the ECJ would apply is whether the rule in question impedes the exercise of corporate freedom of establishment so that it makes the establishment in another Member State less attractive and with an exception for rules that are too ‘indirect and uncertain’.¹⁵⁷ The latter term serves as a filter to eliminate vague obstacles from the scope of the freedom of establishment. The problem becomes more concrete when we take an example: a given company, incorporated in Member State A, decides to move its entire business to Member State B while remaining incorporated in State A. According to the ECJ, the company has to be recognised in its entirety in Member State B; it may not be subjected to, for example, a different capital regime or accounting provisions.¹⁵⁸ Yet the Insolvency Regulation, on the basis of its Article 3(1), would provide for the courts of Member State B having jurisdiction to open insolvency proceedings. This is because under regular circumstances, the described ‘letterbox company’ would lead to a rebuttal of the presumption contained in Article 3(1) sentence 2.¹⁵⁹ Furthermore, the rule in Article 4 of the Regulation would trigger the applicability of the insolvency law of Member State B. Whilst the first element, the applicability of a mere procedural rule (Article 3), does not necessarily violate fundamental freedoms and could be regarded as too ‘uncertain and indirect’,¹⁶⁰ this would surely not apply to a conflict-of-law rule, triggering the application of the substantive insolvency law of the host state (Article 4). According to the Regulation, alongside the place of jurisdiction in Member State B, the substantive insolvency law of that Member State also applies. This goes far beyond what the ECJ would

¹⁵⁶ *Inspire Art*, above n 154, para 133.

¹⁵⁷ Joined cases C-418/93 and others *Semeraro Casa Uno Srl v Sindaco del Comune di Erbusco* [1996] ECR I-2975 para 32.

¹⁵⁸ This is the gist of case *Inspire Art*, above n 154.

¹⁵⁹ Case C-341/04 *Eurofood IFSC Ltd* [2006] ECR I-3813 para 35. The case is discussed at IF Fletcher, *Insolvency in Private International Law—Supplement to Second Edition* (Oxford University Press, 2007) para 7.44.

¹⁶⁰ The ECJ has held mere procedural rules to be ‘uncertain and indirect’, cf case C-412/97 *ED Srl v Italo Fenocchio* [1999] ECR I-3845 para 11. See A Flessner, ‘Diskriminierung von grenzüberschreitenden Rechtsverhältnissen im europäischen Zivilprozess’ (2006) 14 *Zeitschrift für Europäisches Privatrecht* 737, 739–40; WG Ringe, ‘Überseering im Verfahrensrecht—Zu den Auswirkungen der EuGH-Rechtsprechung zur Niederlassungsfreiheit von Gesellschaften auf das Internationale Zivilprozessrecht’ [2007] *IPRax* 388, 390. But see K Lenaerts et al, *Procedural Law of the European Union* (2nd edn, Sweet & Maxwell, London, 2006) para 3-001, esp n 385; and case C-43/95 *Data Delecta Aktiebolag and Ronny Forsberg v MSL Dynamics Ltd* [1996] ECR I-4661.

classify as too ‘uncertain and indirect’. To illustrate this criterion, two examples from the Court’s jurisprudence may be given. The first concerned a prohibition for a vessel to discharge into the sea chemicals that were harmful to the marine environment—here the Court declined every connection between this rule and the ‘establishment’ of the shipping company.¹⁶¹ The other example concerned a law which required retail shops to close on Sundays and public holidays.¹⁶² Again, the ECJ found no connection between the sales volume and the decision to found an establishment in another Member State. In these two examples, national provisions were scrutinised by the ECJ that were only indirectly related to the existence of the company and concerned instead ‘business arrangements’.¹⁶³ In our case, by contrast, Article 4 of the EU Insolvency Regulation applies substantive insolvency law to a foreign company which concerns the latter’s immediate existence, more specifically how its reorganisation or liquidation is organised. Insolvency law not only concerns the company’s relationship to everyday business, but goes to the very heart of its existence. This is reminiscent of the German ‘real seat’ theory, also a conflict-of-law rule applying German company law to foreign companies, which was eventually struck down in *Überseering*.¹⁶⁴ The two connecting factors—COMI in the interpretation as the head office on the one hand and ‘real seat’ on the other hand—bear remarkable similarities. This is why the Insolvency Regulation has been characterised as a ‘victory for the civil-law inspired “real seat” theory’.¹⁶⁵

The point has been made that insolvency law only comes into play once the debtor is insolvent and therefore does not have an equal influence on the choice of establishment in the moment when the company wishes to establish itself in the host Member State.¹⁶⁶ However, on the one hand I believe that when the company chooses the establishment in the host state, it already needs to adjust to the new insolvency law and possibly take anticipatory measures in order to comply with the new insolvency law. This

¹⁶¹ Case C-379/92 *Matteo Peralta* [1994] ECR I-3453.

¹⁶² *Semeraro Casa Uno*, above n 157.

¹⁶³ With an allusion to the famous ‘selling arrangements’ developed by case C-267/91 *Keck and Mithouard* [1993] ECR I-6097.

¹⁶⁴ Case C-208/00 *Überseering BV v Nordic Construction Company Baumanagement GmbH* [2002] ECR I-9919.

¹⁶⁵ G Moss et al, *The EC Regulation on Insolvency Proceedings—A Commentary and Annotated Guide* (Oxford University Press, 2002) para 3.11. Cf H Eidenmüller ‘Der Markt für internationale Konzerninsolvenzen: Zuständigkeitskonflikte unter der EuInsVO’ [2004] *Neue Juristische Wochenschrift* 3455, 3456–7; O Sussman, ‘The Economics of the EU’s Corporate-Insolvency Law and the Quest for Harmonisation by Market Forces’ in X Freixas et al (eds), *Handbook of European Financial Markets and Institutions* (Oxford University Press, 2008) ch 8; Enriques and Gelter, above n 120, 442 (‘is not entirely unlike real seat theory’); T Bachner, *Die Limited in der Insolvenz* (Vienna, LexisNexis, 2007) 28.

¹⁶⁶ Armour, above n 146, 406, referring to T Tröger, ‘Choice of Jurisdiction in European Corporate Law—Perspectives of European Corporate Governance’ (2005) 6 *European Business Organization Law Review* 3.

means that insolvency law can well have an influence on the question of establishment.¹⁶⁷ On the other hand, there is no criterion in ECJ case-law that the impediment has to be concrete in the moment where the establishment decision was taken. For instance, amongst the provisions successfully challenged in *Inspire Art* was one rule submitting directors to a joint liability for legal acts adopted in the name of the company during their directorship for so long as the requirements concerning disclosure in the business register have not been met.¹⁶⁸ In the case before the ECJ, no concrete liability situation had occurred, and it was uncertain that it would ever apply. Nevertheless, the Court found the mere existence of this rule to be a violation of the freedom of establishment. Finally, one can reply to this argument that it is just this debate about forum shopping that shows how important insolvency law can be. If insolvency is such an important location factor that it is able to attract companies from abroad, then it is equally in a position to deter companies from choosing their establishment in a particular state.

(2) *Obscurity of the COMI Approach* The second problem I see with the COMI standard is that the definition of the COMI is still widely unclear or ‘fuzzy’, as Eidenmüller puts it.¹⁶⁹ The unpredictability of a criterion that is of such importance for the reorganisation procedure which a company might face represents a great burden on the effectiveness of any business activity and raises the information costs. Even after the limited guidelines the definition of a COMI received in *Eurofood*,¹⁷⁰ its meaning and application in a concrete example remain doubtful.¹⁷¹ Moreover, even after *Eurofood*—a case that should shed some light on the COMI criteria—courts across the European Union diverge as to the interpretation of the COMI.¹⁷² The ‘fuzziness’ of the COMI standard (including the uncertainty as to the conditions for the rebuttability of the presumption) is most likely to create legal uncertainty both for the respective company and for third parties who are in business relations with the company. Again, the unpredictability and the vagueness of the ‘head office’ criterion (which was the main element of the ‘real seat’ theory) was one of the major criticisms that were raised against the real seat theory.¹⁷³

¹⁶⁷ This is all the more true since insolvency law apparently even attracts companies from foreign countries; thus, it may well also deter them.

¹⁶⁸ This was Art 4(4) of the famous ‘Wet op de Formeel Buitenlandse Vennootschappen’ (law on formally foreign companies). See *Inspire Art*, above n 154, paras 25, 60ff.

¹⁶⁹ Eidenmüller, above n 114, 428.

¹⁷⁰ Case C-341/04 *Eurofood IFSC Ltd* [2006] ECR I-3813.

¹⁷¹ Paulus, above n 112, 2.

¹⁷² Though it should be borne in mind that the battle over *Hans Brochier* took place well after the ECJ had delivered the *Eurofood* judgment (see above pp 78ff). More examples at Paulus, above n 112, 2.

¹⁷³ Kindler, ‘Internationales Handels- und Gesellschaftsrecht’ in Rebmann et al, above n 63, para 434.

(3) *Consequences* It follows from my analysis that the COMI standard as it is applied does not accord with the freedom of establishment. Coming back to the initial statement¹⁷⁴ that company law and insolvency law are inseparable and basically fulfil the same objective confirms this view: a company registered in England can—due to ECJ case-law—benefit from the possibility of carrying out its entire business in Germany and thereby still be subject to English company law; however, by means of a secondary law instrument—the Regulation—the same is not true for insolvency law. As I have shown, this is a contradiction to the EC Treaty.

An argument has been made that the insolvency situation would be quite different from the company law cases decided by the ECJ.¹⁷⁵ Two remarks should be made in reply to this. First, having in mind the basic idea that both areas have in common, which is to ensure the productivity of business in an efficient yet fair way, implies that we should try to start understanding both areas of law in an inseparable context.¹⁷⁶ Tellingly, Member States draw the line between company and insolvency law quite differently.¹⁷⁷ Second, reiterating our initial statement, a violation of the fundamental freedoms does not depend on the formal legal category that the impeding legal provision belongs to under national law.¹⁷⁸ The fact that our current inquiry deals with insolvency rather than company law is irrelevant from an EC law perspective.

(iii) *Justification*

As to the justification of the COMI standard, it seems to me that the ECJ has shown a tendency to reject a possible justification for every rule that hinders the freedom of establishment in an undifferentiated, abstract way.¹⁷⁹ As Advocate General G Alber puts it,

the lawfulness of such measures depends on the existence of an *actual* basis for concluding there to have been abuse *in the individual case*. It has rejected *abstract, general* assessment under a *statutory provision*, and has indeed emphasised that such an assessment is inadequate.¹⁸⁰

This assessment was later to be confirmed by the ECJ: any Member State's assessment is not permissible 'save where abuse is established *on a case-by-case basis*'.¹⁸¹ According to the COMI approach, both forum and appli-

¹⁷⁴ See above p 98.

¹⁷⁵ Eidenmüller, above n 114, 445–6.

¹⁷⁶ Paulus, above n 112, 5.

¹⁷⁷ Examples at Eidenmüller, above n 106, 435.

¹⁷⁸ See above p 98.

¹⁷⁹ Compare the opinion of AG Alber in Case C–167/01 of 30 January 2003, [2003] ECR I–10159 paras 102, 106 and the judgment in *Inspire Art*, above n 154, paras 105, 143. See in more detail Ringe, above n 55, 197–8.

¹⁸⁰ Alber, above n 179, para 117 (emphasis added).

¹⁸¹ *Inspire Art*, above n 154, paras 105, 143.

cable law in most situations follow the location of the head office of the company. This rule is not of such nature that the ECJ would classify it as applying on a ‘case-by-case basis’ and is therefore beyond what is necessary in order to attain its purpose in the sense of *Gebhard*.¹⁸² Hence, it seems that for whatever good reason the COMI rule was enacted, it would not fulfil the Court’s justification criteria.

(b) EC Law Conform Solutions

What could be the alternative to the present system? I see two ways to amend the current law that would fit into the route of fundamental freedoms as interpreted by the ECJ.

The first option would be to abolish the idea of a rebuttable presumption (which de facto means head office approach) and instead to connect both jurisdiction and applicable law to the relevant Member State of *incorporation*. To this end, the text of Article 3(1) of the Regulation could be reformed as follows:

The courts of the Member State within the territory of which the centre of a debtor’s main interests is situated shall have 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 Regulation could remain unchanged. This radical approach would have the clear advantage of a predictable jurisdiction venue and a predictably applicable insolvency law. Additionally, it would give a harmonised coherence of both company and insolvency laws, since both would be governed by the law of incorporation.

The second and milder solution could be to reform the choice-of-law rule in Article 4 of the Regulation so that the applicable law would be the one of the Member State of origin, whereas the jurisdiction clause in Article 3 could remain unchanged. To this end, Article 4(1) 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’.¹⁸³

Article 3 could then remain unchanged. This solution would have the same advantages as the first; however, insolvency proceedings could be initiated in the Member State where the debtor has its COMI, thereby taking

¹⁸² Case C-55/94 *Reinhard Gebhard v Consiglio dell’Ordine degli Avvocati e Procuratori di Milano* [1995] ECR I-4165 para 37.

¹⁸³ For this solution, a separate rule for natural persons would need to be introduced.

account of the convenience of such a jurisdiction venue for most stakeholders who are typically involved in business with a letterbox company in the host Member State. Arguably, the latter approach would not violate primary law according to what was said above,¹⁸⁴ because the company would only be subject to a procedural rule in the host Member State (which would be too uncertain and indirect),¹⁸⁵ and the substantive insolvency law would remain that of its Member State of origin. However, this solution would lead to practical problems when courts of the host Member State would need to apply insolvency law of the Member State of origin, thereby possibly being required to carry out duties that originate in public authority, such as winding up the company.

From an EC law perspective, both solutions would be equally acceptable and could be freely chosen by the European legislator. Both would entail significant advantages over the current system: not only would they conform better to the Treaty, they would also harmonise the applicability of company law and insolvency law to a company, a topic that is currently a matter of much controversial debate.¹⁸⁶ Moreover, they would create a genuine reliable system of cross-border insolvency in the Community, giving creditors and other stakeholders a predictable answer as to which insolvency regime applies in case the company becomes insolvent. A predictable and easily ascertainable insolvency regime reduces the information cost and thereby enhances the efficiency of a reorganisation procedure.¹⁸⁷

We should not, however, forget the disadvantages that the system proposed here would entail: the ‘radical’ solution (1)—according to which both place and law of insolvency would be according to the Member State of registration—would require most creditors to pursue their claims in a Member State other than their own. Assuming that most creditors will be located in the state where the company carries out its business, this will mean that the pursuit of their claims might become more difficult for them. Furthermore, if they file for insolvency, they have to orient themselves towards a different Member State—which involves choosing legal representatives in another Member State, travel cost, etc. However, creditors will have the option of opening secondary proceedings (Article 3(3) of the Regulation) in any Member State where an ‘establishment’ exists, which in the event of big corporate debtors is most likely to include their own

¹⁸⁴ See text to n 160.

¹⁸⁵ The ECJ has stated that normally it would consider a procedural rule too ‘uncertain and indirect’ to be regarded as liable to hinder trade between Member States. See *Fenocchio*, above n 160, para 11.

¹⁸⁶ Due to the high number of English limited companies in Germany in the wake of the ECJ decisions, the discussion has turned to the (fruitless) debate of how to differentiate between insolvency and company law; see only WG Ringe and C Willemer, ‘Die “deutsche Limited” in der Insolvenz’ [2006] *Europäische Zeitschrift für Wirtschaftsrecht* 621.

¹⁸⁷ Eidenmüller, ‘Free Choice in International Company Insolvency Law in Europe’, above n 106, 429–30.

country of residence. Solution (2) is less radical and would mean that creditors could file for insolvency in the host Member State, whereas the applicable insolvency law would be governed by the state of registration. The disadvantages have already been described above: Member States might come into the situation of applying foreign insolvency law—a delicate issue when it comes to ‘formative’ acts of a public authority nature. Nevertheless, it is my belief that these disadvantages will be outweighed by the reliance and predictability advantages of the two alternatives discussed above.

In sum, two alternatives are available that harmonise better with the requirements of the EC Treaty than the current COMI approach. Either both criteria (jurisdiction venue and conflict-of-law rule) or at least one, the conflict-of-law rule, are amended to point to the Member State of registration (ie a non-rebuttable presumption). Both models would be preferable over the current system; their minor shortcomings would be outweighed by predictability and a harmonised company/insolvency law approach. Moreover, both models would be in accordance with primary EC law.

(c) Implications for the Forum-Shopping Situation

So far, we have only analysed the compatibility of the current COMI approach with EC law and what solutions could be found to the conflict. This discussion has wide consequences, in particular to the subject of our inquiry, the pre-insolvency forum shopping.

The first aspect I would like to outline with respect to the system that is currently in force (Articles 3 and 4 of the Regulation) is that it follows from the discussion above that every attempt to hinder company migration or to make it less attractive—even and in particular in the vicinity of insolvency—is liable to violate the freedom of establishment.¹⁸⁸ The COMI approach itself is a tool to make forum shopping more difficult.¹⁸⁹ If the COMI approach were to be amended as suggested above, this would also make forum shopping easier. Second, it is worth recalling that making use of the disparities of different jurisdictions within the Internal Market in order to benefit from it for the purpose of one’s own business activities has been hailed by the ECJ as profiting from the key idea that underlies the internal market idea.¹⁹⁰ This should be remembered when discussing legislators’ attempts to hinder insolvency forum shopping in an even stricter way than the Insolvency Regulation itself.¹⁹¹ As it was recently put by the Cologne Local Court:

¹⁸⁸ As explained, this does not apply to creditor protection measures.

¹⁸⁹ See above p 76.

¹⁹⁰ Case C-212/97 *Centros Ltd v Erhvervs- og Selskabsstyrelsen* [1999] ECR I-1459 para 27.

¹⁹¹ This is why, for instance, the proposal made by Moss and Paulus, above n 80, to amend the

The debtor's migration to another Member State only aimed at the applicability of a more favourable law. This, however, cannot constitute an abuse, but, on the contrary, can only be considered as an admissible exercise of the (secondary) freedom of establishment.¹⁹²

This statement has to be welcomed. The rationale, stemming from *Centros*, is that as long as there is no harmonisation—and wide areas of law are not yet harmonised at all—market actors are allowed or even encouraged to make use of the persisting disparities.

Third, allowing insolvency law migration as described above does not mean that there should be no protection for creditors or other stakeholders at all. On the contrary, the solution I suggested above means that the applicable insolvency law would be the jurisdiction of the registered office. However, the registered office is not freely transferable. If a company were to forum-shop under the proposed regime, it would need to register in a new Member State. For now, the cross-border move of the registered office is only available via the European Company (SE)¹⁹³ or—indirectly—via a cross-border merger.¹⁹⁴ These instruments provide for certain safeguards that have to be guaranteed before the cross-border operation can take place. In particular, shareholders, creditors and employees have to be adequately protected, as explained above.¹⁹⁵ These safeguards represent the 'price' that the company must pay in order to profit from a different (insolvency) jurisdiction. To be sure, these safeguards have to be interpreted in the light of the fundamental freedoms, but they do not represent a violation of the freedom of establishment.¹⁹⁶ Hence, a migration for the purposes of a new insolvency law would be dependent on the fulfilment of these conditions. In an overall consideration, this seems to be appropriate: by this, the interests especially of the creditors are well ensured, which was discussed above as a counterpart to economic benefits of insolvency forum shopping. In a way, this model seems to be the key solution to all problems that have been discussed in this paper: the model would be compatible with the EC Treaty, but would nevertheless secure the interests of the creditors while maximising the company's flexibility.

text of the Regulation in a way that would further impede forum shopping has to be strongly rejected.

¹⁹² Amtsgericht Köln, judgment of 19 February 2008, reported in [2008] *NZI* 257, 260. Translation by the author.

¹⁹³ Art 8 of the SE Regulation provides for the cross-border transfer of the registered office. See on this Ringe, above n 55.

¹⁹⁴ Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies, [2005] OJ L310/1.

¹⁹⁵ See above pp 95–6.

¹⁹⁶ See in detail WG Ringe, *Die Sitzverlegung der Europäischen Aktiengesellschaft* (Mohr Siebeck, Tübingen, 2006) 103ff. An exception has to be made for the requirement that both head and registered offices have to be in the same Member State (Art 7 SE Regulation). Cf Ringe, above n 55.

On a different issue, I am aware of the fact that my solution would entail consequences for the question of insolvency of corporate groups.¹⁹⁷ Firmly attaching the COMI with the ‘registered office’ leads to the consequence that no common insolvency procedure for corporate groups can be established. However, this is in line with the underlying principles of the Regulation explicitly *not* to cover the question of corporate groups¹⁹⁸ and—more importantly—the ECJ’s decision in *Eurofood*, which found the COMI of the subsidiary not at the same place of the parent company’s COMI.¹⁹⁹ It is submitted that the question of corporate groups still awaits a general and sustainable solution. The first working groups—on the international as on the national level—have begun to explore a legislative solution to the problem.²⁰⁰

(d) Economic ‘Countercheck’

An economic control of the proposed regime might be helpful to confirm the intuitive feeling that an EU insolvency system governed by the ‘registered office’ criterion alone would be preferable to the current one.

We have no proof for this hypothesis, but economic literature has already analysed the benefits of the Insolvency Regulation, introduced in 2002. Oren Sussman examined five EU Member States—Germany, Spain, France, the United Kingdom and Italy—to ascertain whether the Regulation had reduced cross-border borrowing costs.²⁰¹ Over the period from 2001 to 2003, he found a similar pattern in funding with respect to the return on assets and the level of gearing, observing that the German, Spanish and UK companies with a non-domestic EU industrial holder had reduced their gearing by 15 per cent to 40 per cent over the period. By contrast, he found that there was no change in gearing for companies with non-domestic EU subsidiaries.²⁰² Of course, this is only the first economic study of the Regulation, and the effectiveness of the legislation is therefore still to be properly debated. But Sussman ultimately calls for an insolvency regime governed by market forces. This postulation coincides with the result that was found here from the legal perspective. Not surprisingly, perhaps: if the fundamental freedoms are applied in a correct way, they will contribute to

¹⁹⁷ See above pp 73ff.

¹⁹⁸ Weller, above n 45, 413.

¹⁹⁹ *Eurofood*, above n 5, paras 26ff.

²⁰⁰ UNCITRAL’s working group V is currently debating the ‘Treatment of Enterprise Groups in Insolvency’, see http://www.uncitral.org/uncitral/en/commission/working_groups/5Insolvency.html (accessed 28 March 2008). On German proposals for an insolvency law for corporate groups, see H Hirte, ‘Vorschläge für die Kodifikation eines Konzerninsolvenzrechts’ [2008] *ZIP* 444. On the European dimension, see D Adam and C Poertzen, ‘Überlegungen zum Europäischen Konzerninsolvenzrecht’ [2008] *ZInsO* 281, 347.

²⁰¹ Sussman, above n 165, 238ff.

²⁰² *Ibid.*, 259.

the best allocation of resources within the European Union. That is what they are ultimately designed for.²⁰³

VII. CONCLUSION

The problem of 'forum shopping' in insolvency law cases has been considered from different perspectives.

The motivations behind a pre-insolvency migration are not always as dishonest as common belief suggests. The discussion of the economic rationale behind forum shopping has revealed that in most cases it will entail beneficial effects for creditors, in particular in those cases where the migration has been supported or even initiated by the creditors. In all other situations, a possible disadvantage for creditors is secured by means of either specific creditor protection law or by the applicability of tort law. Nevertheless, insolvency forum shopping faces hostile tendencies from different sides, most notably from the way the current COMI standard is applied.

An analysis of the problem in the context of (primary) EC law leads to the result that the current COMI approach, the combination of Articles 3 and 4 of the Regulation, violates the fundamental freedoms of the Treaty. Two alternative models have been developed that fit better into the system of EC law. The application of the insolvency law of the Member State of registration could be a solution *de lege ferenda* that would provide for a better solution, both in respect to the parameters set by the Treaty but also with regard to an easier and more predictable insolvency law regime in Europe. If the applicable insolvency law is always that of the company's registered office, it is easily predictable but remains changeable under the fulfilment of the conditions that are necessary to move a registered office across the border.

This solution would facilitate a maximum of flexibility within the internal market, granting economic benefits to companies and thereby maintaining the protection standard for creditors and other stakeholders.

²⁰³ C Engel, 'Imposed Liberty and its Limits. The EC Treaty as an Economic Constitution for the Member States' in T Einhorn (ed), *Spontaneous Order, Organization and the Law. Roads to a European Civil Society—Liber Amicorum Ernst-Joachim Mestmäcker* (The Hague, Asser Press, 2003) 429.

The ‘Centre of the Debtor’s Main Interests’: Comments on the Eurofood Judgment of the ECJ¹

GEORGES KHAIRALLAH

I. INTRODUCTION

THE COMMUNITY LAW on international insolvency is still very young; its history does not go back beyond 2000. Apart from a few international conventions,² its place was occupied by national law alone, which very early on reflected a constant desire to extend the jurisdiction of national courts. The jurisdiction rules which it developed are so varied that the national courts in question practically always have jurisdiction to open insolvency proceedings, and comparative law shows that this phenomenon is found in numerous countries. In France, the relevant rule, which is at present in article R600-1 of the Commercial Code, is construed as conferring jurisdiction on the French courts when the registered office of the business is situated in France, and if it is in another country, jurisdiction is given to the French court within whose district ‘the centre of a debtor’s main interests’ is situated. This concept appeared to cover all the bases of jurisdiction that have been developed by the courts since the 19th century: the French courts have jurisdiction if the debtor has a mere establishment, such as a branch or agency, in France, if he has property in France, such as an immovable or a bank account, if he carries on a business in France, or if he concludes contracts there.

For several years general national law has coexisted with Community

¹ Case C-341/04 *Eurofood IFSC Ltd* [2006] ECR I-3813; in France, see [2006] *Dalloz AJ* 1286; case note JP Rémy: [2006] *Droit des sociétés* 360; case note G Khairallah: [2007] *Journal du Droit International* 151.

² For France, the France–Belgium convention of 8 July 1899; France–Italy, 3 June 1930; France–Monaco, 22 July 1935; France–Austria, 27 February 1979. Other conventions on mutual assistance (jurisdiction and recognition of judgments) relate to civil and commercial matters, which include insolvency, but no specific rules for the insolvency are laid down.

law. Community law on bankruptcy or insolvency has now developed as a 'special law' in certain specific areas, eg the directives on the reorganisation and winding-up of credit institutions or insurance undertakings.³ There has also developed, if I may use the term, a general Community law of insolvency with Regulation 1346/2000 of 29 May 2000.⁴

As these are unifying measures, these different instruments had to use a single basis of jurisdiction for the courts even though this meant admitting the possibility of more than one set of proceedings being opened in relation to the same debtor, main proceedings and secondary proceedings.⁵

The basis of jurisdiction adopted by the special law should not, in itself, create great difficulties of interpretation. The directives refer to the jurisdiction of the courts of 'the Member State of origin', ie the state in which the insurance undertaking or credit institution was authorised. Anyway, as yet we have no specific cases of application of these measures for exploring the difficulties to which they may give rise.

The same does not apply to the measure that constitutes the general law of insolvency, Regulation 1346/2000. Article 3 of the Regulation confers jurisdiction to open insolvency proceedings in the courts of the Member State within which 'the centre of a debtor's main interests' is situated. From the beginning⁶ it was foreseeable that the application of this jurisdiction rule was bound to create difficulties because the concept of the 'centre of main interests' (COMI) can be understood in different ways. Clearly it does not have the same meaning as the meaning that has been given to the 'main centre of the debtor's interests' in French law because the latter has to cover a large number of bases of jurisdiction, whereas in Community law there should be a single basis of jurisdiction. However, the concept of the COMI is sufficiently vague for each country to give it the meaning suggested by its own private international law, with the result that such a 'centre' may be, for some, the place where the legal person was incorporated, and for others, the seat of management, the centre of its economic activities or again its actual registered office. The claim has even been made that, for a group of companies, the COMI of each company is in the parent company's country.

The ECJ aimed to give a definition of the 'centre of main interests' in the

³ Directive 2001/24/EC of 4 April 2001 on the reorganisation and winding up of credit institutions [2001] OJ L125; Directive 2001/17/EC of 19 March 2001 on the reorganisation and winding up of insurance undertakings [2001] OJ L110.

⁴ Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings [2000] OJ L160/1.

⁵ After the opening of the main proceedings in the country of the COMI, secondary proceedings in the country of establishment can only be winding-up proceedings (Art 3(3) of the Regulation). Exceptionally they may be reorganisation proceedings in the cases set out in the Regulation.

⁶ See D Bureau, 'La fin d'un îlot de résistance: Le règlement du Conseil relatif aux procédures d'insolvabilité' (2002) *Revue Critique de Droit International Privé* 613.

Eurofood judgment of 2 May 2006 (section II). It further gave guidance on the application of the criterion of the 'centre of the debtor's main interests' (section III).

II. THE CONCEPT OF THE 'CENTRE OF THE DEBTOR'S MAIN INTERESTS'

The aim of Regulation 1346/2000 was to avoid the risk of differing interpretations being taken of the COMI depending on the courts in the Member State where collective proceedings are opened. The Regulation states that, 'the place of the registered office shall be presumed to be the centre of . . . main interests in the absence of proof to the contrary' (Article 3(1)).

The place of the registered office is certainly a simple criterion as it is easy to locate. However, the Regulation sees it as a mere presumption which can be rebutted if it is shown that the COMI is in another country. This meant that the problem of uncertainty reappeared because most of the laws of the Member States do not accept the registered office criterion, without qualification. As was to be expected, since 31 May 2002 when the Regulation entered into force, the courts of the Member States have on several occasions been confronted with the problem of determining the COMI, and, every time, there have been differences among them as to the purpose and meaning of the concept. It is therefore necessary to ascertain what approach should be taken in dealing with this issue. Two methods may be proposed; it would be possible to use the conflict-of-laws method (section II(a) below), or to adopt a substantive definition of the concept—as was preferred by the ECJ in the *Eurofood* judgment (section II(b) below).

(a) Determining the Centre of a Debtor's Main Interests by the Conflict-of-Laws Method

As the definition of the COMI differs according to the Member States, strict adherence to their own laws would necessarily leave it to each of them to give the definition. The Regulation appears to prefer this method because it itself avoids taking sides on the definition and also because it reasons on the basis of the conflict-of-laws method with regard to jurisdiction and the applicable law.⁷

In presuming that the COMI is in the country of the registered office, the Regulation appears to give priority to the law of that country for deciding whether it regards the registered office as the centre of the

⁷ See Arts 3 and 17ff on determining the competent court and recognition of judgments; Art 4ff on the applicable law and its scope.

debtor's main interests. For a company that has its registered office in England, it will be for English law to decide whether the registered office is the COMI; for a company which has its registered office in France, it will be for French law to decide whether the registered office is the COMI. Recourse to the law of the country of the registered office for determining whether that country is the centre of the debtor's main interests makes it possible to avoid the impasses to which other lines of reasoning may lead, as illustrated by the *Isa Daisytek* case.⁸

In that case the Daisytek companies formed a group comprising the parent company and several subsidiaries established in England and with other subsidiaries established in Germany and other countries. One of the subsidiaries, SAS Isa Daisytek, had its registered office in France and an office in Bradford, England. The Leeds District Registry of the High Court of Justice opened insolvency proceedings in relation to all the companies of the Daisytek group, including SAS Isa Daisytek. A few days later, a French court opened reorganisation proceedings for the same company. In order to do so, the French court undoubtedly had to find that the French registered office of the company was the actual registered office, which means, according to the criteria of French law, that it was the COMI of SAS Isa Daisytek. However, for its part, the English court also had to find that this centre was situated in England. In actual fact, it appears that the English court enumerated significant acts performed in Bradford, and then set out the criteria governing the concept of COMI and concluded that this centre was indeed situated in Bradford. The judge also observed that the Bradford office of the company functioned in relation to that company in the same way as to the German companies and concluded that Bradford was the COMI of the French company. This reasoning undoubtedly emphasises the existence of certain activity of the company's office in England, which is quite normal for a group of companies in which the unity of the economic objective requires at least some collaboration in making 'strategic decisions'.⁹ The reference to the criteria laid down by French and English law support the view, respectively, that the COMI was in France and that the COMI was in England. To avoid an impasse of this kind in making an assessment, the best thing would be to leave it to the law of the country where the registered office is situated, to say whether or not that country is the centre of the debtor's main interests.¹⁰ Since the Regulation states that

⁸ *Klempka v ISA Daisytek SA* (Court of Appeal Versailles, judgment of 4 September 2003) [2003] BCC 984, [2003] JCP G 89; case note by G Khairallah [2003] *Revue Critique de Droit International Privé* 655.

⁹ See J Béguin, 'The Legal Nationality of Commercial Companies Should be the Same as their Economic Nationality' in *Le Droit Privé à la Fin du XXe Siècle, Etudes Offertes à Pierre Catala* (Paris, Litec, 2001) 859, no 40, who writes, but only in relation to nationality, that the centre of strategic decisions is the most decisive criterion of nationality.

¹⁰ In the *Isa Daisytek* case, the Versailles Appeal Court found that the French court had no jurisdiction, without troubling itself to verify, either directly or by reference to the findings of the

the registered office is presumed to be the centre of the debtor's main interests, the consequence must be that the reply to that question is to be provided by the law of the registered office only.

However, in the *Eurofood* judgment, the ECJ did not opt for that method and preferred to directly provide a substantive definition of the 'centre of main interests'.

(b) The Substantive Definition

Regulation 1346/2000 omits any definition of the COMI, but it does define the 'establishment' which is a basis of jurisdiction for the opening of secondary or territorial proceedings. Article 2(h) of the Regulation states that 'establishment' means 'any place of operations where the debtor carries out a non-transitory economic activity with human means and goods'. The Regulation gives no definition of 'centre of the debtor's main interests'. The reader has to go back to Recital 13 of the preamble to the Regulation to find the statement that the 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'.

In the *Eurofood* judgment, the Court refers to the aforementioned guidance in the preamble and observes that:

in determining the centre of the main interests of a debtor company, the simple presumption laid down by the Community legislature in favour of the registered office of that company 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 different from that which locating it at that registered office is deemed to reflect.¹¹

The location of the registered office is deemed to reflect the actual situation as to where the debtor regularly administers the company, which is readily ascertainable by third parties. The registered office will be disregarded if it does not reflect the actual situation, particularly if it appears to be only a 'letterbox' and not the place where the debtor regularly administers its

English court, whether the French registered office was genuine or fictitious. In failing to do so, it skipped an essential stage in determining the court with jurisdiction to open collective proceedings, namely that the COMI is presumed to be the place of the registered office in the absence of proof to the contrary: by leaving the English court to determine the COMI in principle, according to its own definition, without beginning by saying in what way the French registered office of the company was fictitious, the Appeal Court misused, if not rendered meaningless, the presumption of Art 3(1) of the Regulation. It is perhaps comparable to the situation in which in applying Art 4 of the Rome Convention of 19 June 1980 on the law applicable to contractual obligations (80/934/EEC), a court had settled on the law of the country with which the contract was most closely connected (Art 4(1)), while disregarding the presumptions of Arts 4(2), 4(3) and 4(4) without stating why it disregarded them (Art 4(5)).

¹¹ *Eurofood*, above n 1, para 34.

interests. In brief, the Regulation enshrines, according to the ECJ, the concept of the ‘actual registered office’, the same approach traditionally taken in French case-law.¹² That concept must be used even if the company in question belongs to a group. The fact that its economic choices are dictated to it by a company established in another Member State, which is characteristic of a group of companies, is not sufficient to rebut the presumption. The presumption will be rebutted only if it is proved that the COMI is in some other place.

The ECJ states that the presumption can be rebutted, though only if

factors which are both objective and ascertainable by third parties enable it to be established that an actual situation exists which is different from that which locating it at that registered office is deemed to reflect.

The Court illustrates this by referring to a company not carrying out any business in the territory of the Member State in which its registered office is situated.

It is not easy to understand the connection established by that reasoning between the actual registered office of the company and the place where it carries on its business. Although in many cases a company has its business in all material respects in the same country as its registered office, that is not always the case, particularly at a time when businesses engage in increasingly more numerous and more substantial ‘relocations’. For a long time a distinction has been made between the ‘real seat’ (*siège réel*) and the place where a company carries on business. The real seat is defined as the place where a company has its management and supervisory organs—where decisions are made and strategy decided on. A seat which performs those functions is not the ‘letterbox’ to which the *Eurofood* judgment refers, even if the company’s business is carried on in another country.

The simultaneous reference to the real seat and the place where a company carries on its business, which may therefore be located in different countries, is likely to cause difficulties in the assessment of the centre of the debtor’s main interests which will be made by the courts of the different Member States, particularly as, although the factors on which the two criteria are based are objective, as the ECJ asserts, they remain necessarily flexible, not to say vague. Consequently it may be feared that the definition given in the *Eurofood* judgment, which presents it as autonomous and specific to the Regulation, will become a new source of divergence and therefore uncertainty in applying the jurisdiction rule.

¹² The ‘actual registered office’ is defined by the courts as the place where the company has its management and supervisory organs, where decisions are made and strategy is decided on, see Cass Civ, 15 June 1957, D 1957, 596.

III. APPLICATION OF THE CRITERION OF THE DEBTOR'S 'CENTRE OF MAIN INTERESTS'

A petition for the opening of insolvency proceedings may be lodged in more than one court. This occurs mainly where the petition relates to a company that is a member of a group, as demonstrated by all the large-scale cases which have been brought before the courts since Regulation 1346/2000 entered into force (*Isa Daisytek*, *Metal Europ*, *Parmalat*, *Rover*, *Eurotunnel*, etc).¹³ In that situation the petition is most often lodged at the court of the Member State of the registered office of the company and that of its parent. Therefore it is necessary to determine which court has jurisdiction: to determine where the centre of the debtor's main interests is situated (section III(a) below) and to determine the effects in other states of the judgment which that court will give on that point (section III(b) below).

(a) Determination of the Court with Jurisdiction to Determine the Country of the Centre of the Debtor's Main Interests

Strict adherence to the Regulation may require jurisdiction to be conferred only on the court of the Member State within which the registered office is situated, to decide whether, according to the ECJ's definition, the registered office is indeed the centre of the debtor's main interests. Accordingly, in the *Isa Daisytek* case, this meant that it was for the Pontoise court, and for it alone, to say whether the French-registered office of SAS Isa Daisytek SA was the centre of its main interests and whether this had to be done by reference to the actual or fictitious registered office. In the *Eurofood* case, jurisdiction ought to have been conferred upon the High Court of Ireland, the court of the place of the registered office of the company Eurofood, to determine whether, according to Irish law, that registered office was the centre of the company's main interests. If the court of the place of the registered office therefore considers that it is so, that court alone will have jurisdiction for the purposes of the collective proceedings. If the court does not so consider, it will decline jurisdiction, leaving the court where the COMI is located with jurisdiction for the opening of collective proceedings.

This system is explained by the exclusive nature of the jurisdiction of the court for the COMI which is presumed to be the place of the registered office. The system is in harmony with the other jurisdiction rules of Community law.¹⁴

¹³ See eg B Wessels, *International Insolvency Law* (Deventer, Kluwer, 2006) para 10739.

¹⁴ See Art 19 of the Brussels Convention of 27 September 1968 on Jurisdiction and the Enforcement of Judgments in Civil and Commercial Matters, and Art 25 of Council Regulation (EC) 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of

A different system could be envisaged whereby any court, in proceedings concerning a company having its registered office in another Member State, is given the task of ascertaining whether that registered office is indeed the centre of the debtor's main interests, but on condition that it is done in accordance with the criteria used by the law of the Member State of the registered office. Thus, in the *Isa Daisytek* case, the English court could have ascertained whether the French registered office really was the centre of the main interests of SAS Isa Daisytek, provided that this was done in accordance with the criteria of French law, that is to say, by establishing whether the registered office was genuine or fictitious. If it is genuine, the English court will have to decline jurisdiction; if the French registered office is fictitious, the English court may find that it has jurisdiction because, this time according to its own criteria, it considers that the centre of the main interests of the company is in England.

In the *Eurofood* judgment, the ECJ appeared to accept that a court other than that of the registered office can take cognisance of the opening of collective proceedings, eg the court of the Member State where the registered office of the parent company is situated, which will be required to hear and determine a petition for the opening of collective proceedings in relation to another company of the group. This is not incompatible with Regulation 1346/2000 because none of its provisions confers exclusive jurisdiction on the court of the registered office to deal with that precise question. However, by giving a substantive definition itself of the COMI, which has already been shown to be ambiguous due to the contrary factors of the real seat and the place where a company carries on its business, the *Eurofood* judgment enables each court before which the matter is brought to reintroduce in its assessment its own concept of the definition of 'centre of the debtor's main interests'. This is illustrated by the *Isa Daisytek* case, in which the English court found that it had jurisdiction for the opening of the main proceedings, although it had not been found that the French registered office of SAS Isa Daisytek was fictitious. Consideration of the system laid down by the *Eurofood* judgment for the recognition of the judgment-opening proceedings shows how far that system may be found to be fraught with difficulties.

judgments in civil and commercial matters OJ L12/1. Art 16 of the Brussels Convention confers exclusive jurisdiction on the courts of the country in which the company has its seat in proceedings which have as their object the 'validity of the constitution, the nullity or the dissolution' of the company, which is restated by Art 22 Regulation 44/2001. Even if this rule does not specify which is the competent court for determining the actual seat (registered office) of the company, the same Art 22 Regulation 44/2001 adds that 'in order to determine that seat, the court shall apply its rules of private international law'. For the whole question, see H Gaudemet-Tallon, *Compétence et exécution des jugements en Europe* (3rd edn, Paris, LGDJ, 2002) paras 110 and 111.

(b) Recognition of the Judgment Opening the Main Insolvency Proceedings in Other Member States

According to the *Eurofood* judgment, the first judgment-opening insolvency proceedings is recognised without the jurisdiction of the court delivering the judgment being open to review. The only obstacle to recognition is where the judgment may have effects manifestly contrary to the public policy of the state in which it is sought. For the ECJ, the system of recognition established by the Regulation lays down a rule of priority 'based on a chronological criterion, in favour of the opening decision which was handed down first'.¹⁵

In this respect the *Eurofood* judgment corresponds to Recital 22 of the preamble to the Regulation, which also states that the principle of 'mutual trust' should make it possible to resolve any dispute 'where the courts of two Member States both claim competence to open the main insolvency proceedings'. It is the judgment of the court opening the main proceedings that should be recognised in all other Member States.

Consequently the pre-eminence of the opening judgment is due to a mere matter of date. In the *Isa Daisytek* judgment, because the Leeds court gave its judgment opening proceedings a few days before the French court, the latter no longer had jurisdiction and the English judgment prevailed. The question of date is familiar from the law of civil procedure in the matter of *lis pendens* and related actions, where the court that is second seised of the matter will sometimes have to leave priority with the court first seised. However, the court first seised may not always have priority, as the principles of *lis pendens* and related actions will produce their full effect only if the court first seised actually has jurisdiction.¹⁶ In the field of collective proceedings, the jurisdiction of the court which was the first to give judgment presupposes that the court of the registered office has no jurisdiction, that is to say, for a French-law company, that its French registered office is fictitious. It might therefore be thought that the guidance given in the preamble to the Regulation on the recognition of the judgment of the court which is the first to open proceedings must be circumscribed within very precise limits: where the registered office coincides, according to the criteria of the law of the country of that registered office, with the centre of the debtor's main interests, only the judgment given by the court for that registered office commands recognition and there is no reason to apply the rule of the pre-eminence of the earlier judgment of the court of

¹⁵ *Eurofood*, above n 1, para 49.

¹⁶ See Arts 21–3 Brussels Convention and Arts 27–9 Regulation 44/2001. For *lis pendens*, a court other than the court first seised stays its proceedings until the jurisdiction of the court first seised is established, and only when it is established does the other court decline jurisdiction. Where the applications are related, the court other than the court first seised may decline jurisdiction only if the court first seised has jurisdiction over the actions in question.

another country. The pre-eminence rule will apply only if the registered office and COMI do not coincide, so that the courts of more than one country will claim competence, each with reference to its own definition of that centre.¹⁷

The *Eurofood* judgment, for its part, presupposes that the court first seised has jurisdiction and the guidance it gives for determining the COMI, when added to ‘mutual trust’, appear to the ECJ to be sufficient for interpreting Article 16(1) of the Regulation as meaning that

the main insolvency proceedings opened by a court of a Member State must be recognised by the courts of the other Member States, without the latter being able to review the jurisdiction of the court of the opening State.¹⁸

In other words, as the ECJ has clarified the rule of jurisdiction for opening the main proceedings, the courts of the other Member States are trusted to apply the rule correctly and the judgment opening the first proceedings will take effect everywhere, without the matter of jurisdiction being open to review, particularly by the courts of the state of the registered office, if the judgment is given by a court of another Member State.

However, there are good reasons for thinking that the Regulation does not exclude a review of jurisdiction.

It is true that Regulation 1346/2000 does not lay down the conditions for recognition, in the same way as the other Community measures.¹⁹ At the most, it includes in Article 26 a proviso that the judgment-opening proceedings should not be contrary to public policy. The same Recital 22 of the preamble to the Regulation provides for recognition of the judgment of the first court to open proceedings without the other Member States ‘having the power to scrutinise the court’s decision’.

However, automatic recognition of the judgment-opening proceedings, or recognition ‘with no other formality’, although essentially dispensing with authorisation for enforcement, does not mean that the receiving country must not make recognition subject to conditions. As for Recital 22, whatever its merits, it does state that ‘grounds for non-recognition should be reduced to the minimum necessary’, thereby admitting the existence of conditions for recognition.

Those conditions should include a review of jurisdiction where the judgment-opening proceedings are given by a court of a state which is not that of the registered office. Even if the Regulation does not formally lay

¹⁷ In the areas of *lis pendens* and related actions, the automatic declining of jurisdiction in favour of the court first seised is envisaged only where the actions come within the exclusive jurisdiction of several courts (Art 23 Brussels Convention, Art 29 Regulation 44/2001). This situation cannot arise with regard to collective proceedings: if the registered office and the centre of the debtor’s main interests coincide, the court of the place of the registered office will have exclusive jurisdiction to open the main proceedings.

¹⁸ *Eurofood*, above n 1, para 69.

¹⁹ Arts 34, 35 and 45 Regulation 44/2001.

down such a condition, the entire system which it establishes does seem to indicate that jurisdiction should be reviewed. Although the jurisdiction rules of Article 3 of the Regulation are exclusive, it may be difficult to admit that the country whose court has such jurisdiction should accept a judgment-opening proceedings given by another court on the basis of a criterion other than that laid down by the Regulation. By and large that is the position of Community law because it always makes a proviso for a review of jurisdiction where it is exclusive.²⁰

The particular nature of insolvency proceedings is a further argument in favour of an obligation to review the jurisdiction of the court of the country where proceedings are opened. Unlike other matters in which only the interested parties are involved in the proceedings, as they are able to lodge submissions and seek remedies from the beginning, insolvency proceedings may be opened on the initiative of various persons, even on the initiative of the court alone, thus presenting the other interested parties with a *fait accompli*.

Furthermore, Articles 16 and 17 of Regulation 1346/2000 lay down the principle of recognition without any formality other than that judgments should handed down by a court 'which has jurisdiction pursuant to Article 3' and, with regard to a company in a case such as *Isa Daisytek*, the competent court pursuant to Article 3 is that of the Member State in which the registered office is situated, until it is proved that it is fictitious. It may also be added that if the Regulation had been intended to exclude the review of a court's jurisdiction, this would have been expressed formally, in the same way as in other Community measures.²¹

In the *Eurofood* judgment the ECJ decided otherwise, leaving as the only ground of non-recognition incompatibility with the requirements of public policy, provided for by Article 26 of the Regulation. The Court referred to that provision and, in reply to the question before it, ruled that public policy precludes recognition 'where the decision to open the proceedings was taken in flagrant breach of the fundamental right to be heard, which a person concerned by such proceedings enjoys'.²²

The cases where considerations of public policy arise are relatively unforeseeable. But would they not be bound to increase if no other ground, particularly that relating to jurisdiction, can be put forward to challenge recognition of judgments opening insolvency proceedings?

²⁰ See Art 35 Regulation 44/2001.

²¹ See Art 24 Council Regulation (EC) 2201/2003 of 27 November 2003 concerning jurisdiction and the recognition and enforcement of judgments in matrimonial matters and the matters of parental responsibility, repealing Regulation (EC) No 1347/2000 [2003] OJ L338/1, which provides as follows: 'Prohibition of review of jurisdiction of the court of origin. The jurisdiction of the court of the Member State of origin may not be reviewed. The test of public policy . . . may not be applied to the rules relating to jurisdiction.' There is no analogous provision in Regulation 1346/2000.

²² *Eurofood*, above n 1, para 67.

IV. CONCLUSION

The *Eurofood* judgment will be welcomed in so far as it refers to the need to apply scrupulously the jurisdiction rule laid down by the Regulation, thus putting an end to deviations illustrated by the cases where insolvency proceedings are opened in relation to companies belonging to the same group. Even if one company is a subsidiary of another, it is not necessarily an 'establishment' of it, and the centre of its main interests, which is the basis of jurisdiction for opening the main proceedings, is presumed to be the place of its registered office. No doubt this is a mere presumption which will be rebutted if it is shown that the registered office is not the COMI. The ECJ defines this directly, but the definition it gives takes two directions that will not necessarily be complementary. Sometimes its definition comes close to the COMI in the definition of the actual registered office and sometimes it is treated as the place of the company's business. The uncertainty regarding the definition is accompanied by a reference to the sometimes vague factors that determine the actual registered office or place of business. The differing approaches in determining the COMI taken by all the judgments concerning companies belonging to a group are likely to reappear, particularly as the court that has to deal with the opening of the main proceedings is not necessarily the court of the Member State in which the registered office is situated. The consequences of these differing interpretations will be all the more serious in that only the first judgment to be given benefits from the recognition system and recognition must be accepted in all the Member States, with no possibility of reviewing the jurisdiction of the court which gave the judgment. Only public policy remains to provide a bulwark against recognition, but any breach of public policy must be flagrant. Only time will tell whether the *Eurofood* judgment has brought the serenity which the national courts needed so much in order to apply the Regulation and whether the same serenity will be brought by the 'principle of mutual trust' which is required in order to settle the difficulties in the relations of 27 Member States.

European Insolvency Proceedings and Party Choice: Comment

JOHN ARMOUR

I HAVE READ BOTH chapters with great interest: they are novel and thought-provoking contributions to an area that is extremely challenging, being both complex and fast-moving. The chapters focus on the challenges posed for international insolvency proceedings within the EU ('European' insolvency proceedings) by the possibility that parties may be able to exercise some choice over the jurisdiction(s) in which such proceedings are conducted, a process often referred to as 'forum shopping'. They differ, however, on the aspect of these challenges upon which they principally focus.

Professor Khairallah's chapter is concerned with the uncertainties associated with the meaning of a key concept under the European Insolvency Regulation,¹ which raises the possibility that insolvent corporate debtors may engage in 'forum shopping' by persuading courts in a friendly Member State to open proceedings. Before the coming into force of the Regulation in 2002, the issue of jurisdiction to open cross-border insolvency proceedings was left to national laws, each of which tended to adopt a parochial and expansive approach to the question of the competence of its courts to open proceedings. The Regulation sought to resolve this problem by imposing a single criterion for determining both jurisdiction and choice of laws: the place of the debtor's 'centre of main interests' (*centre des intérêts principaux*), or COMI. This is presumed in the first instance to be in the jurisdiction in which a corporate debtor's registered office is located. Unfortunately for the cause of legal certainty, this presumption may be rebutted as the debtor's COMI if 'proof to the contrary' is established.² Who is to decide this, and how?

¹ Council Regulation (EC) No 1346/2000 of 29 May 2000 on Insolvency Proceedings [2000] OJ L160/1, Art 3(1).

² *Ibid.*

Professor Khairallah suggests an elegant solution to this problem. The question of the determination of COMI and the status of this presumption might have been approached from a conflict-of-laws perspective. The fact that the Regulation defines the concept of ‘establishment’ in Article 2(h)—upon which jurisdiction to open secondary proceedings turns—but does not define COMI implies that the matter is left to ordinary conflicts rules. On this view, the question whether the debtor’s COMI was in fact the same jurisdiction as its registered office would fall to be determined in accordance with the conflicts rules of the jurisdiction in which the debtor has its registered office.

This solution has the benefit of maximum adherence to the principle of subsidiarity. However, it was not the approach taken by the ECJ in the *Eurofood* decision. The Court gave an autonomous meaning to the concept of COMI,³ an approach which I have to say I support.⁴ In so doing, the Court relied heavily on guidance in Recital 13 of the Regulation’s preamble as to the meaning of COMI, saying that the ‘simple presumption’ in favour of the place of a company’s registered office can be rebutted only if:⁵

factors which are both objective and ascertainable by third parties enable it to be established that an actual situation exists which is different from that which locating it at that registered office is deemed to reflect.

Professor Khairallah sees similarities between the operation of the presumption and the way in which a corporate debtor’s *siège réel*—or ‘real seat’—is understood in French law. The seat of the registered office (*siège statutaire*) is not the company’s *real* seat if it is shown to be merely a ‘letterbox’. Rather, the real seat is the place where the company has its organs of direction and control, where the decisions are made and the strategy is decided. These are surely ‘objective factors’. However, what is confusing about the reasoning in *Eurofood*, in his view, is the Court’s statement that the presumption might be rebutted by a finding that no business activity is carried on there. Business activity is another ‘objective factor’, but it might point to a place other than where the organs of direction and control reside.

It seems to me that the Court has, in keeping with the guidance in Recital 13, put appearances to third parties at the core of ‘objectivity’, and, to the extent that this is different, it takes precedence over the factors relevant to the determination of the *siège réel*. However the divergence illustrates nicely the problems in this area. A multiplicity of national definitions has been rejected in favour of a single autonomous definition. Yet because it is new and ill defined, Member States’ courts are likely to view it through the

³ Case C-341/04 *Eurofood IFSC Ltd* [2006] ECR I-3813.

⁴ See J Armour, ‘European Corporate Insolvencies—The Race Goes to the Swiftest?’ (2006) 65 *Cambridge Law Journal* 504, 507.

⁵ *Eurofood*, above n 3, para 34.

prism of their domestic concepts, with a resulting divergence of outcomes. When coupled with the Court's other holding in *Eurofood*—that the decision of the court first seised to open proceedings may not be reviewed in other Member States—this uncertainty creates a very real danger of forum shopping. Debtors thereby have a perverse incentive to persuade courts in a 'friendly' jurisdiction to open proceedings first.

I share Professor Khairallah's pessimism, at least as regards the short run. Debtor-lead forum shopping seems clearly undesirable. Debtors have incentives to seek out jurisdictions that undermine creditors' entitlements, which may in turn reduce the value of debt finance. It will take a series of references to the European Court before the contours of the (autonomous) 'objective factors' can be conclusively worked out. Yet in the medium to long run, such autonomous interpretation may come to reduce the possibilities for debtor-lead forum shopping in a different way. It removes any incentive for Member States to introduce ever-broader jurisdiction rules so as to capture cases in the context of a strict first-in-time rule.

Dr Ringe's chapter focuses principally on a different variety of forum shopping, namely where an insolvent corporate debtor 'migrates' from one Member State to another. Strictly speaking, the effect is not so much to move a single debtor's COMI, but to substitute a new debtor—with a different COMI—for the original debtor. In a number of recent instances, this has occurred at around the time insolvency proceedings were due to commence. Such shifts have, it appears, been motivated by a desire on the part of the *creditors* of the insolvent debtor to secure a more favourable resolution of their claims in a different jurisdiction.

Forum shopping following multilateral creditor agreement raises quite different policy issues from that initiated unilaterally by debtors. A unilateral option over forum selection is likely to be exercised for the private benefit of the party making the choice, and there is every possibility that this will come at the expense of others. However, a selection following multilateral agreement is only likely to occur if it benefits all parties to the agreement. The crucial policy question concerns the 'agreement' procedure used to make a multilateral selection. Must all creditors vote in favour, or only a majority? If unanimous consent is not required, how can we be sure to protect involuntary creditors and others who are unable to participate in the deliberations?

Vulnerable claimants are protected in three ways.⁶ First, the Insolvency Regulation provides specific choice-of-law exceptions to the application of the *lex concursus* for certain types of creditor: for example, the effects of insolvency proceedings on employees are determined by the law applicable

⁶ For further discussion, see J Armour, 'Who Should Make Corporate Law? EC Legislation versus Regulatory Competition' (2005) 58 *Current Legal Problems* 369, 402–8.

to the employment contract.⁷ Secondly, the Regulation provides for territorial ‘secondary’ proceedings to be opened in any jurisdiction in which the debtor has an ‘establishment’.⁸ The threshold for determining the existence of an establishment is lower than that for COMI.⁹ If a business migrates its COMI from Member State A to Member State B, it is likely that at least some part of its physical activities—sufficient to constitute an ‘establishment’—will remain in Member State A. If particular classes of vulnerable creditor would be given a better priority status under the laws of Member State A, they will still have the option to open secondary proceedings there to protect their interests. To be sure, such proceedings must be liquidation, rather than rehabilitation, and this might impede the chances of successful rescue for the business as a whole. Yet it is open to the office-holder in the main proceedings to make a deal with the vulnerable creditors in Member State A whereby they are paid as much as they would have received in territorial proceedings, provided they forbear from opening them.¹⁰

The third source of protection for vulnerable creditors lies in the procedural mechanisms by which such migration may be effected. Dr Ringe very helpfully explains the route used by Shefenacker and other German firms in recent cases. These involved transfers of assets and liabilities to new entities. Were such a transfer effected to the detriment of local creditors, it would be subject to challenge by a Paulian action, the equivalent to English law’s action to reverse a transaction defrauding creditors.¹¹ The new mechanisms of European law that facilitate the migration of a company’s registered office—eg through conversion to a SE, or a cross-border merger—provide that creditor protection issues are to (continue to be) left to domestic law.¹²

Dr Ringe makes a cautiously positive assessment of the phenomenon of consensual forum shopping for insolvency proceedings. In light of these protections, this seems highly persuasive: granting creditors the option to relocate a debtor’s COMI will tend to strengthen rather than hinder their position. Dr Ringe goes on to suggest, however, that the Insolvency Regulation’s framework of COMI may unlawfully contravene the principle of freedom of establishment enshrined in the EC Treaty.

In the *Centros* line of cases, the ECJ made it clear that if a company is

⁷ Art 10 Regulation 1346/2000. See also Arts 5–8 (*lex situs* governs security interests and real property).

⁸ *Ibid*, Art 3(2).

⁹ See Art 2(h), defining ‘establishment’ as ‘any place of operations where the debtor carries out a non-transitory economic activity with human means and goods.’

¹⁰ See Art 33 Regulation 1346/2000.

¹¹ S 423 Insolvency Act 1986; see also s 238.

¹² Council Regulation (EC) 2157/2001 of 8 October 2001 on the Statute for a European Company (SE) [2001] OJ L294/1, Art 8(7); Parliament and Council Directive (EC) 2005/56 of 26 October 2005 on cross-border mergers of limited liability companies [2005] OJ L310/1, Art 4(2).

validly formed in a Member State that uses the registered office as connecting factor for company law questions, then other Member States cannot impose impediments on its ability to conduct business in their territory save where this is consistent with the principles of freedom of establishment.¹³ Dr Ringe asks why, if the application of the *Sitztheorie* in *Überseering* was an infringement of freedom of establishment, the rebuttal of the presumption that COMI is the jurisdiction of the registered office is not also such an infringement, given that this will force a company to be subject to a different insolvency law than that which would govern under the laws of its jurisdiction of incorporation.

This is a very thoughtful and original argument. However, whilst I am certain that freedom-of-establishment principles also apply to corporate insolvency laws as well as company laws,¹⁴ I am less sure that Article 3 of the Regulation constitutes, *per se*, an impediment to this freedom. One must bear in mind that all Article 3 does is stipulate a process for selecting a jurisdiction and governing law. It is hard to see how this can be said to be an impediment to freedom of establishment until the content of the substantive law thereby selected is known. The mere fact that there is a difference from the laws of the state of incorporation (say) is not enough—the difference might equally well favour as hinder the corporation's establishment in the host Member State. Rather, I suspect that the application of freedom of establishment principles in this area will turn on whether substantive rules of insolvency law create a burden for re-establishment.

This area is made interesting by the difficulties and uncertainties that surround many of its core concepts. Considerable progress toward their resolution is made by these two chapters, for which I should like to thank both authors once again.

¹³ Case C-212/97 *Centros Ltd v Erhvervs-og Selskabssyrelsen* [1999] ECR I-1459; case C-208/00 *Überseering BV v Nordic Construction Company Baumanagement GmbH (NCC)* [2002] ECR I-9919; case C-167/01 *Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd* [2003] ECR I-10155; case C-411/03 *SEVIC Systems AG* [2005] ECR I-10805.

¹⁴ Armour, above n 6, 402–6.

8

The Recent Influence of Insolvency Law on the Evolution of Security in French Law

PIERRE CROCQ

I. INTRODUCTION

SINCE THE REFORMS introduced by the laws of 13 July 1967 and 25 January 1985, French insolvency law has not really been favourable to creditors who have security interests such as pledges or mortgages. French insolvency law has encouraged the recovery of faltering businesses by curtailing the rights of creditors (in general) in three ways.

First, it provided that petitioning for insolvency meant that creditors lost their right to act individually against the debtor to obtain execution (or the termination of a contract in the event of default of payment) until the court had decided the fate of the business. Furthermore, that right to act was lost for good where, first, the business was to be taken over and, second, the liquidation was closed due to lack of assets. Next, insolvency law also gives priority to creditors whose claims date from after the insolvency petition was filed, over those with claims prior to filing, which often causes the claims of the latter to fail. Finally, in some cases, French insolvency law even goes so far as to oblige a creditor holding a charge over an asset to be affected by the selling of that asset for a very small amount, which means that he does not receive full payment since his claim can only be exercised on that amount.

However, this evolution in French insolvency law has also had an indirect effect on the law governing secured claims,¹ namely reducing the efficacy of secured claims; in practice it has led to the use of other forms of security which can be enforced outside the collective proceedings, including all secured claims based on use of a property right, such as transactions on

¹ In this regard, see P Crocq, 'Propriété et garantie' (1995) 248 *Bibliothèque de Droit Privé* pref M Gobert, 306.

the basis of retention of title, or the assignment of a debt as security. It is true that the legislators could have opposed the use of such security, but that was not done as they had recognised that if the credit market was to develop, then creditors would, as a matter of necessity, require effective security.

French law has therefore developed in two different directions: on the one hand, curbing the efficacy of secured claims to help struggling businesses, and on the other, allowing new, more rudimentary, forms of security to develop, in the hope of protecting credit. This influence, both direct and indirect, of trends in insolvency law on the provisions governing security continues today after the law of 26 July 2005, which amended French insolvency law by replacing the settlement procedure with a conciliation procedure, and creating a new safeguard procedure in addition to the insolvency and liquidation proceedings (the safeguard procedure is a form of administration that may be opened even when the debtor is not yet in cessation of payments).

This is because the current position is that: first, the reform of insolvency law by the law of 26 July 2005 once again changed the rules applicable to security² and made it less effective (section II below); and second, fear of the insolvency laws led to the recent reform of the provisions governing security, by the ordinance dated 23 March 2006, seeking new means to provide charge holders with more security (section III below).

² In this regard, see P Crocq, 'Réforme des procédures collectives et sort des créanciers munis de sûretés' (2006) 146 *Droit et patrimoine* 90ff; P Crocq, 'Le projet de loi sur la sauvegarde des entreprises et le respect des concepts du droit des sûretés' (2005) *Droit et patrimoine* 43; P Crocq, 'La réforme des procédures collectives et le droit des sûretés' [2006] *Recueil Dalloz Cahier droit des affaires* 1306ff; R Damman, 'La situation des banques, titulaires de sûretés, après la loi de sauvegarde des entreprises' (2005) 103 *Banque et droit* 16ff; R Damman, 'Réflexions sur la réforme du droit des sûretés au regard du droit des procédures collectives: pour une attractivité retrouvée du gage' [2005] *Recueil Dalloz Cahier Droit des Affaires* 2447ff; F Derrida and JP Sortais, 'La situation des créanciers forclos dans les nouvelles procédures collectives' (2006) 58 *Les Petites affiches* 7ff; F Girard, 'Le régime et les modalités de la déclaration des créances' (2005) 222 *Les Petites affiches* 7; PM Le Corre, 'Les nouvelles règles de fixation du passif du débiteur' (2005) 252–3 *Gazette du Palais procédures collectives* 17; F Macorig-Venier, 'Premières remarques sur la réforme des procédures collectives. Créanciers antérieurs. Arrêt des actions en paiement et en résolution. Arrêt des inscriptions' (2005) *Revue de procédures collectives* 210; F Macorig-Venier and C Saint-Alary-Houin, 'La situation des créanciers dans la loi du 26 juillet 2005 de sauvegarde des entreprises' (2006) *Revue de droit bancaire et bourse* 60ff; F Pérochon, 'Les créanciers postérieurs et la réforme du 26 juillet 2005' (2005) 250–1 *Gazette du Palais procédures collectives* 57ff; N Rontchevsky, 'Les sûretés personnelles à l'épreuve de la loi de sauvegarde des entreprises' (2006) *Banque et droit* 17ff; Ph Roussel Galle, 'Règlement amiable et procédure de conciliation' in P Crocq and Cl Brenner (eds), *Lamy Droit de l'exécution forcée*, Etude n 320; Ph Roussel Galle, 'Voies d'exécution et procédures de sauvegarde, de redressement et de liquidation judiciaires' in P Crocq and Cl Brenner (eds), *Lamy Droit de l'exécution forcée*, Etude n 332; O Staes, 'Premières remarques sur la réforme des procédures collectives. Créanciers antérieurs. Instances en cours' (2005) *Revue de procédures collectives* 215ff.

II. CHANGES TO THE PROVISIONS GOVERNING SECURITY IN THE INSOLVENCY LAW REFORM

There were two reasons for the changes to the provisions governing security that resulted from the latest reform of insolvency procedures: first, the desire to use the provisions relating to security to encourage creditors to participate in the recovery of a struggling business (section II(a) below); and second, the aim of making the provisions stricter, so that creditors would be dissuaded from demanding extortionate security (section II(b) below).

(a) Using the Law of Security

To encourage creditors to participate in the recovery of struggling businesses, these creditors are favoured by the law of 26 July 2005 through the technique of granting them privileges: first, this law created a new preference to encourage creditors to co-operate in the new conciliation procedure (section (i) below); and second, it limited the existing priority of claims dating from after the opening of the safeguard, insolvency or liquidation procedure solely to those creditors who had loaned money that was of use to the struggling company or the insolvency proceeding (section (ii) below).

(i) Creation of a New Conciliation Preference

Before the law of 26 July 2005, there was no advantage to creditors in agreeing to participate in an attempted settlement if the attempt failed, and as a result the firm went into administration or liquidation. This did nothing to encourage creditors to opt for this type of procedure.

Under the law of 26 July 2005, creditors agreeing to provide the firm in difficulty with a new asset or service in the course of a settlement procedure, or to contribute to its capital (not, however, where shareholders and partners contribute in the context of a capital increase), are granted new security rights (by the new article L611-11 of the Commercial Code), in the form of a priority that can be claimed where the business recovery attempt fails and insolvency proceedings ensue.

This new privilege is of value to creditors wishing to settle, since they will be paid, albeit after the exercise of the ‘super-priority’ of the employees and legal expenses, but before other creditors with claims dating from after the opening of the insolvency proceedings and also before those creditors with claims prior to that, even though they hold mortgages. In fact, the result of this is that the effectiveness of security in general is reduced since the legislator has thus created a priority ranking ahead of those secured claims.

However, it should be noted that this new priority is subject to three conditions: first, it can only be granted if the settlement agreement has been approved by a court, which is not always the case in practice; second, it can only be exercised if the creditor wishing to settle remembers to declare the claim in the insolvency proceedings likely to ensue (failing which, the creditor cannot receive any payment in the proceedings and will therefore, necessarily, forego the privilege); and finally, it does not give creditors the right to payment at the due date and they must therefore wait for the distribution of proceeds in the insolvency proceedings, unlike creditors whose claim dates from after the opening of safeguard, insolvency or liquidation proceedings. This leads us to examine what has happened to this latter right since the reform of 26 July 2005.

(ii) Limited Priority for Creditors Whose Claim Dates from After the Opening of Safeguard, Insolvency or Liquidation Proceedings

Before the law of 26 July 2005, the priority granted to creditors whose claim dated legitimately from after the opening of insolvency or liquidation proceedings was not a true privilege, as asserted by the Commercial Chamber of the Cour de Cassation in a judgement of 5 February 2002,³ since this right did not arise from the intrinsic nature of the claim but merely from its date. Thus, *any* claim, which actually dated from after the opening of proceedings, benefited from this right to settlement.

In order to reward only those creditors whose loans had really benefited the firm in difficulty, the law of 26 July 2005 limited the scope of application of this preference and turned it into a real privilege arising from the actual nature of the claim. Today, only claims which both date from after the opening of insolvency proceedings and which benefit the firm in difficulty or assist in the proceedings may benefit from this right. It should be noted here that this amendment to French insolvency law favours creditors holding a prior secured claim, since the number of creditors that may step ahead of them is reduced by this provision.

It is therefore clear that, although the legislation has favoured creditors useful to the struggling business by putting them ahead of creditors with secured claims, it also limits that privilege solely to those creditors whose loans have been really useful. This reigning in of privileges can also be seen in the treatment of conventional security. The law dated 26 July 2005 evinces the wish to dissuade over-greedy creditors and to favour security interests.

³ Cass com, 5 February 2002, Bulletin civil IV, n 27; [2002] *La Semaine Juridique Edition Générale* I 144, n 15, obs M Cabrillac and Ph Pétel; [2002] *La Semaine Juridique Edition Générale* I 162, n 19, obs Ph Delebecque; (2002) *Revue trimestrielle de droit civil* 337 case note P Crocq; [2002] *Recueil Dalloz* 805 case note A Lienhard; (2002) *Revue trimestrielle de droit commercial* 542ff case note A Martin-Serf; (2002) *Act proc coll* n 100 case note S Piedelièvre.

(b) More Ethical Security

This wish to give a more moral tone to security interests appears clearly in the new article L650-1 of the Commercial Code, which provides that, ‘creditors cannot be held liable for the losses arising from their assistance except . . . where the charge held in consideration of such assistance is extortionate’.⁴ Here, the legislator wished to limit the possibilities of holding a creditor liable for providing abusive credit to three particularly reprehensible types, one of which is the taking out of extortionate guarantees, which are therefore cancelled under paragraph 2 of article 650-1 of the Commercial Code.

The purpose is to punish irresponsible creditors who seek to maintain a loan or grant a new loan while taking a charge on all of the debtor’s remaining assets, to ensure repayment. In this case, extortionate security is a revealing clue to the abusive nature of a loan. However, the cases in which security can be deemed extortionate still need to be clarified and the new provision is of great concern to bankers insofar as it fixes no threshold, and therefore the assessment of whether the security is disproportionate (or otherwise) is left to the discretion of the commercial courts or courts of appeal. This concern is all the greater as, where the issue is a matter of fact, the decision that the security is disproportionate cannot be reviewed by the French Cour de Cassation. This new article L650-1 of the Commercial Code therefore poses a threat to creditors, and the first-instance decisions enforcing this provision are awaited with some trepidation.

Confronted with the restrictions and threats to secured creditors that are posed by insolvency law, the authors of the reform of the security provisions therefore sought to increase the efficacy of security in order to foster the development of credit.

III. THE INFLUENCES OF INSOLVENCY LAW ON THE REFORM OF THE PROVISIONS ON SECURITY

The efforts of the legislators to give more reassurance to creditors with secured claims led in two directions: the first was the scope of application

⁴ In this regard, see P Crocq, *Sûretés et proportionnalité* (Paris, Litec, 2006) 291; D Legeais, ‘Les concours consentis à une entreprise en difficultés (C com, art L650-1)’ [2005] *La Semaine Juridique Edition Entreprise et Affaires* 1747; P Hoang, ‘De la suppression du dispositif prétorien de la responsabilité pour soutien abusif’ [2006] *Recueil Dalloz* 1458; J Moury, ‘La responsabilité du fournisseur de “concours” dans le marc de l’article L650-1 du Code de commerce’ [2006] *Recueil Dalloz* 1743; V Perruchot-Triboulet, ‘La responsabilité des créanciers’ [Nov 2007] *Revue Lamy Droit Civil* 64; G Piette, ‘Une nouvelle proportionnalité en droit des sûretés—brèves observations sur l’article L650-1 du Code de commerce’ [June 2006] *Revue Lamy Droit Civil* 27; D Robine, ‘L’article L650-1 du Code de commerce: un “cadeau” empoisonné?’ [2005] *Recueil Dalloz* 69; R Routier, ‘Le cantonnement de la responsabilité pour soutien abusif’ (2005) 252–3 *Gazette du Palais procédures collectives* 33.

of security over movables, which was extended to avoid the secured claim being cancelled in the event of a subsequent petition for insolvency (section III(a) below); the other was the reinforcing of the methods for realising secured claims in order to avoid the consequences of a subsequent petition for insolvency (section III(b) below).

(a) The Influence of Insolvency Proceedings on the Scope of Application of Security Over Movables

Under article L632-1 of the Commercial Code, applicable to insolvency or liquidation proceedings, a proprietary security constituted for debt previously contracted is void if the security was provided in the suspect period (ie between the date of the debtor's cessation of payments and the date the insolvency proceedings were commenced). However, this provision has always been difficult to apply in cases where the security comprises revolving assets, such as negotiable securities.

This is because the security must be reconstituted every time an asset is disposed of and replaced by another. However, as a result of this, not only must the creditor pay for the publicity or registration thereof, but he also runs the risk of seeing the secured claim cancelled if such reconstitution occurs after the debtor's cessation of payments since, in this case, the new security will have been constituted in the suspect period in order to secure a debt contracted prior to that constitution. To avoid this drawback, the only solution is to decide that a floating charge was constituted at the outset, not on each of the assets individually but on the whole, and therefore that there is no need to reconstitute the security every time any asset is replaced by another.

This is the technique the legislators used initially when, under the law of 2 July 1996, they replaced security in the form of negotiable securities by security in the form of financial instruments. The technique was used again later in the ordinance of 23 March 2006 reforming the provisions on security. This reform allowed a pledge to be constituted, once and for all, on a group of assets (this included all fungible assets) that the debtor could assign, as long as they were replaced by other identical assets, without the need to reconstitute the pledge to include these new goods (article 2342 of the Civil Code and article L527-5, paragraph 2 of the Commercial Code). This reform of the provisions on security thus means that pledges of fungible assets, including stocks, will not be cancelled under article L632-1 of the Commercial Code.

However, the reform of these provisions went further than merely reducing creditors' risk when their security is formed: it also endeavoured to strengthen the efficacy of the security upon realisation.

(b) The Influence of Insolvency Law on Methods of Realising Secured Claims

To enable security to be more effective when it is called up and insolvency proceedings are filed, the creditor must be given exclusive rights enabling him to avoid collective actions in recovery: either he must be empowered to invoke a right to seize the pledged asset and keep it until he is fully paid, this right of seizure being enforceable in the insolvency proceedings; or he must be allowed the property rights to the pledged asset, ie an exclusive right to this asset that the other creditors of the debtor cannot claim.

The first possibility was implemented by the ordinance of 23 March 2006 on secured loans: article 2363 of the Civil Code of this reform now provides that after the debtor has been notified of the pledge, only the beneficiary of the security may receive the proceeds of the debt, and the drafters of this reform intended this to give the creditor the equivalent of a possessory lien, although this view is sometimes contested today in French doctrine, not least by Professor Philippe Théry.⁵

The second possibility was also introduced by the ordinance of 23 March 2006, but with limited, even doubtful success, for two reasons. First, the ability to make use of a *commissoria lex*, introduced into the French Civil Code by this reform in respect of all security, is nevertheless forbidden where insolvency proceedings are filed against a debtor (new article L622-7, paragraph 1 of the Commercial Code), thus obviously depriving it of practically any practical value. Secondly, the possibility of a court permitting a proprietary claim over the pledged asset, which already existed for pledges and was extended to mortgages by the ordinance of 23 March 2006 (article 2458 of the Civil Code), is currently giving rise to interpretation problems in the case of insolvency proceedings. This is because new article 2427, paragraph 3 of the Civil Code continues to provide that in the event of insolvency proceedings against the debtor, registration of a mortgage gives rise to effects provided for in insolvency law, but the provision has not been amended in this respect and continues to provide for judicial allocation only for pledges. Thus, in the event of liquidation, a creditor holding a mortgage might not be allowed to make a proprietary claim over the mortgaged asset in the same way as the holder of a pledge can, and here again, it is hoped that the Cour de Cassation will clarify the position.

However, creditors may see their situation improved due to the imprecise drafting of another, fairly recent provision: the law of 19 February 2007.⁶ Articles 2011ff of this law of the Civil Code introduce the

⁵ P Théry, 'Cass com, 19 December 2006' (case note) (2008) *Répertoire Defresnois* 414, especially 416ff.

⁶ On this law, see, amongst others, L Aynès, 'Fiducie: analyse et applications pratiques de la loi' (2008) 46 *Revue Lamy Droit Civil* 5; F Barrière, 'La loi instituant la fiducie: entre équilibre et

concept of the ‘trust’⁷ for all assets, whereas previously the validity of these kinds of constructs had only been recognised by French law for certain categories of moveable assets. Moreover, this law also enables the new ‘trust’ to be used as security, which means that from now on, property in any asset, including a building, may be transferred to a creditor as security. Strangely, although implementation of a *commisoria lex* was refused for secured claims where insolvency proceedings were opened, no such provision has been made in the case of security in the form of a ‘trust’. This legislative oversight enables a creditor to claim a property right in the asset given as security and, thus, to escape the insolvency laws altogether.

This situation, of course, will not last. The French Ministry of Justice is currently preparing a new reform of insolvency law,⁸ and one of the important features of this will be that security in the form of the trust will be rendered ineffective where the debtor is subject to safeguard proceedings. Here again, the efficacy of security will be subordinated to the aim of debtor recovery. This is, however, only of limited significance, because the ‘trust security’ will retain its full effect in cases where the debtor goes into liquidation.

incohérence’ [2007] *La Semaine Juridique Edition Entreprise et Affaires* 2053; A Cerles, ‘La fiducie, nouvelle reine des sûretés?’ [2007] *La Semaine Juridique Edition Entreprise et Affaires* 2054; P Crocq, ‘Lacunes et limites de la loi au regard du droit des sûretés’ [2007] *Recueil Dalloz* 1354ff; Ph Dupichot, ‘Opération fiducie sur le sol français’ [2007] *La Semaine Juridique Edition Générale* 121; Ch Larroumet, ‘La loi du 19 février 2007 sur la fiducie. Propos critiques’ [2007] *Recueil Dalloz* 1350ff; R Libchaber, ‘Les aspects civils de la fiducie dans la loi du 19 février 2007’ [2007] *Répertoire Defresnois* 1094ff and 1194ff.

⁷ This refers to the transfer of property of the asset to the creditor to secure the debt. When the debt is fully repaid, the asset is returned to the debtor.

⁸ In this regard, see MH Monsérié-Bon and C Saint-Alary-Houin, ‘La loi de sauvegarde des entreprises: nécessité et intérêts d’une réforme annoncée’ [2008] *Recueil Dalloz* 941ff; A Outin-Adam and C Alexandre-Caselli ‘Projet d’ordonnance portant diverses dispositions en faveur du droit des entreprises en difficulté’ [2008] *Recueil Dalloz* 1540. This reform has just been introduced by the ordinance dated 18 December 2008.

9

Guarantees and Collective Procedures

LAURENT LEVENEUR

I. INTRODUCTION

ALTHOUGH FRENCH LAW has the characteristics of a system which is largely written, it is far from completely resembling a formal garden laid out in the French manner. This is shown in particular by the rules governing the use of guarantees in collective procedures.

The guarantee, being a form of personal security, is a contract whereby a person, the surety, gives an undertaking to a creditor to fulfil the obligation owed to him if the principal debtor fails to do so himself: that is the definition given by article 2288 of the Civil Code.

In principle, where the principal debtor is found to be insolvent when the debt falls due, the situation is straightforward: the surety has to pay in accordance with the undertaking he has given.

However, some serious complications arise where the debtor's poor financial situation leads to the commencement of a collective procedure for dealing with his difficulties. This produces various effects and there are various measures that can be taken in the debtor's favour: individual actions can be stayed, longer periods for payment can be granted, debts can be remitted, or certain claims which existed against him may be extinguished, etc. Consequently the question arises whether these effects and measures have any effect on the guarantee, with the result, if so, of impairing its effectiveness.

The difficulty is caused in part by one of the characteristics of the guarantee: it is an accessory obligation, in that the surety's obligation is very heavily dependent on that of the principal debtor. This characteristic lies at the heart of the guarantee.¹ It leads to several consequences, in

¹ The elements of a guarantee are sometimes tricky to determine precisely because it has its limits and is subject to exceptions laid down by the legislature itself, see D Grimaud, *Le caractère*

particular three famous rules: a surety cannot be held liable if the principal debt is void (or in the words of article 2289 of the Civil Code: ‘the guarantee may exist only on a valid obligation’²); a guarantee cannot be for more than the amount owed by the principal debtor (article 2290, first paragraph, of the Civil Code: ‘a guarantee shall not exceed what is owed by the principal debtor, nor shall it be contracted on more onerous conditions’); and a surety can in principle plead against a creditor all defences (for refusing to pay) affecting the principal obligation (article 2313, first paragraph, of the Civil Code: ‘the surety may plead against the creditor all defences available to the principal debtor which are inherent in the debt’).³ But does this mean that all the obstacles that a creditor may encounter when he attempts to obtain payment from his principal debtor when the latter is the subject of a collective procedure may likewise be raised against him by the surety? Certainly not, because of the very reason for the existence of the guarantee, namely to guarantee payment to the creditor if the debtor defaults.⁴ However, it is not always easy to determine those effects of the collective procedure which may be pleaded by the surety and those which may not.⁵ Recently, this question has given rise to considerable uncertainty and has led to various changes in case-law and in legislation.

The difficulty also partly arises from the law relating to collective procedures, which sometimes includes provisions that relate to guarantees and are intended to modify the ordinary operation of that security in the event of such procedures.

Thus the object of rescuing a business in difficulty sometimes leads the present-day legislature to protect certain sureties, particularly individuals, on the basis that they are often managers of the business in question and that, if the opening of a collective procedure has the effect of protecting them personally, they may be induced not to defer a step which, if taken quickly, can only be favourable to achieving the aim of reorganisation of the business.

The subject is made even more complex by the different types of collective procedure which have been introduced in France. While the 1807 Com-

accessoire du cautionnement (Aix-en-Provence, Presses Universitaires D’Aix-Marseille, 2001), pref D Legeais; P Malaurie and L Aynès, *Les sûretés, La publicité foncière*, ed L Aynès and P Crocq (2nd edn, Paris, Defrénois, 2006) no 121ff; HLJ Mazeaud, *Sûretés, Publicité foncière*, ed Y Picod (7th edn, Paris, Montchrestien, 1999) nos 15–22; P Simler, *Cautionnement et garanties autonomes* (2nd edn, Paris, Litec, 2001) no 46ff.

² The second paragraph of the same article makes an exception for certain grounds of nullity: ‘an obligation may nevertheless be guaranteed although it could have been annulled by a defence purely personal to the debtor; for example, in the case of minority’.

³ Here again the second paragraph lays down a limit to the principle: ‘but the surety shall not raise defences which are purely personal to the debtor’.

⁴ See P Théry, *Sûretés et publicité foncière* (2nd edn, Paris, PUF, 1998) no 52.

⁵ For a proposed system, before the Act of 26 July 2005, see P Crocq, *Cautionnement et procédures collectives*, *Mélanges Ph Malaurie* (Paris, Defrénois, 2005) 173.

mercial Code originally regulated only the insolvency of traders,⁶ we now have, after repeated reforms (the Acts of 13 July 1967, 25 January 1985, 31 December 1989, 10 June 1994, 8 February 1995, 1 August 2003 and, finally, the Act of 26 July 2005), several types of collective procedure covering a very broad field, so that today when a surety is called upon to pay a debt, it is very often owed by a debtor involved in a collective procedure. These different procedures may be classified in two categories.

The first category consists of procedures which are appropriate for businesses who are in financial difficulties (now including commercial, craft and agricultural businesses and even those consisting of self-employed and professional persons governed by statutory rules; also the difficulties of all private-law legal persons falling within this category: articles L620-2, L631-2 and L640-2 of the Commercial Code⁷). These procedures are regulated by the Commercial Code: Book Six, entitled 'Difficulties of Businesses', is devoted to them. There are four procedures, adjusted to the degree of financial difficulty in question. At the prevention stage there is the *conciliation procedure* (articles L611-1 to L611-15). This is followed by the *protection procedure* (articles L620-1 to L627-34), created by the Act of 26 July 2005, applying to any business in difficulties which it is unable to overcome and which may lead to the cessation of payments. This procedure includes an observation period and, when it has expired, a protection plan is agreed upon and put into effect. The *reorganisation procedure under the supervision of the court* (articles L631-1 to L632-4) aims to try to rescue businesses whose cessation of payments is established, ie where current liabilities exceed available assets. Finally, where reorganisation appears manifestly impossible, a *liquidation procedure under the supervision of the court* (articles L640-1 to L642-25) is initiated in respect of a company which has ceased to make payments. The assets are realised, if necessary, by the transfer of all or part of the business, or by sale of various individual assets, and the liabilities are settled by distribution of the proceeds among the creditors.

The second category consists of procedures for bankrupt private individuals, ie those with non-business debts. To be precise, these situations of bankruptcy arise where the debtor, a natural person, finds it impossible in good faith to meet all his non-business debts, both those already payable and those yet to fall due. The available procedures are laid down this time by the provisions of the Consumer Code (a relatively recent code, which

⁶ See Book III of the Commercial Code in the 1807 version, entitled 'Insolvency and Bankruptcy'. The first two articles read as follows: art 437: '*any trader who ceases to make his payments is insolvent*'; art 438: '*any insolvent trader who finds himself within one of the cases of serious misconduct or fraud provided for by this Act is in a state of bankruptcy*'.

⁷ It may be noted that, in view of the very broad field that it covers, particularly where it regulates collective procedures for enterprises, the present Commercial Code bears an inappropriate and simplistic title: it would be wiser to call it 'Code of Occupational Activities'.

was enacted in France in 1993 to consolidate legislation for the protection of consumers in their relations with suppliers and which has been amended constantly since then). First, there is the *procedure for dealing with situations of bankruptcy*, which consists of a number of measures (the rescheduling or even remission of debts, the set-off of part payments against the principal sum first, etc) which may be prescribed, where permitted by the debtor's available resources or assets, before the 'private individuals' bankruptcy commission' (article L330-1, paragraph 2 of the Consumer Code) and, secondly, the *personal recovery procedure* (created by the Act of 1 August 2003⁸) which may be applied for from the court dealing with the enforcement of judgments where the debtor is in a situation of irretrievable jeopardy in which it is impossible to take measures to deal with his situation (article L330-1, new paragraph 3 of the Consumer Code). In practical terms, the liquidation of the debtor's assets is then arranged, the creditors are paid from the proceeds of the assets which had a market value and were sold, and as that is hardly ever enough to pay all the claims, in practice the procedure ends in closure for want of assets, which wipes out the remainder of the debtor's non-business debts (article L332-9).

However, the treatment of the surety is not always the same in the different procedures.

This can be seen in the two main questions arising from the confrontation between guarantees and collective procedures: to what extent do these procedures affect the right of creditors whose claims are secured by a guarantee to sue their surety for payment (section II below)? Can such procedures have consequences for the amount of the surety's debt (section III below)?

II. COLLECTIVE PROCEDURES AND THE RIGHT TO SUE THE SURETY

If the debt falls due but a collective procedure has already been commenced in relation to the principal debtor, can the creditor demand payment from the surety? This is a real problem because the collective procedure against the principal debtor often has the result of paralysing, delaying or even extinguishing actions against the principal debtor: can the surety also avail himself of those effects of collective procedures to try to avoid payment, either temporarily or permanently?

Although the reply is generally negative in principle, there are some cases where it is positive, such as where the principal debtor is granted a stay of

⁸ For the present system overall, and the difficulties created by the addition of the personal recovery procedure, see V Vigneau and GX Bourin, *Droit du surendettement des particuliers* (Paris, Litec, 2007).

actions and time limits for payment (section II(a) below), and where the creditor commits certain wrongful acts or omissions which trigger particular consequences under the law of collective procedures (section II(b) below).

(a) Discontinuance, Stay of Actions and Time Limits for Payment

(i) Discontinuance and Stay of Actions Against the Principal Debtor: What Are the Consequences for the Surety?

A judgment commencing a protection procedure (article L622-21 of the Commercial Code), a reorganisation procedure under the supervision of the court (article L631-14) or the liquidation of an enterprise under the supervision of the court (article L641-3) all have the immediate effect of discontinuing or prohibiting any judicial proceedings by creditors prior to the procedure seeking an order requiring the debtor to pay a sum of money.⁹

In the same way an application to an enforcement judge for the purpose of the personal recovery of a bankrupt individual automatically entails a stay of enforcement proceedings against the debtor, the stay being prolonged by the judgment initiating the recovery procedure until its closure (articles L331-3-1 and L332-6 of the Consumer Code). This effect may also be achieved when the case is dealt with by the bankruptcy commission if the commission applies to the enforcement judge for a provisional stay of enforcement proceedings against the bankrupt debtor (article 331-5).

In principle, the discontinuance and stay of proceedings are of no advantage to the surety of the principal debtor concerned. The guarantee is unquestionably an accessory liability. This means that, for example, it cannot be contracted on conditions more onerous than the principal debt (article 2290 of the Civil Code) and that it cannot, in principle, continue to exist if the principal obligation is reduced to nothing (article 2289). However, the guarantee is nevertheless a contract which was concluded between the creditor and the surety precisely in order to alleviate the

⁹ In the protection and reorganisation procedures, this effect lasts until the judgment adopting a protection or reorganisation plan. In practice, there is every chance that the effect will be continued by the time limits for payment that may be laid down in the plan. In the case of liquidation, the effect lasts a very long time: the officers of the court are appointed to realise the assets and to effect distribution among the creditors, who do not in principle recover the individual right to bring an action against the debtor even where operations are closed for want of assets, subject to certain exceptions (art L634-11 of the Commercial Code); regarding this regrettable statutory assertion of the right of debtors not to pay their debts, see G Ripert and R Roblot, *Traité de droit commercial*, ed P Delebecque and M Germain (17th edn, Paris, LGDJ, 2004) vol 2, no 3275. On the other hand, the discharge effect of closure for want of assets is of no advantage to the surety, which is implicitly but necessarily clear from article L643-11, II (see, to that effect, *ibid*).

consequences of the principal debtor's default. Where the handling of the financial difficulties encountered by the debtor leads to shielding him more or less permanently from individual actions by his different creditors in order to put in place a collective organisation, there is no reason why the debtor's sureties should enjoy the same immunity; on the contrary: the fact that individual actions cannot be brought by creditors is one of the potential manifestations of the debtor's default. The guarantee was given with a view to this happening, and this eventuality falls within its object.

That contract of guarantee, which is separate from the one that gave rise to the principal obligation, results in an obligation owed by the surety himself, arising when the principal debtor defaults, as is the case here. The creditor has an autonomous right of action¹⁰ to enforce that obligation which is not affected by the paralysis of individual actions against the principal debtor. This is very logical.

However, the current legislature (Acts of 10 June 1994 and 26 July 2005) has made two exceptions to this principle. In the protection procedure (article L622-28, second paragraph, of the Commercial Code) and the reorganisation procedure (article L631-14), the judgment initiating the procedure also stays any action against individuals who have given a guarantee, and this stay lasts for the entire observation period. The idea is that sureties who are individuals are often the directors, or persons close to them, of the business, who have agreed to guarantee the debts of the company to third-party lenders. A director of a company which is getting into difficulty may want to delay the opening of a collective procedure for as long as possible if he knows that, as it is impossible in practice during this procedure for creditors to sue the principal debtor, the company, for payment of due debts, the creditors will be induced to have direct recourse to the surety, ie the director himself or members of his family. The temporary paralysis of actions against a surety who is an individual, which occurs at the beginning of the protection and reorganisation procedures, but not the liquidation procedure,¹¹ encourages directors to submit a company in difficulties to the protection procedure or to file a petition for winding up as soon as possible.¹² Fundamentally, therefore, the aim is to promote the rescue of a business in difficulty because it is thought that the sooner measures are organised to deal with those difficulties, the greater the chance that they will succeed.

The reason for the existence of these two exceptions shows why they

¹⁰ See, to that effect, Malaurie and Aynès, above n 1, no 141.

¹¹ It is true that art L641-3, by referring to art L622-28, causes a liquidation judgment to produce certain effects of the protection procedure. However, art L621-28, second paragraph, which provides for the stay of actions against sureties who are natural persons, makes it last 'until the judgment approving the plan or ordering liquidation'. Consequently, in the event of liquidation, the reference by art L641-3 to art L621-28 is not effective with regard to that aspect of the second paragraph!

¹² See D Legeais, *La caution dirigeante*, *Mélanges B Bouloc* (Paris, Dalloz, 2006) 606, 607.

have limitations: they do not apply to sureties who are legal persons or in the case of sureties who are individuals in relation to a bankrupt private individual.

The outcome is thus that a surety who is an individual is better protected by the law when he guarantees the debts of a business than the non-business debts of an individual.

(ii) Can the Surety Claim the Benefit of Time Limits for Payment Granted to the Debtor?

For the same reason as those discussed above, a surety should not be able, in principle, to take advantage of the time limits for payment that the collective procedures may sometimes allow to a principal debtor in difficulty, whether in the approved conciliation agreement (article L626-18ff of the Commercial Code) or the reorganisation plan of the business (article L631-19), or in the agreed recovery plan for an bankrupt private individual (article L331-6 of the Consumer Code). These measures for deferring or rescheduling debts are ways of dealing with the principal debtor's default. In principle there is no reason why the surety should benefit from them because he has undertaken to pay precisely in the event of the debtor's default.

However, here again, the current legislature has intervened to enable certain sureties to avail themselves of these time limits and thereby avoid being sued for the duration of the period in question, just like the principal debtor. However, the scope of the exception to the principle is not quite the same as those discussed above.

The Act of 25 January 1985 expressly provided that, in the event of a reorganisation under the supervision of the court, *cautions solidaires*, ie directly liable sureties,¹³ could not avail themselves of the provisions of the reorganisation plan (former article L621-65 of the Commercial Code). The adjective *solidaires* (directly liable) which was used in this article was no doubt the result of an error because there was no reason for making a distinction on that point between directly liable and ordinary sureties.¹⁴ Despite this, the courts, interpreting this provision by contrary inference, held that an ordinary surety could take advantage of the provisions of the reorganisation plan.¹⁵

The reform of 26 July 2005 rectified the original error and put an end to the case-law which favoured of ordinary sureties. After this, sureties of

¹³ *Cautions solidaires* cannot require the creditor to have recourse to the principal debtor first or claim that they are liable only for their proportion of the debt if there is more than one surety.

¹⁴ P Simler and P Delebecque, *Les sûretés, la publicité foncière* (4th edn, Précis Dalloz, 2004) no 175, 152; Malaurie and Aynès, above n 1, no 137.

¹⁵ Cass com 23 November 2004: Bull civ IV, no 2003; JCP 2005 I 135 no 9, note by P Simler.

whatever kind can no longer take advantage of the provisions of the reorganisation plan, particularly the time limits for which it provides (new article L631-20 of the Commercial Code).

However, this Act provided for two new exceptions to the principle. The first relates to a conciliation agreement approved by the court in the conciliation procedure: here, all persons who have given guarantees are allowed to take advantage of the time limits laid down in the agreement (article L611-10).¹⁶ The second exception relates to a protection plan, which can be relied upon by persons, ‘with the exception of legal persons’, who have provided a guarantee (article L626-11, paragraph 2). It appears inconsistent, however, that one exception relates to every surety, while the other relates only to individuals. In actual fact, the policy is the same: to promote the opening of the conciliation or protection procedure. Thus, both exceptions should apply only to individuals, usually the managers of businesses and those close to them, as they are the only persons affected by the stay of actions automatically imposed by the opening of the conciliation or protection procedure.¹⁷ Where one or the other of the procedures in question—which the legislature wishes to be opened rapidly—results in a rescue or reorganisation plan (or even liquidation of the company) and the original stay of actions lapses, the court may grant sureties, but only individuals, a time limit of up to two years for payment, irrespective of the plan (article L622-28, paragraph 2 and article L631-14).

It will be noted that in any case, here again, the surety of a bankrupt individual does not benefit in the same way from the legislation.¹⁸

So when do the creditor’s wrongful acts have the effect of discharging the surety under the law of collective procedures?

(b) Discharge of Surety Under the Law of Collective Procedure

A surety is sometimes discharged, partially or in entirety, where a creditor fails to declare his claim within the time limit after the commencement of a collective procedure (section II(b)(i) below). Sometimes discharge is the sanction for a wrongful act, ie providing unjustified financial assistance, resulting in the collective procedure (section II(b)(ii) below).

¹⁶ This continues the approach previously taken by the courts in relation to the former procedure for the settlement of difficulties of enterprises: Cass com 5 May 2004: Bull civ IV, no 84.

¹⁷ See above, section II(a)1.

¹⁸ With regard to the fact that the surety cannot take advantage of measures taken in the over-indebtedness procedure, see Cass I civ 13 November 1996: D 1997, 141, concl Sainte Rose, note by Moussa.

(i) The Effect of a Belated Declaration of Claim in Collective Procedures

Efficient collective organisation of the procedure for dealing with a debtor's financial difficulties depends on determining his financial situation as soon as possible, and in particular his liabilities. Creditors therefore have an obligation, from the date of publication of the judgment commencing the protection procedure (article L622-24 of the Commercial Code), the reorganisation procedure (article L631-14) or the liquidation procedure (article L641-3) of a business, to declare claims originating prior to the judgment. Likewise the creditors of a bankrupt individual must prove their claims after the commencement of the personal recovery procedure (article L332-7 of the Consumer Code).

In all these cases a time limit of two months is allowed (article R622-24 of the Commercial Code; article R332-26 of the Consumer Code).

What are the consequences of failure to declare or prove a claim within the time limit? Under the Act of 25 January 1985, claims which were not declared to the collective procedure authorities within the time limit were extinguished (article 53 of the Act).

There was a fierce academic dispute as to whether a surety could plead such extinguishment as causing his own commitment to be extinguished.

Some influential writers argued that this should not be the case because of the purpose of the guarantee, which is to secure the creditor against the debtor's default, particularly on his insolvency. The disappearance of the principal obligation in the vicissitudes of the collective procedure was said to be irrelevant: the surety's obligation, which was entered into largely to protect the creditor in the eventuality of the debtor's insolvency, must be fulfilled.

Other, no less influential, writers claimed the opposite on the ground that the guarantee was an accessory: where the principal obligation, which is the indispensable basis of the surety's accessory commitment, is wiped out, the guarantee, as an accessory element, is also extinguished. And, in that respect, the situation differs from that where the debtor is shielded from individual actions by his creditors for the needs of organising a collective procedure for dealing with his difficulties. In that case the debtor's obligation still exists, so the guarantee is not, in principle, affected. Further, in the present case, the extinguishment of the debt is due to negligence on the part of the creditor who failed to meet the statutory time limit. To accept that the guarantee survived would enable a creditor to obtain payment of his claim from a surety who, for his part, would then find that he was not able to sue the principal debtor under the doctrine of subrogation, because of the creditor's negligence.

These latter arguments were the more persuasive and they undoubtedly led the Supreme Court to regard the extinguishment of the claim, pursuant to article 53, paragraph 3 of the Act of 25 January 1985, as 'a defence

inherent in the debt' and therefore to find that, in accordance with article 2036 of the Civil Code¹⁹—one of the measures that gives expression to the accessory nature of a guarantee and draws the appropriate conclusions—the surety could raise it as a defence against the creditor.²⁰

However, the recent reform of the collective procedures for businesses in difficulty has just modified the nature of the problem. As a result of the Act of 26 July 2005, the creditor's claim was no longer extinguished by failure to file a declaration within the time limit (new article L622-26 of the Commercial Code). The extinguishment of the claim, which logically entailed the consequential extinguishment of all accessory securities, was not consistent with the European Regulation 1346/2000 on insolvency proceedings, which states that the opening of insolvency proceedings is not to affect rights *in rem*, ie the accessory rights *in rem* constituted by *in rem* securities, in respect of assets situated in the territory of another Member State of the European Union. The difficulty was overcome by the radical removal of this ground of extinguishment of claims, which has effects that are in any case controversial.

Henceforward the only sanction for failure to file a declaration within the time limit is that the negligent creditor will not receive distributions and dividends to which the procedure may lead (article L622-26).

On the other hand, as the principal debt is no longer extinguished, the creditor retains the right to sue his surety for payment: this cause of discharge on an accessory basis, which was a very effective means of defence and frequently used by sureties, has disappeared. Does this mean that a creditor of a debt secured by a guarantee can now free himself with impunity from the obligation to declare his claim in the collective procedure for an enterprise? In reality, nothing is less certain. Failure to declare a claim causes damage to the surety because in practice it renders ineffective the surety's subrogation, as he will be unable to obtain a dividend in the collective procedure relating to the principal debtor. This may have two consequences for the negligent creditor.

The first is what is known as the 'benefit of subrogation',²¹ which enables the surety to escape payment 'where subrogation to the rights, mortgages and privileges of the creditor cannot, because of the creditor's acts, operate in favour of the surety' (former article 2037 of the Civil Code, now new article 2314). This means of defence, which discharges the surety up to the amount which he has lost, ie here the dividend which he would have received if the creditor had not been negligent—in practice, therefore, only a partial discharge because the principal debtor is by

¹⁹ This is the new art 2313 of the Civil Code after the renumbering as a result of the partial reform of securities by the order of 23 March 2006.

²⁰ Cass com. 17 July 1990: Bull civ IV, no 214; D 1990. 494, note A Honorat; D 1991, head-note 12, note F Derrida.

²¹ 'le bénéfice de subrogation'.

definition insolvent—is certainly effective where the claim against the principal debtor secured by the guarantee was also preferential. In contrast, the conventional doctrine is that it is not effective for certain unsecured claims (with no preferential right), but a new element in relation to collective procedures may give rise to a controversial possible broader interpretation of this article of the Civil Code: is not the loss of subrogation to the possibility of receiving a dividend in the collective procedure the loss of one of the creditor's 'rights' to which that article refers?²²

The second possible consequence of the creditor's negligence is to make the creditor liable: such negligence is a form of misconduct (*faute*) which may require the perpetrator to make reparation for the damage caused, here the loss of the right to share, by way of subrogation, in the distributions and dividends of the collective procedure. If it were assumed that such loss does not set in motion the 'benefit of subrogation' doctrine, it would entail an award of damages to the surety, thus reducing, by set-off, what he has to pay the creditor, which therefore amounts to the same thing as a defence.²³

However, the recent amendment of the law relates only to collective procedures for businesses in difficulty.

So far as the personal recovery of a bankrupt individual is concerned, the sanction for failing to file a declaration within the two-month period is unchanged: it is still extinguishment of the claim (article L332-7 of the Consumer Code). Accordingly there is still scope here for applying extinguishment of the guarantee on an accessory basis.

Therefore the consequence for the surety of the creditor's failure to declare his claim in good time in the collective procedure varies: sometimes it is total extinguishment of the guarantee, which affects only the surety (whether a natural or legal person) of a bankrupt individual, who is then in a better position than a surety for the debts of a business; sometimes it is partial discharge due to the effect of the benefit of subrogation, or reparation for the damage caused by loss of the right to receive, by way of subrogation, dividends in the collective procedure for a business.

However, the 2005 reform produced a new ground for the nullification of the guarantee.

(ii) Nullification of Guarantee in Cases of Unjustified Support

One of the great innovations of the Act for the protection of businesses

²² See, in favour of the broad application of forfeiture 'whenever the loss of subrogation causes the surety to lose a benefit', P Simler and P Delebecque, 'Droit des sûretés', JCPG, 2005, I, 185.

²³ See, to that effect, Simler and Delebecque, *ibid.*

of 26 July 2005 is in the new article L650-1 which it added to the Commercial Code.

Previously, credit institutions which had given financial assistance to businesses that subsequently became the subject of collective procedures ran the risk of being charged with having artificially supported such businesses when in reality they were already in difficulty, and of having created a false impression of solvency and delaying a petition for winding up. Therefore they risked being held liable for the damage, possibly very considerable, caused by providing such unjustified support. This was obviously not reassuring and, to prevent persons who might assist businesses financially being deterred from doing so, the reform laid down the principle of non-liability of creditors for damage incurred as a result of assistance given to a business whose difficulties subsequently give rise to a collective procedure: that is the purpose of the new article L650-1.

However, this principle is made subject to three exceptions: fraud, significant interference in the management of the debtor, and 'if the security taken in consideration of that assistance is disproportionate to it' (it seems that this refers only to real security, and not a guarantee which, on the basis of article 2290 of the Civil Code, can never be disproportionate to the debt secured because it cannot exceed it!).

In these three cases—the specific elements of which are rather imprecise²⁴—creditors are liable for the damage that may have been caused by their assistance. And the second paragraph of article L650-1 adds that, where a creditor is found liable, 'the security taken in consideration of his assistance shall be void'. All security, including, therefore, a guarantee, is nullified. In this measure, which only relates to collective procedures for businesses and which provides a sanction for a wrongful act that leads to such procedure, sureties will therefore find, if necessary, the means of a complete discharge from their commitment.

Above all, this provision must not be confused with articles L313-10 and L341-4 of the Consumer Code which in certain cases, but independently of any collective procedure, prevent a business creditor from taking advantage of a disproportionate guarantee given by an individual: the disproportion in question is between the obligation undertaken and the surety's assets and income. On the contrary, here, even if the surety is perfectly able to fulfil his obligation, it may be nullified if the creditor commits any of the wrongful acts referred to by the first paragraph of article L650-1 if he has provided the principal debtor with financial assistance.

Now, assuming that the creditor, after avoiding all the grounds for the stay of actions, discharge of the surety, extinguishment or nullification of the debt, finally succeeds in suing the surety for payment, exactly how

²⁴ See D Robine, 'Article L650-1 of the Commercial Code: a 'poisoned' gift?' [2006] *Dalloz chron* 69.

much can he demand? Once again, the collective procedures may affect the position, as we shall now see.

III. COLLECTIVE PROCEDURES AND THE AMOUNT OF THE SURETY'S DEBT

The amount of the surety's debt obviously depends on the undertaking he has given (which may be limited to a certain figure, but not necessarily) and also on the principal debt. Here, the accessory nature of the guarantee means that it cannot exceed what is owed by the debtor (article 2290 of the Civil Code). In principle, the principal debtor's debt constitutes the maximum, but it is precisely the amount of that debt that may be more or less directly affected by a collective procedure: the cessation of interest (section III(a) below) and possibly the remission of debts (section III(b) below) will reduce the debt or prevent it from increasing excessively. Can the surety take advantage of these consequences?

(a) Cessation of Interest

Where the secured debt bears interest, the surety is also liable for the interest unless he has limited his obligation in that respect (article 2293 of the Civil Code: 'an unlimited guarantee of a principal obligation shall extend to all accessory costs of the debt'). Here again this is an effect of the rule *accessorium sequitur principale* (the liability of the accessory follows that of the principal).

However, the judgment commencing a protection or reorganisation procedure for a business automatically stops the accrual of statutory and contractual interest²⁵ as well as interest on arrears (article L622-28, paragraph 1, and article L631-14 of the Commercial Code). Can the surety plead this and thus avoid an increase in the amount of the debt? In 1990 the Supreme Court held that this was the case, on the ground, based on the accessory nature of the guarantee, that the surety's obligation cannot exceed what is owed by the principal debtor.²⁶ This judgment met with a mixed reception, some commentators approving the reference to the accessory nature of the guarantee,²⁷ while a larger number criticised the judgment on the grounds that the reason for the existence of the guarantee is to secure the creditor in the event of the debtor's default and that to stop the running of interest is not really a reduction in the principal debt, but

²⁵ Save where the interest arises on loan agreements for a term of one year or more.

²⁶ Cass com 13 November 1990: Bull civ IV, no 277.

²⁷ See L Aynès, *Dalloz* 1991, headnote p 387.

²⁸ See F Derrida, *Dalloz* 1991, headnote p 112; Simler and Delebecque, above n 14, no 121.

only a measure that is consequent upon default and is intended to facilitate the reorganisation of the business.²⁸

Quite soon after that judgment, it was overturned by the Act of 10 June 1994. However, the latest reform of collective procedures has gone back to the question by introducing a distinction between different types of sureties: from now on sureties may, provided that they are natural and not legal persons, once again take advantage of the statutory cessation of interest running (article L622-28, paragraph 1 of the Commercial Code). Here again we find that the aim is to induce company directors who have given guarantees for the debts of their own company to bring about as soon as possible the opening of a collective procedure when difficulties arise. If they do so, they benefit from the stay of individual actions,²⁹ and they will also have the advantage that interest will cease to accrue.

However, whereas the stay of individual actions benefits sureties who are individuals in the reorganisation procedure as well as the protection procedure, the cessation of interest affects them only in the protection procedure. Paragraph 1 of article L631-14 refers to certain provisions, including article L622-28, which relate to the case of protection in order to make them applicable to reorganisation. However, paragraph 2 of article L631-14 expressly excludes the possibility of sureties taking advantage of the first paragraph of article L622-28 from this cross-reference.

No doubt this is intended as yet another inducement to open a protection procedure (when the business has not yet ceased making payments) rather than a reorganisation procedure: the more the financial difficulties of the business can be dealt with in the early stages, the greater the chances of success. The fact remains that the legislature has blundered here in making the cross-references which are often made in this area to avoid repeating provisions which have already appeared in relation to a collective procedure earlier on in the Code and which are intended to apply to another. Article L641-3, concerning liquidation under the supervision of the court, makes article L622-28 also applicable to that procedure, but this time without excepting the provision in favour of sureties who are individuals. Consequently this operates in the cases of protection and liquidation, but not in reorganisation. Understand this if you can! This is a defect which could disappear when further alterations are made, which already seem to be in the offing in France (such a frantic hurry!), to the legislation on collective procedure for businesses.

(b) Remission of debts

The remission of debts is always included in the arsenal of measures for

²⁹ See above, section II(a)1.

attempting, with the ultimate aim of rescue, to deal with the difficulties of a debtor involved in a collective procedure with the ultimate aim of rescue. Remission may be one of the elements of the conciliation agreement in the conciliation procedure (article L611-7 of the Commercial Code), the protection plan (article L626-18) and the reorganisation plan (article L631-19) of a business. Likewise the agreed reorganisation plan for a bankrupt individual may include the remission of debts (article L331-6 of the Consumer Code); it may also be included (but only for the balances of loans connected with the purchase of the principal home, after it is sold) among the measures recommended by the private individuals' bankruptcy commission, if agreement with the creditors fails (article L331-7 of the Consumer Code) or on the basis of a personal recovery plan when liquidation in respect of the individual concerned can be avoided (article L332-10).

The law of obligations includes a provision expressly concerning the consequences for a surety of the remission of debts: that is Article 1287 of the Civil Code, which provides that 'the remission or discharge by agreement of the principal debtor shall release the sureties'. This provision is a new manifestation of the accessory nature of the guarantee. Should it be applied where debts are remitted in collective procedures?

For a long time case-law distinguished between remission which, although granted in a collective procedure, remained dominated by a consensual character³⁰ which enabled it to be regarded as remission by agreement within the meaning of article 1287 of the Civil Code, and other remissions which did not fall within the ambit of that provision.³¹ However, this distinction was abandoned more than ten years ago: the courts now consider that, although the remissions granted by creditors in the agreed recovery plan for an over-indebted individual are voluntary,³² they are not, in view of the purpose of such a plan, remissions by agreement within the meaning of article 1287 of the Civil Code. Logically this applies equally to remissions granted in the conciliation procedure for an enterprise.

In principle, therefore, the present position is that a surety gains no advantage from any of the remissions granted to the principal debtor in a collective procedure, even if more or less with the consent of the creditors. There are good grounds for this. The remission of debts takes place as a consequence of the principal debtor's default and is a means of dealing with it. Remission therefore differs profoundly from a genuinely voluntary discharge granted by the creditor outside any default, whereas a guarantee

³⁰ Concerning arrangements with creditors, see Cass civ 17 June 1867: DP 1867, I, 219. This approach also applied, logically, to agreed settlements in cases of over-indebtedness (see, to that effect, Simler and Delebecque, above n 14, no 239).

³¹ Cass req 15 January 1901: DP 1901, I, 325; Cass com 17 May 1994: Bull civ I, no 177.

³² Cass 1ère civ 13 November 1996: Bull civ I, no 401.

is given precisely in order to provide a creditor with security and enable him to obtain payment notwithstanding the debtor's default.

However, the present-day legislature has made exceptions to this principle by distinguishing between sureties. The distinction which was unfortunately made in 1985, here and in relation to time limits for payment, between directly liable sureties (expressly with no right to remission) and ordinary sureties (with an implicit right, by contrary inference) was likewise abandoned in the reform of 2005. However, this distinction was replaced by another, that between sureties who were individuals and those who were legal persons, still with the aim of inducing directors of businesses to apply for the commencement of a collective procedure without awaiting the cessation of payments. From now on, a surety who is an individual can take advantage of the remission of debts provided for in the protection plan for the business (article L626-11 of the Commercial Code), but not in the reorganisation plan. The same aim led to the same right being granted to sureties with regard to the remissions in an approved conciliation agreement (article L611-10, paragraph 3), with no distinction being made between individuals and legal persons as sureties—although no one really knows why!

However, a surety of a bankrupt individual does not have the benefit of remission.

* * *

In short, it can be seen that the effectiveness of a guarantee depends to varying degrees on the existence of a collective procedure. Several factors are at work: the nature of the procedure, the types of effects and whether the surety is a natural or legal person.

Overall the following balance sheet may be drawn up:

- the weakest guarantee—and therefore the best protected surety—is that given an individual for the debt of a business which is the subject of a conciliation or protection procedure;
- the strongest guarantee—and therefore the least favoured surety—is that for debts of a bankrupt individual;
- in the middle is a guarantee for the debts of a business enterprise in reorganisation.

But this approximate table is subject to numerous slight exceptions and differences owing to the many distinctions made by modern French law at every possible opportunity.

The encounter between the guarantee and collective procedures does not take place in a garden in the French manner or one in the English manner, but in what sometimes resembles a Cretan labyrinth!

Table of the effects on the guarantee of different possible consequences of collective procedures

	Conciliation procedure	'Sauvegarde' procedure	Reorganisation	Liquidation	Over-indebtedness	Personal recovery
Stay of actions		<ul style="list-style-type: none"> • Surety individual: yes • Surety legal person: no 	<ul style="list-style-type: none"> • Surety individual: yes • Surety legal person: no 	Surety: no	Surety: no	Surety: no
Time limits for payment	Time limits in the approved conciliation agreement Surety: Yes	<ul style="list-style-type: none"> • Surety individual: yes • Surety legal person: no 	Surety: no	Surety: no	Surety: no	Surety: no
Consequences of belated declaration of claim		Extinguishment of guarantee: not automatic; benefit of subrogation or DI	Extinguishment of guarantee: not automatic; benefit of subrogation or DI	Extinguishment of guarantee: not automatic; benefit of subrogation or DI		Extinguishment of guarantee: yes
Unjustified support	Nullification of guarantee: yes?	Nullification of guarantee: yes	Nullification of guarantee: yes	Nullification of guarantee: yes	Nullification of guarantee: no	Nullification of guarantee: no
Interest ceases to accrue		<ul style="list-style-type: none"> • Surety individual: yes • Surety legal person: no 	Surety: no	Surety: yes		
Remission of debts	Remission in the approved conciliation agreement Surety: yes	<ul style="list-style-type: none"> • Surety individual: yes • Surety legal person: no 	Surety: no	Discharge after closure Surety: no	Surety: no	Surety: no

Comments and Discussion Report

HUGH BEALE

When we consider the effectiveness of security devices in the two legal systems, we have to ask questions at a number of levels. The first question is which assets can be subjected to security interests. The wider the range of assets that can be used as collateral, the greater the possibilities for secured credit. At the same time we need to ask how the legal system treats the various forms of security device. Does it, for instance, require registration or some equivalent form of publicity? If it does not, there is a risk that borrowers may find it harder to obtain credit—creditors may not be prepared to lend, or not to do so on such favourable terms, if they have no ready way of finding out whether the assets offered as collateral are already subject to a security interest in favour of another creditor.

English law makes it relatively easy to take security over almost any form of asset, though with circulating assets such as inventory and receivables the charge can in practice be only a floating charge. This is because a charge that allows the security provider to dispose of assets free of the charge, or which allows the debtor to use the proceeds of receivables when they are paid,¹ cannot be a fixed charge. It is not generally feasible to obtain the secured creditor's consent every time that a piece of inventory is sold, and in practice it is difficult to require the security provider to pay the proceeds of receivables into a 'blocked' account from which they can be removed again only with the secured creditor's consent to each payment out.² A floating charge is less effective as a form of security than a fixed charge because it is vulnerable to loss of priority to subsequently created floating charges³ and because, in insolvency, certain preferential creditors and a contribution to a fund for unsecured creditors must be paid before the floating charge holder.⁴ But the floating charge makes it possible to take

¹ See *Re Spectrum Plus* [2005] 2 AC 680 (HL).

² See the discussion in H Beale, M Bridge, L Gullifer and E Lomnicka, *Law of Personal Property Security* (Oxford University Press, 2007) paras 4.70ff.

³ See *ibid*, paras 13.73ff.

⁴ *Ibid*, paras 15.01ff.

security over the whole of a business's assets in a simple way, and thereby to capture elements such as goodwill over which it is not possible to take a separate charge because they have no independent existence.

English law also makes it easy to use forms of quasi-security: sales of inventory subject to retention of title, hire purchase and finance lease for equipment and outright sales of receivables. And whereas most non-possessory security—mortgages or charges—require registration⁵ except where the charge is one over financial assets and the requirements of the Financial Collateral Directive⁶ are met, quasi-security does not require registration. The only qualification is that in practice the courts nearly always treat 'extended' retention of title clauses—ie clauses that attempt to cover not only the original goods supplied but also new products made out of them or the proceeds of their disposition—as charges.⁷

French law now seems to permit security of the traditional kind over most forms of asset, though I understand that it does not permit an enterprise charge. It also recognises the various types of quasi-security. To make a proper comparison, we need also to look at the publicity requirements.

The second question is the enforceability of the security in insolvency. For practical purposes it seems to me that a security interest that is of no effect if the security provider becomes insolvent is not worthy of the name. But we have to recognise that many systems restrict the effectiveness of security interests in insolvency, particularly when there is a possibility of a rescue of the business—in English terms, when the business might be put into administration rather than into liquidation. Then a moratorium may be placed on enforcement by secured creditors and those holding quasi-security interests.⁸ We have to consider a number of questions. What triggers the moratorium—is there an automatic stay as soon as some step is taken by a secured creditor, must court proceedings be at least initiated or is a court decision necessary? What is the effect of the moratorium on each type of security or quasi-security? Who is empowered to 'run' the business during the moratorium? Who bears the costs? And so on. And if there is no possibility of a rescue, or if the rescue attempt has failed, we have to ask questions about the process by which the security provider's assets will be made available to the secured creditor and which, if any, interests will have priority over them.

Thirdly, we need to consider the less frequent case of enforcement

⁵ Companies Act 2006, Part 25. See Beale et al, above n 2, ch 8.

⁶ European Parliament and Council Directive (EC) 2002/47 of 6 June 2002 on Financial Collateral Arrangements [2002] OJ L168/43. In practice the impact of the Directive on registration requirements in English law is limited because fixed charges over shares, bank accounts and money market deposits are not registrable under the Companies Act 2006. See Beale et al, above n 2, para 10.03.

⁷ See *ibid*, paras 5.07–5.25.

⁸ See *ibid*, para 15.10.

outside insolvency. What procedures are available to the secured creditor or party who has a quasi-security interest?

In enforcement procedures both in and outside insolvency, we have to consider the extent of the secured creditor's rights and any restrictions on the remedies available. As to the right, in English law with a traditional security (pledge, mortgage or charge) the creditor's right is limited, in effect, to the recovery of the total amount due. Any surplus must go to junior creditors or, if there are none, be returned to the security provider. An agreement that the secured creditor should be able to take the asset (*pacte commissore*) will be invalid.⁹ The only exception is the procedure for foreclosure by a mortgagee, which is subject to strict supervision by the courts.¹⁰ In contrast, with quasi-securities such as hire purchase or finance leases, the creditor can simply retake its property. The most the courts may do is to give 'relief against forfeiture' by giving hirer or lessee additional time in which to pay.¹¹ As to remedies, as we have said, if there is to be a rescue attempt via an administration procedure, there is a moratorium which applies equally to traditional and quasi-security. In other cases, with traditional security the security provider has the right to redeem by paying the full amount due before the secured creditor has sold the collateral; and in the case of some quasi-securities, as just remarked, the court may give the hirer or lessee extra time in which to pay.

To an English lawyer one puzzling feature of French law is the reference to 'excessive' security. We can understand that to take a pledge over a very valuable asset for a small debt—pawning a Picasso to secure a debt of £25—may seem excessive. But with any traditional security interest in English law, the surplus value has to be returned to the security provider and there seems to be nothing to prevent him from using that 'equity' to create a second-ranking security. So in what sense is a security ever excessive? But we understand that even some French lawyers now find the concept of excessive security to be unnecessary.

French law now grants a privileged status—a form of super-priority—to creditors who take part in the conciliation procedure. I assume that by 'taking part' is meant advancing further funds or possibly refraining from enforcement. I do not see any direct equivalent to this in English law. However, this may be an example of quite a common difference between the two laws—what is provided by legislation in French law seems quite often in English law to be left to the parties to agree. In other words, the secured creditor might refuse to 'participate' without first negotiating for the priority of its security interest, and if necessary obtaining a subordination agreement from other creditors who might otherwise have priority.

⁹ See *ibid*, paras 16.10ff.

¹⁰ See *ibid*, paras 17.24ff.

¹¹ See *ibid*, para 18.11.

In French law is there some restriction which might otherwise prevent the parties reaching such an agreement? If so, that would explain the need for a statutory provision.

In the discussion after the presentations, the issue of proportionality was explored further. Professor Théry pointed out that there is at least one situation where the concept of 'disproportionality' is used in French law, and this is where an individual guarantees a debt for more money than he or she actually has. This is disadvantageous not only for the individual, but for the creditors as well. As in English law, it is the case that under French law the secured creditor can never recover more than the value of his claim. However, under French law, a disproportionate mortgage on two houses for a single loan is seen as a waste of security, and also creates uncertainty for second-ranking creditors, as they do not know to which security the first-ranking creditor will have redress.

There was also some discussion in relation to which assets could be the subject of security in French law, as in English law there are no restrictions. The restrictions in French law are now much reduced, although it is still not possible to take a global charge.

The Exclusion of Certain Creditors from the Law of Collective Proceedings

HERVÉ SYNVEY

I. INTRODUCTION

IN FRENCH LAW, the term 'collective proceedings', which has replaced the term 'insolvency' and is now sometimes replaced by 'law of businesses in difficulty', describes the procedure introduced as an alternative to the enforcement proceedings regulated by Act 91-650 of 9 July 1991 and the measures implementing it. Enforcement proceedings, mainly different forms of seizure, are available to unpaid creditors who seek to realise their security individually. The aim of collective proceedings is to replace dispersed actions by different creditors of a debtor in difficulty with an ordered system for dealing with all his liabilities in order, if possible, to promote his recovery or, failing that, to organise the liquidation of his assets in favour of all his creditors. The collective nature of the proceedings, which is a principle of national and international¹ public policy, illustrates that there is a sense of restraint imposed on all the creditors of a debtor in difficulty. Technically, it entails the stay of individual actions and the prohibition of enforcement proceedings. The rule is now set out in article L622-21 of the Commercial Code in the following terms:

I—The judgment commencing the proceedings shall interrupt or prohibit any judicial action on the part of all the creditors whose claim is not mentioned in I of article L622-17 seeking:

1° an order requiring the debtor to pay a sum of money;

2° the rescission of a contract for non-payment of a sum of money.

¹ Cass civ, 8 March 1988, Bulletin civil I no 66, p 42; [1989] *Recueil Dalloz* 577 (case note by J Robert); [1989] *Revue de l'arbitrage* 473, case note by P Ancel.

II—It shall also stay or prohibit any enforcement proceedings on the part of creditors in respect of movables and immovables.

III—The time limits allowed on pain of forfeiture or annulment of rights shall consequently be suspended.

Article L622-17 of the Commercial Code lists excepted claims, namely those claims duly arising after the judgment commencing the proceedings. Claims prior to this judgment are therefore the only ones of interest in the context of this chapter. In relation to these, the rule laid down by article L622-21 has an all-encompassing effect: by virtue of the judgment commencing the collective proceedings, all creditors lose the right to sue their debtor individually and to institute enforcement proceedings against him.

Consequently to speak of the ‘exclusion of certain creditors from the law of collective proceedings’ raises the question of whether there are exceptions to the principle: do certain creditors escape the restraint imposed by the judgment commencing collective proceedings? Can they continue to exercise their rights and realise their security notwithstanding the modification in their debtor’s legal situation? At first sight the question is factual and objective: it involves measuring the true effect of the stay of individual actions and the prohibition of enforcement proceedings. However, a more fundamental question underlies it. If part of a debtor’s liabilities escapes the common rule, is it still correct to describe the proceedings as collective? More importantly, would it not be the case that the attainment of their objectives is likely to be seriously disrupted?

It would be slightly naïve to think that the answers are to be found in the law of collective proceedings itself. It may be thought that it should define its own scope; in particular, it should state which creditors must obey the restraints it imposes and which others may escape it. However, observation of legal reality shows that matters are more complicated. The law of collective proceedings is not isolated. It must reach a balance with other principles and, more fundamentally, imperatives belonging to other branches of law. First of all, there is the law of securities *in rem*, which creates situations involving exclusive rights. There is also financial law, as conceived by the Basel committee and given prescriptive force by Community law. The condition of ‘insolvency’ is, from the perspective of financial law, a source of legal uncertainty that is difficult to accept. The aims of these different legal disciplines are broadly contradictory. Their interaction leads to a point of equilibrium that is unstable and always provisional.

In actual fact, each of the branches of law concerned tends to give priority to interests of a certain type and tries to improve the effectiveness of its own apparatus, while not really taking the other branches into account.

The development of the law of collective proceedings is a good example of this. The central concept of the Commercial Code of 1807, as augmented by the Insolvency Act of 28 May 1838, is the concept of the body

of creditors, which expresses the idea that the unsecured creditors of the insolvent debtor lose their individual rights: they are brought together in a body, represented by a trustee who carries out the collective seizure of all the debtor's assets. However, certain creditors remain outside the body. They are, most importantly, holders of a specific security *in rem* (mortgage, pledge, specific charges). These secured creditors are not affected by the suspension of individual actions, at least in so far as they exercise their right *in rem*, and the debtor's state of insolvency does not preclude the realisation of the asset which is specifically charged to them.² It is this particular situation of secured creditors that has been gradually called into question. The reforming legislation of 13 July 1967 provided that these secured creditors had to have their claims verified. This was based on the distinction between 'the man and the enterprise' (it was thought that they must be treated differently: the enterprise was to be saved, if possible—and its director was to be punished, if necessary). Once it was recognised that these secured creditors were beginning to have to submit to the restraints of the collective procedures, the courts used this as a pretext for applying the stay of individual actions³ to them, as well as the prohibition of enforcement proceedings until their claims were admitted. In that way the law of collective proceedings extended its scope and the particular differences pertaining to the situation of certain creditors were eroded. The trend became more marked with the Act of 25 January 1985, which placed the rescue of the enterprise at the forefront of its concerns. Technically, the concept of the body of creditors was abandoned, which made it possible to do away with the category of creditors outside the general body and to treat all creditors without distinction, whether secured or unsecured and whatever the nature of the security for their claim. As a result, it was recognised that there was a serious deterioration in the position of holders of specific securities *in rem*, a weakening which in its time gave rise to a controversy on the constitutionality of the reform.⁴ The latest legislation, the Act of 26 July 2005, merely accentuated the trend. Echoing the explanatory memorandum of the draft Act ('the protection of businesses is a major focus of our economy and the people who develop it'), the new measure introduces a new form of proceedings, the so-called protection proceedings, which take place earlier than the older proceedings of reorganisation and winding-up under the supervision of the court. Accordingly it is no longer necessary to await the debtor's cessation of payments

² In a curious return to the past, this is the principle that prevails today in Art 5 Council Regulation (EC) 1346/2000 of 29 May 2000 on insolvency proceedings [2000] OJ L160/1: the opening of insolvency proceedings in a Member State of the Community leaves the holders of a security over assets situated in another member State free to exercise the rights *in rem* attached to that security.

³ Cass Ass plén, 13 February 1976, Bulletin civil Ass plén, no 3, p 4.

⁴ Decision 84-183 DC of the Constitutional Council, 18 January 1985 (the Constitutional Council dismissed the complaint of retrospective effect of the Act on mortgages).

(protection proceedings may be opened on application by a debtor ‘who proves difficulties which he is unable to overcome and which may lead to the cessation of payments’, article L620-1 of the Commercial Code) in order to paralyse the exercise of creditors’ rights on the ground—or the pretext—of rescuing the business. As we have seen, the entire evolution of the law of collective proceedings has consisted of drawing all creditors into its ambit, promoting a policy of reorganisation of businesses in difficulty.

Consequently, the law of secured creditors has become diversified. It also seeks effectiveness, but its own effectiveness, which is not the same thing.

Accordingly in French law we have seen the appearance and development of the use of title as a security technique. The legislature started this by enshrining the effectiveness of retention of title clauses,⁵ and then in accepting that commercial receivables can be assigned to secure bank lending.⁶ The courts have not lagged behind. To them we owe the acceptance of leasing (constructed by practice on the basis of a combination of a mandate, a sale, a lease of goods and a unilateral promise of sale) in French law, even though it originally received its legislative blessing in an Act of 2 July 1966. It was also the courts that provided a foundation for the delivery of money as collateral security—what is called, somewhat clumsily, a ‘cash pledge’ in several judgments of the Supreme Court making ordinary realisation of the security possible.⁷

More recently, the law of specific security interests *in rem* has been completely reformed. This was done by an ordinance of 23 March 2006, which added a new book, Book IV, to the Civil Code. Without going into the details of this reform, its liberal character should be pointed out here. The ordinance removed the requirement of dispossession for a pledge of tangible movables, allowed the alienation of pledged fungibles by the pledgor/borrower ‘if the agreement so provides, provided that they are replaced by the same quantity of equivalent goods’ (article 2342 of the Civil Code), adopted a modern regime for pledging receivables based on the Dailly Act and introduced the technique of the rechargeable mortgage. Generally speaking, creditors holding specific security interests *in rem* have

⁵ This is an Act of 12 May 1980 which allowed the validity of a retention of title clause as against the collective proceedings, subject to certain conditions. More recently, the Civil Code was amended to include the retention of title in the new Book IV, concerning security interests (art 2367 provides that, ‘the title to goods may be retained as security by the effect of a retention of title clause which suspends the conveyance effect of a contract until payment in full of the obligation which constitutes the consideration for the goods’).

⁶ Act 81-1 of 2 January 1981, known as the Dailly Act, amended by Act 84-46 of 24 January 1984. Today the first paragraph of article L313-24 of the Monetary and Financial Code provides that, ‘even where it is effected as security and without the stipulation of a price, the assignment of a receivable transfers to the assignee the title to the receivable assigned’.

⁷ Cass com, 17 May 1994, Bulletin civil IV, no 178, p 142, [1995] *Recueil Dalloz* 124, note Ch Larroumet; 3 June 1997, Bulletin civil IV, no 115, p 147, [1997] *Semaine Juridique* II 22891, rep Rémy; 4 February 2003, [2003] *Recueil Dalloz* AJ 1361.

a greater variety of rights and the realisation of their security has been simplified.⁸

Finally, and more spectacularly, the *fiducie* has entered French law thanks to an Act of 19 February 2007. According to the new article 2011 of the Civil Code,

a trust is an operation whereby one or more settlors transfer assets, rights or securities, or a number of assets, rights or securities, present or future, to one or more trustees who, keeping them separate from their own property, act for a specified purpose for the benefit of one or more beneficiaries.

No doubt it would be unwise to say that French law has taken a step in the direction of the English trust: the French concept of property remains unitary, so that the separation of rights to the property between the trustee and the beneficiary could be difficult to accept. On the other hand, it is clear that the new regime enshrines the concept of a special-purpose fund. The trustee must keep the property received from the settlor separate from his own property and it can be seized only by persons with claims arising from the keeping or management of the trust property (article 2025 of the Civil Code). Thus the way is open to the use of the trust for security purposes. The settlor-debtor will transfer the title to one or more assets to a trustee who will dispose of them for the benefit of the beneficiary (who may be the trustee himself) in the event of the settlor's default. The desired security will be obtained by a contractual definition of the acts which the trustee will be appointed to carry out in the beneficiary's favour (eg sale of the property received and delivery of the proceeds to the beneficiary in repayment of his claim).

It must be said that this represents an improvement on conventional security interests, which have been transformed in order to obtain greater effectiveness. Faced with the encroachment of the law of collective proceedings, everything takes place as if the virus (the security) were becoming more and more resistant to antibiotics.

To make this interplay of divergent forces more complicated, recent years have seen the development of legislation specifically relating to certain financial operations. In particular, it covers interbank settlements, temporary transfers of investment securities (loans of financial instruments, repurchase agreements) and derivatives (options, swaps, etc). The aim has been to strengthen legal certainty for operators, and in particular to limit counterparty risk and to avoid chain defaults that could lead to the commencement of collective proceedings against one of them. The traditional rules of insolvency law could be regarded as an aggravating factor: the stay of individual proceedings was an obstacle to the rescission of a

⁸ Accordingly foreclosure clauses have been recognised as effective, although traditionally viewed with disfavour in French law.

contract for non-payment of a money sum. The prohibition of payment by the debtor was likely to paralyse the operation of set-off, and it was becoming impossible to realise collateral taken to ensure the proper execution of financial operations.

That is why special legislation has gradually been enacted with the aim of setting aside the effect of the general law of collective proceedings. Its early history is that of its improvement and expansion: here again development has been 'unilateral'. In French law the legislature first took action in 1993.⁹ Then, Directive 98/26/EC on settlement finality in payment and securities settlement systems¹⁰ and Directive 2002/47/EC on financial collateral arrangements¹¹ were implemented in national law. As these directives do not effect maximum harmonisation, they have not exhausted the flow of legislation and amendments are periodically made to the law concerning financial operations.

As a result, there is some inconsistency between the wording of measures governing collective proceedings (all creditors are subject to them) and the true situation (an increasing number of creditors escape them). This paradoxical situation calls for technical analysis and a critical assessment.

In relation to the technical aspect, the question is by what means do certain creditors succeed in remaining outside collective proceedings? Examination of the actual arrangements shows that two main methods are used. Sometimes the law of collective proceedings is not applied because the creditor succeeds in having his original status overlooked and asserts rights other than those attaching to his claim against the debtor for whom protection, reorganisation or winding-up proceedings are commenced; the creditor is then a sort of 'legal Janus'. At other times the general law of collective proceedings is subjugated to a special system constituting an exception laid down by law. Beside the general law of collective proceedings, a number of special systems are appearing which specifically cater for certain businesses or activities. Consequently there is a sort of 'legislative erosion'.

With regard to the conceptual assessment, the obvious question that arises concerns the justification for the derogations and exceptions to the uniform application of the law of collective proceedings. More generally, the question that has to be asked is whether the existing system is internally consistent: what has become of the aims of the law of collective proceedings if more and more creditors, through various means, succeed in avoiding its constraints?

The plan of this chapter is mapped out accordingly. We shall discuss each

⁹ Act 93-1444 of 31 December 1993.

¹⁰ European Parliament and Council Directive (EC) 98/26 of 19 May 1998 on settlement finality in payment and security systems [1998] OJ L166/45.

¹¹ European Parliament and Council Directive (EC) 2002/47 of 6 June 2002 on financial collateral arrangements [2002] OJ L168/43.

of the two methods of exclusion before submitting a few observations on the quality (or lack of quality) of the result obtained.

II. EXCLUSION ON A TECHNICAL BASIS

This circumvention of the law of collective proceedings is based on an informed use of the main categories of French law. The opening of proceedings paralyses the creditors' rights over the debtor's property (general charge) or certain assets belonging to the debtor (rights attaching to specific securities *in rem*, such as the right to have the assets sold and to obtain preferential payment from the proceeds, the right to have the assets assigned to him by the court, the right to appropriate the assets by virtue of a foreclosure clause). To avoid this, it is necessary either to avoid appearing as a creditor or to procure rights in assets placed among the property of a person other than the debtor.

(a) Exclusion by Having the Status of Owner of the Property Serving as Security

In substance this covers five groups of situation which may be classified according to whether or not the creditor has possession of the property serving as security, from the beginning. The five situations are (1) retention of title; (2) hire purchase; (3) finance leasing; (4) assignment of receivables; (5) cash pledge.

The first category consists of retention of title, hire purchase and finance leasing. A retention-of-title clause enables the supplier of goods to retain the title to the goods sold until he is paid in full. Where collective proceedings are opened in relation to the buyer, the second paragraph of article L624-16 of the Commercial Code applies; this states that,

the recovery of goods sold with a retention of title clause may also be claimed if they subsist in kind at the time of the opening of the proceedings. The clause must be agreed upon by the parties in writing not later than at the time of delivery. It may be agreed upon in a document governing a number of commercial transactions between the parties.¹²

This action for recovery is an action brought by an owner. It is not affected by a stay of individual actions, which paralyses only the right to receive payment of a debt. In practice, therefore, the party retaining title is not subject to the constraints of collective proceedings.

Similar reasoning is followed in the case of hire purchase and leasing.

¹² This is followed by detailed provisions on movables incorporated in other property after sale, and on fungibles.

Here, a credit institution purchases at its customer's request the item which the customer needs and then leases it to the customer (if there is also a unilateral promise of sale in the lessee's favour, the transaction constitutes a hire purchase). The credit institution retains title to the item financed, although it does not use it, and transfers it to its customer only in a hire purchase if the credit is 'repaid' in full and the promise of sale is taken up. If the lessee defaults and collective proceedings are commenced against him, article L624-9 of the Commercial Code enables the lessor to recover the goods, and, where the agreement is registered (which is required by law in the case of hire-purchase), article L624-10 makes things easier for the lessor:

the owner of the goods need not obtain recognition of his title to them where the agreement relating to them is registered. He may claim the return of his goods according to the conditions laid down by decree in Council of State.¹³

Once again, the status of 'owner' confers a right which is not affected by the commencement of collective proceedings and thus enables the creditor-owner to obtain actual satisfaction (the return of the leased goods).

In other situations the creditor-owner's position is even better. As the goods have already been transferred to him as security, the debtor's default enables him to keep them with final effect, and this is not precluded by the commencement of collective proceedings. Consequently, where commercial receivables are assigned as security, the banker himself, after notifying the account debtor, collects the assigned debts as and when they fall due and can keep the funds received until the secured claim is paid off.¹⁴ If collective proceedings are opened in respect of the debtor, the banker will merely deduct the amounts received from the total of his claim. The security is all the more effective in that the law permits the assignment of future receivables, and the courts, after some hesitation, have accepted that the assignee acquires the title to receivables arising after the judgment commencing proceedings is delivered.¹⁵ Not only do collective proceedings not paralyse the rights of this type of security holder, but they also do not interrupt the flow of receivables that go to enrich the bank's assets.

The cash pledge is a similar arrangement. In its purest form, the debtor transfers title to a sum of money to his creditor to secure payment of his obligations. If he defaults, the Supreme Court has held that the creditor can set off his unpaid claim against his obligation to return the pledge.¹⁶ The commencement of collective proceedings does not prevent the operation of

¹³ A registered letter with request for acknowledgment of receipt, sent to the administrator, is sufficient: art R624-14 of the Commercial Code.

¹⁴ In practice, banks generally stipulate that they will hold the funds as a cash pledge.

¹⁵ Cass com, 7 December 2004, Bulletin civil IV, no 213, p 239, [2005] *Recueil Dalloz* 230, case note Ch Larroumet; 22 November 2005, Bulletin civil no 230, p 249, [2007] *Recueil Dalloz* Pan 760, case note DR Martin.

¹⁶ See the judgments cited above (n 7).

this set-off because the claims in question are connected. A different, and no doubt more coherent, line of reasoning, would be that the debtor's default consolidates the creditor's title. As he is already the owner of the funds delivered to him as security, he would cease to be under an obligation to return them because of the non-payment of the secured debt, so that his title would acquire final effect.¹⁷

The cash pledge could also fit into the pattern of a pledge of fungibles. Since the reform of the law of securities, the second paragraph of article 2041 of the Civil Code has provided that,

if the agreement exempts the creditor from that obligation [to keep fungibles received in pledge separate from things of the same kind belonging to him], he shall acquire the title to the things pledged, provided that the same quantity of equivalent things is returned.

No doubt it is debatable whether it is correct to confer the status of owner on someone who is only a creditor-pledgee, but, in view of the law of collective proceedings, this change can only be found to be advantageous to the creditor. Having become the owner, he need no longer worry about the realisation of his pledge, and it may be possible to set off his obligation of restitution against his own claim.

The various courses of action described above call for a number of observations.

First of all, it will be noted that the list is somewhat heterogeneous. In French law, there is no general principle permitting the use of title as security (article 2367 of the Civil Code relates only to retained title, which in practice concerns almost only a seller on credit). Case-law therefore has an important role. However, it appears difficult to identify a unifying principle. Sometimes the courts are receptive to devices enabling a lender to plead the status of owner (eg with regard to hire purchase, the courts have succeeded in adapting and combining the rules of general law applying to the various elements of the transaction so as to take its purpose into account¹⁸), while at other times it is restrictive (eg the Supreme Court recently refused to allow the assignment of a claim as security, outside the provisions of the Dailly Act¹⁹).

Secondly, it is clear that, in all the situations described above, legal form

¹⁷ On these conclusions, see D Bureau, 'Le gage-espèces, une sûreté atteignant sa maturité' (1999) 77 *Droit et patrimoine* 22; D Legeais, 'Le gage-espèces après la réforme des sûretés' (2007) 162 *Droit et patrimoine* 70.

¹⁸ For example, by accepting that the lender-lessor can, by means of an express stipulation in the contract, exempt himself from giving a warranty against hidden defects referred to in art 1721 of the Civil Code, since the lessee has a direct claim against the seller of the goods with whom he determined their characteristics (Cass com, 30 October 1973, Bulletin civil IV no 303, p 271).

¹⁹ Cass com, 19 December 2006, Bulletin civil IV no 250, p 275, [2007] *Recueil Dalloz* 344, case note Ch Larroumet.

takes precedence to substance. Every time, the reality is that credit is granted (by the seller who supplies goods before being paid, by the banker who finances the purchase of a capital item) in consideration of the provision of *in rem* security. But the creditor is given the possibility of asserting his status as owner, which enables him to escape the constraints of the law of collective proceedings (primarily, the stay of individual actions). One judgment took the logic of dual capacity (creditor/owner) to its ultimate conclusion in holding that the extinguishment of an undeclared claim did not preclude an action for recovery by the seller who had stipulated a retention of title clause.²⁰ Thus the seller may claim the recovery of the article even though he is no longer the creditor of the price. The title is left isolated; it is no longer at the service of the claim.

Finally, it may be thought that, behind this seemingly technical reasoning, there are probably choices of legal policy. The beneficiaries of arrangements based on retention of title are the suppliers and, first and foremost, the banks.²¹ Furthermore, the two most effective devices (because they do not even require an action for recovery or restitution) are of a financial nature: the Dailly Act assignment as security and the cash pledge.

(b) Exclusion as a Result of Assets Securing the Debt Being Situated Amongst Third-party Property

In this second group of situations, the creditor no longer conceals his original status, but can realise his security (or have it realised) without having to act against the debtor, which enables him to remain unaffected by the collective proceedings commenced against the latter.

Two securities fall within this type of situation. The first is the charge on receivables. The subject-matter of the security is then a claim which the person creating the charge has against a third party. The debtor of the charged claim must be given notice of the charge in order for it to be valid as against him (article 2262 of the Civil Code). However, this formality strengthens the creditor's rights, which are laid down by article 2363 of the Civil Code as follows:

After notification, only the secured creditor shall receive valid payment of the charged claim in both the principal sum and interest. Each of the creditors, the others having been duly summoned, may seek enforcement of the charge.

²⁰ Cass com, 11 March 1997, Bulletin civil IV no 70, p 63, [1997] *Droit des Affaires* 510 (under the Act of 25 January 1985, a claim that was not declared within the prescribed time limit was extinguished; today, the sanction is exclusion from dividends and other distributions).

²¹ Even a retention-of-title clause benefits banks in so far as it is transmitted with the claim for the price which it secures. The Supreme Court has held that, where the buyer is involved in collective proceedings, it is unnecessary to distinguish according to whether the claim is asserted by the seller or by a third party subrogated to his rights: Cass com, 15 March 1988 (two judgments), Bulletin civil IV no 106, p 74, [1988] *Recueil Dalloz* 330, case note F Pérochon.

In this way a kind of direct action (or direct right of payment) is created in favour of the secured creditor against the debtor of the charged receivable. Only the secured creditor can receive the sums paid by the debtor of the receivable constituting the security, whether voluntarily or after legal proceedings. Therefore the commencement of collective proceedings against the borrower does not prevent these rights being exercised. In fact, the secured creditor does not seek an order requiring his debtor to pay a sum of money, nor does he claim to enforce it, in the proper sense of the term. He merely exercises his right to be paid directly by a third party, the debtor of the charged receivable, in the words of article 2363 of the Civil Code. Article L622-21 of the Commercial Code should therefore not be applied in so far as it prohibits actions and enforcement proceedings against the debtor.²²

The situation is even clearer where a trust is used for security purposes. The assets concerned are segregated from the settlor's property at the very beginning. The title to them is transferred to the trustee, who must keep them separate from his own property. This separation means that they can be sheltered from the consequences of the commencement of collective proceedings against the trustee: in accordance with article 2024 of the Civil Code, 'the commencement of protection, reorganisation or winding-up proceedings on behalf of the trustee shall not affect the trust property'. However, more importantly, in principle the settlor's creditors lose every right in the assets which no longer form part of their debtor's property. This follows by contrary inference from the first paragraph of article 2025 of the Civil Code, which provides that,

without prejudice to the rights of the settlor's creditors holding a right to trace assets which attaches to a security registered prior to the trust agreement, and save for cases of fraud on the rights of the settlor's creditors, the trust property may be seized only by persons with claims originating from the keeping or management of that property.

Save for situations where there is a right to trace property (eg if a mortgaged immovable is transferred to a trust) and fraud (which will probably be rare in relation to a security trust because the trust is then constituted in order to obtain or maintain a loan, and not to create a kind of defence to seizure by artificial means), the assets transferred are sheltered from action by the settlor's creditors. That is what puts collective proceedings 'offside' if they are opened against the settlor. In the first place, as the trust assets are segregated from the settlor's property, there are no grounds for including them in the assets for the purpose of the

²² To that effect, see H Synvet, 'Le nantissement de compte' (2007) 161 *Droit et patrimoine* 66, 66-7; cf with reservations, F Faure-Dauphin, 'La modernisation des instruments de sécurisation des encaissements dans les opérations de titrisation' (2006) *Revue trimestrielle de droit financier* 111.

proceedings. Secondly, realisation of the security (which will be carried out by the trustee acting in conformity with the stipulations of the trust agreement, rather than by the creditor directly) can take place sheltered by the rule that individual actions are stayed, and if there are any, they are brought in relation to assets that now belong to the trustee. In other words, henceforward everything happens between the trustee and the creditor. The settlor and, behind him, the court's agents, are entitled to receive only the balance after payment in full of the secured debt.²³

In terms of the effect of these arrangements, on the one hand, the fact that they are recent means that they have not yet been tested in the courts. The interpretation of article 2363 of the Civil Code remains to some extent uncertain. So far as the use of trusts is concerned, it is in the very early stages. There are reports of the constitution of security trusts by parties of first-class standing (of creditors).²⁴ We shall have to wait for a degree of democratisation of the institution and the default of a settlor in order to verify, on a test case basis, whether the creditor's rights resist the effects of the collective proceedings affecting the settlor.

On the other hand, the reception of the trust in French law marks a real turning point. Up to now, special rules existed which enabled certain creditors to evade the constraints of the law on collective proceedings (lender-lessor, assignee of commercial receivables). With the trust, we pass from special devices to a technique which can be used for any type of property and even entire collections of assets, and those assets may be segregated within a special-purpose fund, which was not the case with the security transfers of title previously known to French law. Therefore the trust is potentially a formidable instrument for circumventing the law of collective proceedings which has just been placed at the disposal of creditors. If we add that certain regulated professions (credit institutions, insurance companies, providers of investment services) have been given the monopoly of acting as trustees (article 2015 of the Civil Code), it can be said that the reform is a valuable 'gift' offered to the financial sector.

III. EXCLUSION BY VIRTUE OF A STATUTORY EXCEPTION

Unlike the situations that have just been described, in this case exclusion from the law of collective proceedings is direct. It is no longer a question of putting oneself in a situation where the law of collective proceedings ceases

²³ The rule that the beneficiary cannot enrich himself to the detriment of the settlor still does not form part of the law. To give it effect, it would have to be inferred from the concept of security.

²⁴ See R Dammann, G Podeur and V Roussel, 'Fiducie: des débuts prometteurs' [10 March 2008] *Option Finance* 37 (in one of those trusts, the settlor is Gaz de France; in the other, the beneficiary is the French state, for tax and social (labour relations) debts).

to apply. Theoretically, the conditions for it to operate are fulfilled but, exceptionally and because of legislative provision, certain creditors escape the general rule.

The source of evolution here has been mainly, but not exclusively, Community law. First of all, there is substantive law applying to certain transactions which aims to harmonise, at least partly, the legal regime applicable throughout the Community. But Community law also takes into account the frequently international character of the relevant legal situations. Therefore the system that has developed to remove certain creditors from the constraints of collective proceedings is divided into two parts: firstly, there is a special substantive regime derogating from the general law of collective proceedings; and secondly, there are particular rules of private international law so that, even if the collective proceedings are not governed by the *lex fori*, the creditors who are to be given preference can avoid falling within its ambit.

(a) Ouster of the Law of Collective Proceedings

There are three financial devices to which the law of collective proceedings does not apply: interbank settlement and delivery systems for financial instruments; financial collateral arrangements; and securitisation of debt or receivables.²⁵

In relation to the first, the impulse came from Directive 98/26/EC on settlement finality in payment and securities settlement systems. At the time it was rightly observed that one of the risks of these settlement processes was the opening of collective proceedings against one of the participants.²⁶ That is why paragraph II of article L330-1 of the Monetary and Financial Code, implementing the Directive into national law, provides that:

notwithstanding any legislative provision to the contrary, payments and deliveries of financial instruments effected in the framework of interbank settlement systems or in the framework of settlement and financial instrument delivery systems up to the end of the day when a judgment commencing protection, reorganisation or winding-up proceedings against an establishment participating, directly or indirectly, in such a system, is delivered, shall not be annulled even on the ground that that judgment has been delivered.

For the sake of system security, this prevents nullity arising from the suspect period (which is from the date of cessation of payments until the date of the judgment commencing the proceedings) and amends the rule prohib-

²⁵ Leaving aside the rules for real property loan companies (art L515-19 of the Monetary and Financial Code).

²⁶ V Canu and B de Saint Mars, 'Intermédiation financière et droit des procédures collectives' (1998) *Revue de Droit Bancaire et Bourse* 119.

iting payments (which should operate from 0h00 on the day when the judgment commencing the proceedings is delivered) so that its effects are delayed until the end of the day. In addition, the French legislature has extended this exceptional measure, which originally affected only payments and the delivery of financial instruments, to payment instructions and instructions for the delivery of financial instruments, ‘as soon as they have become irrevocable’ (article L330-1, paragraph III of the Monetary and Financial Code).

To this must be added the special treatment of security interests and collateral security which the operating rules or agreement governing the system may require from participants. The methods of realising assets or rights provided as collateral security are laid down by the operating rules or agreement, without interference from Book VI of the Commercial Code (article L330-2, paragraphs II and III of the Monetary and Financial Code). This means that creditors holding such security interests or collateral security (eg a clearing house) are placed outside the scope of collective proceedings. By a curious return to the past, creditors ‘outside the general body’ have been given new life.

With regard, secondly, to financial collateral arrangements, the French legislature has not gone as far as permitted by Directive 2002/47/EC, which gives a very broad definition of the obligations that may be secured by a financial collateral arrangement—obligations, ‘which give a right to cash settlement and/or delivery of financial instruments’ (article 2(1)(f)). And there are several kinds of person who may be parties to a financial collateral arrangement since the measure is potentially applicable to arrangements between a regulated person (public sector body, central bank, credit institution, insurance undertaking, etc) and, ‘a person other than a natural person, including unincorporated firms and partnerships’ (article 1(2)(e)). By way of a partial opt-out, French law lists three types of financial obligation (article L431-7, paragraph I of the Monetary and Financial Code):

- those arising from operations in financial instruments where at least one of the parties is a regulated person;
- those ‘arising from a contract giving rise to cash settlement or to the delivery of financial instruments where all the parties’ are regulated persons;
- those ‘arising from a contract concluded in the framework of a system mentioned in article L330-1’ (there is therefore some overlap with the rules for interbank settlement systems and financial instrument settlement and delivery systems discussed above).

In other words, the largest category of financial obligation that may be secured by a financial collateral arrangement—that covering any settlement

in cash—applies only to contracts concluded between professionals in the financial sector (to simplify the situation slightly).

For financial obligations as listed above, the technique of close-out netting has been shielded from the law of collective proceedings (article L431-7-2 of the Monetary and Financial Code). Accordingly certain creditors receive favourable treatment: they escape the rule of continuation of current contracts outlined by article L622-13 of the Commercial Code (ie the termination part), and they can effect set-off in spite of the prohibition of payments which is in principle applicable, on the commencement of collective proceedings for protection, reorganisation and winding-up,

In addition, the balance remaining after close-out netting itself receives favourable treatment. It can be secured by the delivery on the basis of absolute ownership of stocks and shares, financial instruments, bills, claims, contracts or money sums, or by,

the constitution of security over such realisable assets or rights, even where one of the parties is the subject of one of the forms of proceedings provided for by Book VI of the Commercial Code.

(article L431-7-3, paragraph I of the Monetary and Financial Code)

Thus, once again, a creditor holding a security *in rem* finds himself in the situation that prevailed before the 1967–85 reforms of insolvency law: the assets charged are his, and he can realise them irrespective of the collective proceedings opened against his debtor.

The securitisation of debt or receivables is the third operation in respect of which the legislature has found it appropriate to derogate from the law of collective proceedings. In French practice, debt or receivables are assigned to a common fund, which issues securities, but the recovery of the claims normally continues to be handled by the assignor institution. As long as the assets or claims exist, the fund is protected against the commencement of collective proceedings against the assignor: the assets or claims are segregated from its own property, in accordance with an arrangement similar to that already seen in the assignment of commercial receivables as security.²⁷ However, the recovery of the claims by the assignor means that it receives funds which become inseparable from the whole of its property, which would mean that they would become part of its assets for the purpose of the collective proceedings. To avoid this, as a result of an Act of 1 August 2003, article L214-46, paragraph 3 of the Monetary and Financial Code now provides as follows:

the management company and the institution responsible for the recovery of the debt or receivables assigned may agree that the sums recovered shall be credited to an account specially designated for the fund or, as the case may be, to the compartment, against which the creditors of the institution responsible for recov-

²⁷ See text at nn 13 and 14 above.

ery cannot pursue the payment of their claims, even in the case of proceedings opened against it for reorganisation or winding-up under the supervision of the court.²⁸

Consequently, thanks to the legislature, the rights of the common fund of debt or receivables prevail over those of the collective proceedings, even though the contested asset—the funds credited to an account—is included in the debtor's property.

Taking all these measures together, the outlines of a financial bubble gradually appear, one which is shielded from all the vagaries of insolvency and capable of remaining in effect for the participants in the operations concerned.

(b) Ouster of *Lex Concursus*

However, protection in relation to the law of collective proceedings would not be complete if it were provided only by a substantive rule. The concept underlying it is not necessarily shared everywhere, and some foreign legal systems may be reluctant to sacrifice the interests traditionally defended by insolvency legislation. In an international situation, the *lex concursus* naturally applies to some of the key points that have been discussed in this chapter. Thus the stay of individual actions is traditionally one of the matters governed by the law that is applicable at the commencement of collective proceedings.²⁹ If the usual principles of private international law are applied, there could be no guarantee that a creditor who enjoys favourable treatment in internal law will do so in an international context.

That is why the legislature completed its work by developing special rules of private international law.

First of all, mention may be made of a particular conflict-of-laws rule. Examples of it can be found in Directive 2001/24/EC on the reorganisation and winding up of credit institutions.³⁰ In implementing this Directive, article L613-31-5, 4^o, of the Monetary and Financial Code states that,

agreements for set-off, agreements for the temporary assignment of financial instruments and those governing transactions carried out in the framework of a regulated market shall remain exclusively governed by the law applicable to those agreements.

If it is accepted, which appears reasonable, that the set-off referred to here

²⁸ For a commentary on this provision, see X de Kergommeaux and Ch Van Gallebaert, 'Du compte à affectation spéciale' (2006) 3 *Revue trimestrielle de droit financier* 134.

²⁹ See H Synvet, *Rép Dalloz Droit international*, "Faillite", no 46; Regulation 1346/2000 on insolvency proceedings went back to this principle in art 4(1)f.

³⁰ European Parliament and Council Directive (EC) 2001/24 of 4 April 2001 on the reorganisation and winding up of credit institutions [2001] OJ L125/15.

includes ‘netting’, its validity as against the administrator of a French bank which is the subject of collective proceedings will be governed, not by insolvency law, but by the law applicable to the netting agreement. If it is an International Swaps and Derivatives Association (ISDA) agreement, this will be English law or the law of the state of New York.³¹ As a result, netting will work in situations not provided for by article L431-7 of the Monetary and Financial Code, which is surprising when it is a French credit institution that is insolvent.

Another technique used is to treat foreign collective proceedings in the same way as French proceedings, where the law prevents them from affecting the operation of the rule favourable to the creditor. For example (and there are others), article L431-7-5 of the Monetary and Financial Code provides that,

the provisions of Book VI of the Commercial Code, *or those governing all equivalent judicial or conciliation proceedings opened on the basis of foreign laws*, shall not preclude the application of this section [which deals with collateral security for financial obligations]’. (emphasis added)

Therefore it is immaterial that the foreign law of insolvency claims jurisdiction: if the collateral is governed by French law (eg where it relates to financial instruments shown on an account located in France), it is sheltered from the effects of foreign legislation applying to the collective proceedings.

This accumulation of exceptions in favour of certain creditors—in fact, almost always the same ones, the banks—is striking. It is therefore not enough merely to find that it exists. Because it is so widespread, it calls for discussion of whether it can be critically justified.

IV. CRITICAL ASSESSMENT

The assessment can be approached from two complementary viewpoints. It may well be asked, first of all, whether the French law is consistent: how can the rather ‘aggressive’ approach of collective proceedings, which puts the emphasis on rescuing enterprises in difficulty, be reconciled with the favourable treatment given to certain creditors, which causes many proceedings to fail? Secondly, we must take a closer look at the justifications given for the exceptions to the uniform application of the law of collective proceedings. Here, French law is not the only subject of examination because to a large extent the initiative goes back to Community law. Is it true that only considerations of general interest have led to the law of collective proceedings being set aside, or have such considerations

³¹ See A Caillemer du Ferrage, ‘Close-out netting et faillites internationales’ [2007] *Revue de Droit Bancaire et Financier* 99.

sometimes served as a cover for promotion of self-interest by the financial sector?

Therefore an assessment must be carried out at two levels: consistency and legitimacy.

(a) Consistency

One of the major innovations of the reform brought about by the Act of 26 July 2005 is the creation of protection proceedings, which occurs at an earlier stage than reorganisation and, even more so, than winding-up. Article L620-1 of the Commercial Code clearly assigns an objective to the new proceedings: they are, 'intended to facilitate the reorganisation of the enterprise in order to enable it to continue its economic activity, to maintain employment and to discharge the liabilities'. This objective can only be attained if two rules are laid down:

- all individual actions must be stayed so that the existing assets are put out of the reach of creditors while the plan is being worked out;
- then, if a sufficiently realistic protection plan can be adopted, it must be effective as against all creditors, so that its financial moratorium can extend to all the debtor's liabilities.

These two rules actually form part of the law. The stay of individual actions attaching to the judgment commencing the proceedings is obviously not new. The effectiveness of the plan is affirmed by the first paragraph of article L626-11 of the Commercial Code: 'the judgment adopting the plan shall render the provisions thereof effective as against all persons'.

However, each of these cardinal rules yields when confronted with security interests and trust arrangements. We have seen how an action for recovery or the transfer of assets into the property of a person other than the debtor makes it possible to avoid the stay of individual actions. The same is likely to happen with regard to the moratorium resulting from the protection plan. As my colleague Corinne Saint-Alary-Houin correctly writes,

the claimant creditors, by the very fact that they can recover the goods sold or leased, of which they remain the owners, escape the plan, which explains the boom in hire-purchase, leasing and retentions of title.³²

No doubt certain precautions are taken all the same where the goods concerned are essential for carrying on the business. Leasing forms part of contracts in progress which the administrator or, failing him, the debtor may require to be performed in spite of the opening of collective

³² C Saint-Alary-Houin, *Droit des entreprises en difficulté* (5th edn, Paris, Montchrestien, 2006) no 923.

proceedings (article L623-13 of the Commercial Code). But it will then be necessary to pay the future rentals promptly. In the same spirit, article L624-16, paragraph 4 of the Commercial Code allows an action for recovery by a seller using a retention-of-title clause to be defeated by immediate payment of the price on the basis of an authorisation by the insolvency judge. However, clearly, because of this immediate payment, the seller on credit has in fact escaped the uniform treatment aimed at by collective proceedings.

Consequently the true situation may be disappointing. By way of illustration we may take the example of an enterprise which has financed its capital goods, even its immovables, by leasing. Its stocks have been purchased by means of sale on retention-of-title terms. It has disposed of its book debts by means of Dailly assignments as collateral security. What assets remain available on the date of the judgment commencing the proceedings? The rule staying individual actions loses all its force. And the adoption of a protection plan is obviously pure fantasy.

In that context, the introduction of the trust into French law is especially significant. Its ability to receive property of any kind, when hitherto there have been only specific techniques applying to certain categories, demonstrates the extent of the threat it poses to the effectiveness of collective proceedings. Even now the courts remain uncertain as to the relationship between protection and the trust: is the plan effective as against the beneficiary? Can a committee of creditors require the beneficiary's claim to be reduced or to be converted into capital? (article L626-30 of the Commercial Code) Does the adoption of the plan preclude realisation of the beneficiary's rights, ie fulfilment by the trustee of his contractual obligations?³³ The fact that all these questions may arise is in itself revealing: the reform of collective proceedings and the adoption of the trust have been pursued separately, without mutual consideration and without regard to consistency.³⁴

Greater attention to examples from comparative law would have made it possible to avoid these defects. In US law, the automatic stay brought about by the opening of the reorganisation proceedings provided for by Chapter 11 affects all creditors with a security interest.³⁵ In English law (if the insol-

³³ On these various points, see the studies by R Dammann and G Podeur, 'Les sûretés-propriété face au plan de sauvegarde' [2008] *Recueil Dalloz* 928; F-X Lucas and M Sénéchal, 'Fiducie vs sauvegarde: fiducie ou sauvegarde, il faut choisir' [2008] *Recueil Dalloz* 29.

³⁴ Things could change with the draft ordinance, submitted for public consultation on 27 March 2008, which aims to amend (already) the Act of 26 July 2005. In particular, it has been proposed to add to the Commercial Code an art L622-23-1 which would provide as follows: 'notwithstanding any clause to the contrary, no assignment or transfer of rights present in the trust assets shall take place in favour of the trustee or a third party, on pain of nullity, by reason only of the opening of the proceedings or the adoption of the plan in relation to the debtor creating the trust or by reason of the debtor's failure to pay a claim arising prior to the judgment opening the proceedings'. The pendulum seems to be swinging back towards the supremacy of collective proceedings.

³⁵ 11 USC s 362(a).

veny proceedings take the form of administration) and in German law (since the *Insolvenzordnung* of 1999) the stay of actions extends also to forms of security interest.³⁶ The main defect of the French system is undoubtedly that it does not want, or does not know what, to choose: on the one hand, the rescue of enterprises is regarded as an object in itself; on the other, an obliging ear is turned to the claims of certain creditors. If the aim of reorganising businesses was once again given a reasonable foundation (to obtain better treatment of liabilities than in a straight-forward winding-up), it would no doubt be easier to bring creditors with security interests back into the fold of the law of collective proceedings.

(b) Legitimacy

The favourable treatment of certain creditors in the context of financial transactions calls for assessment. The reason put forward to justify setting aside the law of collective proceedings is the prevention of systemic risk. This is very clearly expressed in the Community legislature. For example, the preamble to the Collateral Directive observes that,

Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems constituted a milestone in establishing a sound legal framework for payment and securities settlement systems³⁷

and goes on to state that,

in order to improve the legal certainty of financial collateral arrangements, Member States should ensure that certain provisions of insolvency law do not apply to such arrangements, in particular, those that would inhibit the effective realisation of financial collateral or cast doubt on the validity of current techniques.³⁸

It must be determined whether this explanation is actually convincing or whether it conceals, at least in some cases, reasons that relate more to present circumstances.

In actual fact, it is necessary to make a distinction. Where a transaction is carried out between two regulated persons, it can hardly be denied that there is a systemic risk because the two parties are components of the financial system. Default by one of them in fulfilling its obligations is immediately prejudicial to the other, and chain reactions are to be feared. It can then be accepted that arrangements for netting, as well as collateral agreements, are useful, and their effectiveness can be improved by ensuring

³⁶ R Dammann, 'Réflexions sur la réforme du droit des sûretés au regard du droit des procédures collectives' [2005] *Recueil Dalloz* 2447, esp 2451–2.

³⁷ Recital 1.

³⁸ Recital 5.

that the ordinary rules of the law of collective proceedings do not apply to them. On the other hand, where an agreement is made between a regulated person and an unregulated legal person (a commercial company governed by the general law), the justification is less persuasive as the systemic risk may or may not exist. Everything depends on the circumstances: the size of the company in question, the amount of the liabilities undertaken, the number of transactions concluded. It does not appear justifiable that the mere fact of being a banker (or insurer or provider of investment services) should entail the application of privileged rules on the pretext of belonging to the finance industry. As was very properly observed in a recent doctoral thesis:

under the cover of measures against systemic risk, and in the absence of truly substantive international harmonisation of insolvency law, these are English concepts, traditionally favourable to creditors of a debtor in difficulty, which have penetrated our law. Although the French legislature may not necessarily be aware of it, they confront it with a question of principle: can the law of insolvency proceedings remain based on the objective of the debtor's reorganisation and the principle of equality among creditors?³⁹

Furthermore, for the present context, in relations between a regulated person and an unregulated legal person, French law reserves preferential treatment for transactions in financial instruments. Ordinary loans are not eligible for it. However, on the one hand, financial operations are sometimes effected by means of derivatives, particularly in the form of prepaid futures contracts. For the bank, the aim is to bring itself within the ambit of article L431-7 of the Monetary and Financial Code, to escape the law of collective proceedings and, consequently, to make savings in its statutory capital and reserves. The Banking Commission does not appear to be concerned by this. On the other hand, proposals for the reform of the Monetary and Financial Code were published by the Directorate General of the Treasury and submitted for the opinion of professionals, which would amount to the partial opt-out decided upon when Directive 2002/47/EC was implemented in national law. In that situation, certain security interests taken to ensure performance of the borrower's obligations arising from bank loans to an ordinary enterprise would be removed from the ambit of the law of collective proceedings, both for their provision and their realisation. Obviously there can be no question of pleading systemic risk to justify such arrangements. The truth is that it is a matter of giving French banks a competitive advantage in international competition, even at the price of sacrificing the interests promoted by the law of businesses in difficulty.

³⁹ A Gaudemet, *Contribution à l'étude juridique des dérivés* (Doctoral thesis, Université de Paris II 2008) no 561. See also Ch Boillot, 'Droit bancaire et financier et droit des procédures collectives: exception ou contradiction?' [2003] *Recueil Dalloz* 2748.

V. CONCLUDING REMARKS

All of this results in a feeling of disquiet. The exclusion in law of certain creditors (quite a number, in fact) from collective proceedings reveals the dichotomy arising from profoundly contradictory forces. Laws are drawn up in different places (the Community institutions, the Ministry for the Economy and Finance, the Ministry of Justice) which to a certain extent ignore each other in their respective work. What is missing is an overall vision which would make it possible, with full knowledge of the facts, to arbitrate between them.

*How Do the Courts Choose between Different Bankruptcy Outcomes? The Results of a French Survey**

RÉGIS BLAZY, BETRAND CHOPARD, AGNÈS FIMAYER
and JEAN-DANIEL GUIGOU

I. INTRODUCTION

OVER THE PAST two decades, bankruptcy codes have tended to shift towards more pro-debtor legislation. This is particularly true in Europe, where some of the main players—initially known for having pro-creditor systems—have adopted a number of legal reforms introducing more debtor-friendly rules. In particular, the United Kingdom (common law) and Germany (German civil law) have implemented major reforms that go to some extent in such a direction. In the UK, Part 10 of the Enterprise Act (2002) specified new objectives of the law: ‘to facilitate company rescue’ and to ‘produce better returns for creditors as a whole’. In addition, since 2003, the former UK process of receivership (a bank-friendly procedure allowing a creditor—generally a bank—in possession of a floating charge to appoint a receiver to protect his/her own interests) no longer exists. In Germany, a similar trend can be observed in the new bankruptcy code, *Insolvenzordnung* (1994), which was implemented on 1 January 1999. While the German legislation still prioritises the repayment of creditors, the new code sets an additional derogatory procedure (*Insolvenzplan*), allowing for the continuation of activity: liquidation is no longer the sole possible outcome, provided the value of the debtor’s assets exceeds the bankruptcy costs. Overall, even if debtors are less protected in these countries than in France, a country that adopted a pro-debtor view as long ago as 1967, this trend reflects to some extent the legislators’ willing-

* This article sums up the main results of a wider research paper: CREFI-LSF working paper no 0702: ‘Financial vs Social Efficiency of Corporate Bankruptcy Law’. This study was financed by OSEO (CDC IXIS) and Fonds National de la Recherche. Any remaining errors are ours.

ness to use bankruptcy as a tool to protect businesses and employment. Indeed, even if continuation may not reward creditors as much as liquidation, the pursuit of activity should preserve more human resources than piecemeal liquidation.¹

From that perspective, the French law is instructive as it explicitly aims at saving bankrupt firms in order to protect employment. First, article 1 of the 1985 and 1994 French bankruptcy codes explicitly orders the various objectives of the law as: (i) 'safeguarding the business', then (ii) 'maintaining the firm's operations', and finally (iii) 'discharging liabilities'.² Secondly, the decision-making process is fully centralised, as the commercial court has genuine enforcement power during the collective process: the bankruptcy judge decides the adoption of the reorganisation plan (there is no voting procedure or veto power for stakeholders). Thirdly, French legislation offers the stakeholders a specific procedure dedicated to selling a business as a going concern, as an alternative way of restructuring businesses.³ Finally, since 1994, the French legal framework of bankruptcy has been aimed trying to prevent bankruptcy: this is coherent with article 1 of the French law, which prioritises the safeguarding of firms. In practice, the initiation of alert procedures has been facilitated since 1994 and some courts (especially in Paris) have implemented prevention units (*cellules de prévention-détection*) that aim to audit a firm's managers when the court receives signals of difficulties. These specificities reflect a voluntary legal bias in favour of the outcome that saves the most employees (*social efficiency*), rather than favouring the outcome which maximises the value of the firm, ie the sum of the market values of all claims (*financial efficiency*).

There are two major means of protecting specific stakeholders. Either the law settles peculiar rules of collective decision-making (by vote), or grants some enforcement power to the court. When a vote applies, the respective weights given to the different stakeholders and/or the possible deviations from the absolute priority order indirectly give some priority to the final outcome (ie liquidation versus continuation), as they determine

¹ Yet, this trend does not mean the number of continuations is getting higher, compared to liquidations. On the contrary, in the UK, Germany and France, bankruptcy procedures end up with liquidation in more than 90 per cent of cases. However, the quite recent change in the objectives of national laws means the institutional environment of default is evolving, which may finally affect the strategies, taking place in or out bankruptcy.

² RF Weber, 'Can the Sauvegarde Reform Save French Bankruptcy Law? A Comparative Look at Chapter 11 and French Bankruptcy Law from an Agency Cost Perspective' (2005) 27 *Michigan Journal of International Law* 257 explores the effects of this French legal priority set on agency problems between bankrupt firms and their debt holders. Weber argues that French firms have little incentive to file for bankruptcy, due to the court-administered process and the civil and criminal sanctions associated with bankruptcy.

³ Since 2006, the sale as a going concern is viewed as more than a liquidation procedure. However, in our view, sales protect more employment than pure liquidations, as some jobs are saved through sales.

the identity of the residual claimant.⁴ When the court is entitled to enforce a solution, as in France, the orientation given by the law is of great importance, as this may affect the whole post-default renegotiation process. Yet, whatever the ways of the decision-making, the adoption of a pro-debtor system (or, at least a shift toward it) stems from a trade-off between the capacity of the law to promote business continuations, and the global cost incurred by the creditors, who finally have to bear the financial cost of such continuations. From that perspective, two questions should be addressed: (1) How can a pro-debtor law practically implement more continuations, in order to increase social efficiency? (2) Does the bias in favour of continuation result in a financial cost to the creditors as a whole, so that financial efficiency is reduced?

In this chapter, we aim to give some elements of answers to these two questions, exploring a unique sample of 1,004 French bankruptcy files: 230 individual data per file were manually collected from the Parisian courts for the years 1989–2005. Our aim is to provide a benchmark for discussions of the relative merits/drawbacks of such a strong pro-debtor model. Regarding question 1, we test whether the hierarchy of objectives set by the French bankruptcy code decisively influences the activities of the commercial courts, since liquidation, reorganisation and sale as a going concern are wholly controlled by them. Regarding question 2, we focus on a set of rival buyout offers on sales as a going concern, and directly test the courts' trade-off between both kinds of efficiencies. Our main findings can be summarised as follows. First, when analysing the courts' decision-making, it appears that French commercial courts do work to promote continuation, and thus actively improve social efficiency (compared to liquidation, continuation remains the best way to preserve employment, partially or otherwise). Secondly, we find that courts operate under severe constraints (ie the initial characteristics of bankrupt firms), which have been reduced by the development of prevention since the legal reform of 1994. Thirdly, contrary to expectation about such a debtor-friendly system, we find that this orientation of bankruptcy law does not imply a severe cost for the pool of creditors, especially in reorganisation cases (however, this conclusion does not hold for sales as a going concern, since both liquidations and sales generate similar levels of debt recovery). Fourthly, focusing on sales as a going concern, we provide some empirical evidence that the protection of employment acts as a guide to discriminate between rival offers: for these, the court effectively makes a trade-off between social and financial efficiencies.

The chapter is organised as follows. Section I describes the dataset and discusses summary statistics. Section II provides a model of the determi-

⁴ R Blazy and B Chopard, 'Ex Post Efficiency of Bankruptcy Procedures: A General Normative Framework' (2004) 24(4) *International Review of Law and Economics* 447–71.

nants of the courts' decisions regarding the final outcome of bankruptcy (reorganisation, sale as a going concern or liquidation). Section III examines the financial cost of the bias in favour of continuation, focusing first on the levels of recovery rates, and second, on the courts' choices between rival offers in cases of sale as a going concern. The last section presents our conclusions.

II. DATA, METHODOLOGY, AND STATISTICS

We have shown elsewhere that few previous empirical studies have looked closely at the determinants of commercial court decisions between the competing outcomes of corporate financial distress.⁵ In this chapter, we gather both pre-default variables (eg coverage rate, economic value of assets or cause(s) of default) and post-default variables (such as measures engaged by the court). This helps in understanding the *ex ante* and *ex post* factors which impact on the outcome of bankruptcy procedures in a pro-debtor country such as France. In addition, our large dataset drawn from the period 1989–2005 allows us to highlight the impact of the 1994 legal reform (which we interpret as the development of prevention among financially distressed firms) on the courts' decision making and on global recoveries. Last, we explore, for the first time, how such a court-administered process may discriminate between rival offers in the case of sales as a going concern.

(a) Data and Methodology

The French bankruptcy code involves two complementary court-administered procedures: continuation—either through a reorganisation plan or sale as a going concern—and piecemeal liquidation: Appendix 1 presents an overview of the two relevant pieces of French legislation, ie the law of 25 January 1985, and the subsequent reform of 10 June 1994.⁶ In this chapter, we split our cases into two sub-samples, covering the periods 1989–1994 (1985 legislation) and 1995–2005 (1994 legislation), to take into account the 1994 reform of bankruptcy law, and to evaluate the effect of this change. We expect that firms which filed for bankruptcy after the 1994 reform are more likely to be worth saving, because commercial courts—especially in Paris—have increased prevention since 1994 (via an

⁵ R Blazy, B Chopard, A Fimayer and JD Guigou, 'Financial vs Social Efficiency of Corporate Bankruptcy Law', CREFI-LSF working paper no 0702/2008.

⁶ In January 2006, French bankruptcy law was changed to allow for easier bankruptcy filings. However, as the data are not available yet to cover this most recent reform, we focus on the period prior to 2006.

extension of alert procedures and the implementation of several prevention units).

We assembled a unique database of 1,004 French corporate bankruptcy filings over the period 1989–2005: 716 filings under the 1985 bankruptcy law (1989–1994), and 288 filings under the 1994 bankruptcy law (1995–2005). Specifically, we manually collected information from several documents (230 data per file): the bankruptcy declaration form, the court's decision and motivations, the list of claims, and the financial-economic administrator's report on the bankrupt firm.⁷ The data were entered onto a specific template whose general form is described in Appendix 2. We restricted our study to Parisian courts because of the quality and reliability of data, the ease of collection availability, and especially the greater capacity of these courts to develop prevention through out-of-court settlements: since the 1994 reform of bankruptcy law, the Parisian courts were the first to set up prevention units (*cellules de prévention-détection*) which aim to audit a firm's managers when the court receives clear signals of economic/financial difficulties. To evaluate this selection bias, we verified that the characteristics of our sample do not differ significantly from national figures, in several ways (see Appendix 2, Table A1). First, the percentages of various outcomes of bankruptcies do not differ from the national averages (liquidations are more than 90 per cent on average⁸). Secondly, the sectors in which bankruptcy firms perform and the bankruptcy rates in our sample are quite similar to the national figures. Finally, when focusing on the firms' legal form, both populations have a similar structure.

The first step in constructing the database was to exclude agricultural and financial firms which depend on a specific bankruptcy code, and to keep only closed bankruptcy affairs (only closed procedures allow us to compute final creditors' recovery rates). This reduced the sample to 858 bankrupt firms (596 before 1994; 262 after 1994). We chose also to increase the proportion of continuations (ie reorganisations and sales) up to 40 per cent of all procedures, in order to obtain a more balanced dataset compared to the structure of the population, which exhibits a deep imbalance between continuations and liquidations.⁹ Among continuations, we used the SIRENE database of INSEE (the French National Institute of Statistics) to identify firms whose reorganisation failed and consequently

⁷ The French original of these documents reads: 'déclaration de cessation des paiements, extrait Kbis, jugement d'ouverture de la procédure de redressement judiciaire, extraits des jugements modificatifs et jugement définitif sur le sort de l'entreprise, bilan économique et social (rédigé par l'administrateur judiciaire), requêtes auprès du juge commissaire ainsi que les réponses de celui-ci (ordonnances), états des créances, rapports L13'.

⁸ Other European countries show a similar imbalance between continuations and liquidations.

⁹ When computing total statistics, we weighted the figures relative to each outcome in order to have a level of 90 per cent of liquidations and 10 per cent for continuations (sources: INSEE and BODACC).

ended up in liquidation. Thus, our recovery rates take into account the probability of success of reorganisation plans.¹⁰ Since these plans last for several years (seven years on average), we used the risk-free interest rate of the Treasury to discount the recovery amounts at the time of the court's decision. Finally, in France, some peculiar claims can be repaid out of the collective procedure; this is restricted to the providers of goods/merchandise, provided their contractual relations with the firm refer explicitly to such protection.¹¹

For each bankruptcy filing, we gathered data about the firm's economic and financial difficulties, the causes of default (51 codes: see Appendix 2), the measures taken by the courts (33 codes: see Appendix 2), the outcome of the financial distress (we distinguish between reorganisation, sale as a going concern, immediate liquidation and liquidation after an observation period), the verified characteristics of the buyout proposals (sales) and the amounts recovered by each class of claimants according to their legal priority: (1) employee's *superprivilège*, (2) new money, (3) secured creditors (state and social claims, collaterals) and (4) unsecured creditors (for details on our data, see Appendix 3, Tables A2 and A3).

(b) Statistics, Terminology and Sample Structure

The sample firms cover a large cross-section of sectors (from 12 to 23 per cent in the commercial sector, 23 to 34 per cent in industry, and 44 to 55 per cent for services¹²); most firms have limited liability. To estimate the shortage of liquid assets and to compare the market value of assets and the face value of due claims, we used two complementary variables: (1) the variable '*assets minus claims*' measures the market estimated value of total liquid assets minus the total verified due claims; (2) the variable '*coverage rate*' is the ratio of the market value of all assets—estimated at the date of triggering—to the total of all due verified claims. The length of the procedure gives the number of months between the triggering of the bankruptcy procedure and the court's final decision.¹³ Finally, since we did not collect any direct information on the level of bankruptcy costs, we estimated them from the legal remunerations of bankruptcy practitioners, defined by the French regulation no 85-1390 (law of 27 December 1985) which explicitly relates these remunerations to the size of the firm and the

¹⁰ For sale as a going concern, we did not investigate whether those firms went bankrupt again later. In such cases, all debts come due when the bankrupt firm is sold.

¹¹ These peculiar privileges are *droit de revendication* and *droit de rétention*.

¹² These figures are for the period 1985–94. The percentages over the period 1994–2005 are 18.7 per cent for the commercial sector, 27.1 per cent for industry and 54.2 per cent for services.

¹³ We do not take into account the period, after the court's decision, during which assets are liquidated (which may take several months).

Table 1. Summary statistics and sample structure

Averages and averages of ratios	Sale	Reorganisation	Immediate liquidation	Liquidation after observation	Sale	Reorganisation	Immediate liquidation	Liquidation after observation
Sample: Bankruptcy Law 25 January 1985: 596 observations								
No. of observations (sample by issues)	102	88	320	86	88	74	80	20
–Limited responsibility	91.9%	86.0%	88.2%	86.3%	87.5%	86.8%	96.3%	92.0%
–Other legal forms	8.1%	14.0%	11.8%	13.7%	12.5%	13.3%	3.7%	8.0%
–Commerce	22.6%	13.0%	23.6%	22.1%	21.6%	21.7%	20.7%	12.0%
–Industry	25.8%	34.0%	32.7%	30.5%	25.0%	22.9%	24.4%	32.0%
–Services	51.6%	53.0%	43.7%	47.4%	53.4%	55.4%	54.9%	56.0%
No. of employees	31.7	11.6 (2)	3.5 (28)	12.3 (6)	37.2	11.0	7.4	30.0
Assets minus claims (economic values, €000)	–3,259 (63)	–975 (65)	–295 (101)	–2,666 (38)	–2,022 (11)	–566 (5)	–354 (11)	–2,564 (7)
Coverage rate	36.1%	70.3%	16.3%	24.4%	50.1%	55.1%	37.3%	46.2%
Length of the procedure (months)	6.9	13.9 (1)	0.1 (25)	6.5 (4)	8.7 (2)	15.5	0.0 (24)	9.6
Direct bankruptcy costs/recovered amounts	3.4% (44)	19.1% (48)	2.8% (64)	3.6% (20)	10.0%	14.3%	14.0%	9.8%

Figures in parentheses are the number of missing values.

outcome of the bankruptcy process.¹⁴ Table 1 compares the legal outcomes: reorganisations, sales and liquidations.

Upon comparing the samples from before and after the 1994 reform, we observe a slight increase in the length of procedures and bankruptcy costs, when commercial courts increased prevention during the same period. This also reflects a recent rise in the average size of firms (measured by the number of employees). In addition, reorganisations take much time and generate higher bankruptcy costs. In contrast, firms which are immediately liquidated present the lowest values for coverage rates. The best-performing bankrupt firms, according to their coverage rates, carry on through reorganisations, whereas sale as a going concern is concentrated on the largest firms (measured by turnover and number of employees), probably due to their reputation. Finally, Table 1 suggests that decision-making in commercial courts is strongly influenced by the firms' initial characteristics. During the post-1994 period, there has been a significant reduction in the gap between the coverage rates for each outcome of the bankruptcy process. We interpret this change as a consequence of the increase in prevention by commercial courts; after 1994, the importance of financial distress is more uniform between firms when entering the procedure.

III. DO THE COURTS PROMOTE CONTINUATION?

Our main hypothesis is that French commercial courts are biased in favour of those outcomes which better maintain activity, in order to preserve employment.¹⁵ We study how this objective is reflected in the probability of reorganisation or the probability of sale as a going concern, compared to the firm's liquidation. Initially, we determine: (1) which variables drive the bankruptcy courts' decisions about the three issues of default (reorganisation, sale as a going concern and liquidation), and (2) the constraints under which commercial courts operate when they make their decision. More specifically, we measure to what extent the way the courts manage bankruptcy significantly increases the likelihood of continuation. We estimate a multinomial LOGIT regression on two samples of firms which went bankrupt either under the legislation of 25 January 1985 (557 companies) or that of 10 June 1994 (267 companies). The explained variable is

¹⁴ We used the ratio (direct bankruptcy cost/recovered amounts), where recovered amounts are based on the liquidation proceeds, the sale price or the schedule of repayments in reorganisation cases.

¹⁵ Recall that article 1 of French bankruptcy law has since 1985 prioritised the safeguarding the business, then maintaining the firm's activity and employment, and finally the discharging of liabilities.

the probability that a firm, following the court's decision, falls into a reorganisation procedure, is sold as a going concern or is liquidated.

To model the court's decision under constraint,¹⁶ we use a first set of *ex ante* explanatory variables, in the sense they describe the firm's initial situation, and thus constrain the court's choice between continuation and liquidation. This set covers:

1. *The financial situation of the firm when it enters bankruptcy*: the coverage rate (defined as the market value¹⁷ of assets relative to the debts), the amount¹⁸ of claims and the debt structure (the absolute priority rule distinguishes between claims with super-priority status (recent unpaid wages, less than two months), claims with a general privilege status (employees, tax authorities and bankruptcy costs), claims with a special privilege status (secured claims with collateral), and junior claims).
2. *The cause(s) of default*: see Appendix 2: 51 codes of default were gathered into seven groups (*outlets, strategy, production, finance, management, accident, external environment*).
3. *The firm's size*: ie the number of employees (log), which is a key factor likely to affect the courts' willingness to preserve employment.¹⁹
4. *The sector, the legal form and the firm's age*.

We consider also a set of *ex post* variables, which describe the court's management during the procedure. These variables cover the various measures the courts may undertake or allow (Appendix 2 provides a list of the 33 codes we use regarding these measures). This set of measures is a useful proxy of the court's efforts to prepare and promote continuation. Among them, we distinguish between 'connected measures' and those which are not connected.²⁰ Measures are said to be *connected* when they are of same nature as the cause of default (eg the legal administrator may have engaged measures related to *outlets*, when the original cause of default was, partially or not, due to a fall of *outlets*). This distinction between connected and unconnected measures helps in understanding to what extent the court's management is complementary (or not) to the origin of default. Last, we recognise a third kind of measure, namely 'legal measures'. These

¹⁶ For instance, the probability of sale as a going concern depends strongly on both a demand-side constraint (the existence of a potential buyer for the firm's assets) and an offer-side constraint (the present value of its assets).

¹⁷ This value is computed and verified during the procedure by the representative of creditors.

¹⁸ It is more likely that courts take into account the levels of the different claims rather than their relative structure.

¹⁹ Employees are both an *ex ante* constraint and a variable that may affect the courts' *ex post* decision.

²⁰ By analysing the number of connected and of unconnected measures (whatever their type), we reduce the risk of colinearity between the causes of default and the engaged measures.

are specific to the French bankruptcy code and are related to the ability of the courts to enforce the maintenance of peculiar contracts (electricity, furniture, etc).

Table 2 presents the results of a multivariate LOGIT regression analysis. We report the estimated coefficients for reorganisation and sale as a going concern, relative to liquidation. Our hypothesis of the influence of article 1 of French law on court decisions is supported by the data. As predicted, by controlling for firm-level characteristics, commercial courts work to promote continuation in order to maintain employment. The number of both connected and unconnected measures—which reflect the restructuring efforts of commercial courts to promote continuation—have a large, positive and statistically significant effect on the probability of continuation, over the probability of liquidation.²¹ Referring to the first question we address in this chapter, we find that the French courts effectively play a core role in facilitating reorganisation plans and sales as a going concern, hence increasing social efficiency through a higher probability of continuation.

Economic and financial *ex ante* constraints also play a crucial role in the court's decision-making. In other words, even if the efforts of commercial courts in favour of continuation have an effect on the outcome of bankruptcy, other factors predetermine this outcome. First, the probability of sale as a going concern strongly depends on the buyout offers: these are strongly linked to the size of the firm (proxied here by the number of employees). Second, the probability of continuation (either through reorganisation or sale) mainly depends on the firm's initial characteristics, ie the economic value of its assets relative to its debts (see coverage rate), its age, or its capacity to pay wages (see level of claims with a super-priority status).

Bankruptcy law may also have an effect on these constraints through efforts toward prevention. Indeed, the accrued prevention since 1994 has involved two major changes. First, the probability of continuation (especially for reorganisation plans) is less negatively influenced by internal factors (outlets, production) and more by external factors (accident, external environment): this reflects that default is less due to faulty management now prevention is reinforced. Secondly, after 1994, the coverage rate does not impact on the probability of continuation (it was significantly negative before 1994): thanks to prevention, the initial financial situation of the firm no longer predetermines the final outcome. These findings show that earlier resolution of financial distresses, due to efforts in prevention, has significantly strengthened the value of bankrupt firms. In other words, the

²¹ The causes of financial distress (and the sector in which the firm performs) help little in explaining the court's decision. This reflects the low difference between bankrupt firms apart from their level of debt outstanding and their coverage rate.

Table 2. Estimates of outcomes of bankruptcy process

Variables:	Legislation 25 January 1985 (557 companies)		Legislation 10 June 1994 (267 companies)	
	Sales	Reorganisations	Sales	Reorganisations
	Estimation	Estimation	Estimation	Estimation
Constant	-7.3682***	-9.2272***	-3.8693***	-2.965***
No. cause(s) of default: outlets	-0.4589**	-0.5513*	0.0560	-0.256
No. cause(s) of default: strategy	-0.5952	-0.4282	0.1708	0.2469
No. cause(s) of default: production	0.0963	0.8530**	-0.0831	-0.1341
No. cause(s) of default: finance	0.2266	-0.3347	0.1875	-0.0247
No. cause(s) of default: management	0.1129	0.3804	0.4459	-0.0595
No. cause(s) of default: accident	-0.2697	-0.0890	0.5174	0.7576*
No. cause(s) default: external environment	-0.4422	-0.3721	0.2533	0.8111**
No. of connected measure(s)	0.5069**	0.9878***	0.1334	0.8145**
No. of unconnected measure(s)	0.9231***	1.7598***	1.0005**	1.4746***
No. of legal measure(s) (enforcements...)	0.8623	0.0978	-1.8322	-2.4100*
Suspicion period declared (cf. suspicion of tricks)	-0.9121***	-0.5624*	0.0822	-0.0327
Coverage rate (economic value of assets/debts)	2.2373***	6.1739***	-0.0180	0.8335
Legal form: limited responsibility	-0.4291	-0.4819	-0.7823**	-0.1029
Sector: commercial business (ref. industry)	-0.1292	-1.2518***	-0.1905	-0.3549
Sector: services (ref. industry)	0.2981	0.6213**	0.3401	0.1941
Ln(firm's age)	0.8789***	1.2828***	0.4936**	0.2097
Ln(employees)	0.5800***	-0.1457	0.9287***	0.1035
Ln(debts: "superprivilege") (=recent unpaid wages)"	-0.0402	0.0804	-0.7465***	-0.8737***
Ln(debts: secured claims: collaterals)	0.1486*	-0.1868	0.0830	0.1095
Ln(debts: secured claims: state & employees)	0.2751***	0.1648	0.1045	0.2931
Ln(debts: unsecured claims)	0.2549**	0.2787**	0.4383***	0.2868**
Multinomial independent LOGIT regression	Test	χ^2	Test	χ^2
	Likelihood ratio	542.82	Likelihood ratio	182.53
	Score	462.95	Score	150.87
	Wald	187.29	Wald	101.62

NB: This table sets out the results of LOGIT regression of the determinants of the type of continuation (either reorganisation or sale as a going concern) upon the eventual decision to liquidate the firm piecemeal. We distinguish financially distressed firms which filed for bankruptcy before and since 1994. In both samples, the dependent variables are the probabilities of sale and of reorganisation relative to the probability of liquidation. Coefficients significant at the 1, 5 and 10 per cent levels are indicated by ***, ** and *, respectively.

probability of continuation is not only influenced by the way the courts manage bankruptcy, but also by the prevention policy which applies before any default.

To summarise, we find indications that French commercial courts actively seek to promote continuation during the bankruptcy process. Yet, this action is subject to severe external constraints, which the development of prevention, initiated by the legal reform of 1994, has successfully reduced.

IV. DO THE COURTS ARBITRATE BETWEEN SOCIAL AND FINANCIAL EFFICIENCIES?

The relation between the various options in French bankruptcy procedures and the global recovery rate is of interest, because it links the work of commercial courts constrained by article 10 of French law (promoting the protection of employment), with the potential cost (the ‘price’) of this policy on the global recovery rate.²²

To consider the financial cost of social efficiency, we propose two complementary approaches. In Section IV(a), we firstly compute analysis of variance (ANOVA) tests on the averages of recovery rates for each possible course (immediate liquidation, liquidation after an observation period, reorganisation and sale as a going concern) in order to compare the different average recovery rates for each course, and to test whether these averages differ significantly between the courses of action. If the global recovery rates are significantly lower (respectively higher) for continuations than for liquidations, we can infer that the protection of social efficiency—through a preference for continuations—*may* have an absolute cost (respectively gain) in terms of *ex post* financial efficiency. Yet, the ANOVA approach suffers from one drawback: it compares two different populations of firms (ie continued and liquidated firms), whereas analysing financial efficiency would require comparing alternative values (liquidation and continuation values) for *the same* firm. Thus, we extend our analysis in Section IV(b), focusing on the arbitration between social and financial efficiencies: we use rival buyout proposals on sales as a going concern. As each proposal is assessed by a legal administrator before the court selects an offer, we are able to detect which characteristics the judges prioritise when comparing alternative projects (and values) for the same bankrupt firm.

²² We consider that bankruptcy courts maximise the joint welfare of various stakeholders.

(a) The Differences Between Average Recovery Rates

Table 3 shows the structure of claims and the recovery rates for each class of creditors. Higher levels of unsecured liabilities are related to smaller global recovery rates. This seems natural, as junior claimants have lower recovery rates than other stakeholders due to their ranking under the French absolute priority rule. New money (ie claims arising after the bankruptcy triggering) also plays a specific role: new creditors recover as much as (or more than) the average. This fact has led to severe criticism of the French law—in particular, bankers saw this highest priority of new money over previously secured creditors as a threat to collateralisation. This is why the legislator modified the law in 1994, giving higher priority to long-term secured claims over new money (in cases of liquidation). In our opinion, this debate is of minor importance, because we find that new money is marginal when reported on the total of claims (from 0 up to 5.6 per cent); in fact, most post-default payments are paid in cash.

The crucial question is whether the maintenance of social efficiency involves a loss of financial efficiency. This *may* happen if recovery rates are significantly lower for continuations than for liquidations. The differences observed between global recovery rates in reorganisation and liquidation cases (between 66 and 74 per cent for continuations, and between 12 and 26 per cent for liquidations²³) now indicate that bankruptcy courts accurately classify firms as economically efficient versus inefficient when they approve continuation through reorganisation. At this level, we do not find empirical evidence of a trade-off between social efficiency and financial efficiency; in fact the best way to continue the firm's operations (ie reorganisation) also exhibits the largest average recovery rate. In contrast, the difference in recovery rates in reorganisation versus sale as a going concern is sufficiently large (nearly 50 points) to conclude that continuation through sales achieves a lower level of *ex post* financial efficiency, but not worse than for liquidations.

These primary results must be completed by a deeper analysis, presented in the following section, focusing more directly on the trade-off between the social and financial consequences of the courts' decision.

²³ The figures for the later period take higher values than in the first period. Indeed, due to the development of prevention procedures to force financially distressed firms to file earlier for bankruptcy or to promote out-of-court negotiation (such as *règlement amiable*), recovery rates in reorganisation and liquidation are much higher. For sales as a going concern, however, we find the opposite effect.

Table 3. Structure of claims and average recovery rates

Part A Claims (structure)	Sample: Bankruptcy Law 25 January 1985					Sample: Bankruptcy Law 10 June 1994				
	Sale	Reorgan- isation	Immediate liquidation	Liquidation after observation	ANOVA test: Fisher statistic	Sale	Reorgan- isation	Immediate liquidation	Liquidation after observation	ANOVA test: Fisher statistic
Employer's "superprivilege"	2.4%	4.3%	3.1%	1.7%	1.62	4.1%	3.9%	15.8%	15.3%	27.57***
New money	0.0%	5.6%	0.0%	0.0%	22.10***	4.2%	0.4%	0.0%	3.2%	13.71***
State & employees	15.4%	19.7%	10.1%	9.3%	4.70***	29.6%	32.2%	42.0%	44.3%	4.84***
Collaterals	29.6%	19.3%	37.9%	35.3%	9.60***	12.3%	19.6%	8.0%	6.4%	4.05***
Unsecured	52.6%	51.1%	48.8%	53.6%	0.87	50.4%	44.0%	34.2%	30.9%	6.31***

Part B Recovery rates (average of ratios)	Sample: Bankruptcy Law 25 January 1985: 596 observations						Sample: Bankruptcy Law 10 June 1994: 262 observations					
	Sale	Reorgan-isation	Immediate liquidation	Liquidation after observation	Total (weighted)	ANOVA test: Fisher statistic	Sale	Reorgan-isation	Immediate liquidation	Liquidation after observation	Total (weighted)	ANOVA test: Fisher statistic
Employer's "super-privilege"	88.2%	89.8%	57.8%	80.4%	60.2%	3.92**	84.5%	91.3%	75.0%	74.2%	75.4%	3.44**
New money	NS	73.2%	NS	NS	NS	–	60.7%	NS	NS	25.0%	NS	–
Secured (all)	44.2%	64.6%	19.2%	27.1%	20.1%	12.90***	31.0%	73.4%	19.5%	28.8%	21.6%	18.31***
–State & employees	41.8%	63.0%	23.0%	25.4%	24.1%	13.01***	30.7%	73.7%	15.3%	28.2%	17.8%	22.19***
–Collaterals	42.5%	63.9%	17.7%	29.3%	18.8%	11.13***	35.0%	72.0%	36.0%	50.0%	38.0%	13.64***
Unsecured	10.5%	64.5%	5.1%	6.8%	5.7%	43.66***	6.2%	72.1%	2.5%	6.2%	4.9%	286.12***
Total	24.0%	65.7%	12.1%	16.2%	12.9%	16.67***	23.9%	73.8%	23.5%	26.0%	24.9%	65.91***

NB: Part A gives the structure of various claims. Creditors are ordered according to their level of priority: claims with a super priority status → post filing priority claims → claims with a privilege status → secured claims → junior claims. Part B provides the recovery rates of different classes of creditor for the four possibilities: sale, reorganisation, liquidation (immediate or after a period of observation). Recovery rates are given as a percentage of the claims. In both parts, ANOVA tests are shown: averages differing significantly from one possibility to another at the 1, 5 and 10 per cent levels (Fisher statistic) are denoted ***, ** and *, respectively. NS, non-significant figures (not enough observations: less than 1 per cent of the total of claims – sample size).

(b) The Choice on Rival Sales: The Arbitration Between Social and Financial Efficiencies

Until now, we have not *directly* tested for a dilemma between social and financial efficiencies. To do so, we need a set of several rival outcomes upon which the court makes a decision, depending on the *relative* characteristics of each possible outcome. Again, we use our database to perform the test, as it contains a unique source of data on the rival buyout proposals in case of sale as a going concern. The content of these proposals is quite reliable as it directly derives from an evaluation of their pros and cons. This evaluation is made by the legal administrator in charge of the bankrupt firm. The administrator forwards the results of his audit to the court, which uses this information finally to select the winning offer. Since there may be several offers, we explore the criteria used by the court to select the winning one. We expect that commercial courts are primarily influenced by social norms such as employment protection.

If commercial courts follow the implicit hierarchy established by article 1 of the French legislation, they should promote sale propositions which are more likely to maintain employment. To consider this effect, we focus on sales that involved two or more rival buyout proposals (respectively 169 and 123 proposals for the 25 January 1985 and 10 June 1994 samples). The explained variable is the probability that a plan will be chosen by the court. The explicative variables are the plan's characteristics (either accepted or refused), as reported by the administrator.²⁴ Several indices were set up in order to standardise these characteristics. The first is the relative proposed price (out of debts), as a basis for *ex post* financial efficiency: if the courts prioritise this type of efficiency, the relative price should positively influence their choice. The second set of variables deals with the qualities of the offer, which determine the future of the bankrupt firm and its employees with a new owner (the offer 'preserves employment', the buyer is 'financially strong', 'experienced' or 'reputable'); of course, preservation of employment is of key interest since it maintains²⁵ social efficiency. We use a third set of indicators for the motivation of the offer (the expected synergy, the absorption of a competitor, the diversification of business or the increase of reputation).

Following the approach of McFadden,²⁶ we run a conditional LOGIT regression to model the court's choice between competing proposals. The

²⁴ The administrator's report (the *bilan économique et social*) is transferred to the court, for definitive decision.

²⁵ This is a commitment announced by the buyer. The buyer may not adhere to those commitments in the future (especially social ones). Such behaviour is subject to certain sanctions, especially since the 1994 reform.

²⁶ D McFadden, 'The Measurement of Urban Travel Demand' (1974) 3 *Journal of Public Economics* 303–28.

Table 4. Choice between rival offers

Variables		1985 Law (169 plans)	1994 Law (123 plans)
		Estimate	Estimate
Proposed sale price (out of owed debts)		4.6381	1.5782
Quality of the offer: preserve employment		3.3980***	1.4821**
Quality of the offer: the buyer is financially strong		0.9664	1.0101*
Quality of the offer: the buyer is unproven		0.4090	0.5952
Quality of the offer: the buyer is reputable		0.5769	-0.3687
Motive for the buyout: synergy		-0.6785	0.8334
Motive for the buyout: absorption of a competitor		0.2600	1.4057
Motive for the buyout: diversification of business		1.5646*	0.9699
Motive for the buyout: first affair		2.4629**	1.6003
Motive for the buyout: increase reputation		0.6261	-14.5353
Conditional LOGIT regression	Test	χ^2	χ^2
	Likelihood ratio	41.7545	24.4837
	Score	33.2905	21.4333
	Wald	17.3933	13.7616

NOTE. The table gives results of conditional LOGIT regression of rival offers when a firm was sold as a going concern. The dependent variable equals 1 if the judge accepts the offer and 0 if he rejects it. Coefficients significant at the 1, 5 and 10 per cent levels are indicated by ***, ** and *, respectively.

probability is equal to 1 if a proposal is accepted by the court and 0 if it is refused. Table 4 presents the regression results. We observe an interesting result: focusing on the rival buyout proposals, the probability of being selected by the court increases when the offer is likely to preserve employment. All other variables are rarely significant. We do not conclude that the proposed sale price has no effect on bankruptcy courts; rather, we suggest that commercial courts consider each bankruptcy independently and that these courts choose the proposition that will save employment at the best price. To sum up, we do not find a dilemma between the protection of employees and the repayment of creditors, as we do not observe any negative relation between the variables '*Proposed sale price (out of debts)*' and '*Quality of the offer: preserve employment*'. We rather find a *hierarchy* of objectives: social efficiency is the key elements driving the behaviour of the courts, while financial efficiency is viewed as a secondary objective.

V. CONCLUSION

In developed countries, the main goals of bankruptcy law are to restructure, or to close down if restructuring is impossible; and to provide claimants (tax authorities, employees, secured and unsecured creditors) with an absolute priority rule for debt recovery. In practice, however, many differences exist in the rules that govern bankrupt firms and in the objectives of national bankruptcy codes. In this area of comparative law, several of our conclusions show that French bankruptcy courts play a key role in preparing the prioritised outcome (continuation), and actively protect employment at the time of the choice between rival offers for sales as a going concern. More precisely, the strong correlation between the probability of continuation and the legal measures engaged by the courts demonstrate that commercial courts seek to protect employment by promoting continuation. Furthermore, the implicit rules that govern the court's choice between rival offers for the sale of bankrupt firms confirm that social considerations have an impact on the decisions of bankruptcy courts. A further key feature of this research is the determination of the financial cost deriving from this bias in favour of a specific outcome. Reorganisations generate the highest recovery rates for all classes of creditors. However, for sale as a going concern, recovery rates are inhibited by asset illiquidity or by the court's attempt to promote the firm's continuation (and also preserve employment) through sale at a low price.

Our analysis of the French bankruptcy code provides a further avenue for research on the rationale driving bankruptcy (pro-debtor versus pro-creditor systems): from that point of view, the information gathered by the courts is very useful as it helps in having an overview of all the competing interests.

APPENDICES

Appendix 1: French Bankruptcy Law

Since the bankruptcy law reforms of 25 January 1985 and 10 June 1994,²⁷ the French collective system involves two complementary court-administered procedures (see Figure A1). The first aims at continuing business, either through a reorganisation plan or a sale as a going concern (*redresse-*

²⁷ In January 2006, French bankruptcy law was changed to allow for easier bankruptcy filings. These may now be initiated voluntarily by managers, creditors or the court, even if the financially distressed firm is not *en cessation des paiements*. In the previous bankruptcy system, financially distressed firms had to be largely unable to pay debts before they could file for bankruptcy. Since 2006, all firms that face the possibility of going bankrupt in the future may initiate a bankruptcy filing. However, the data are not yet available to cover this last reform.

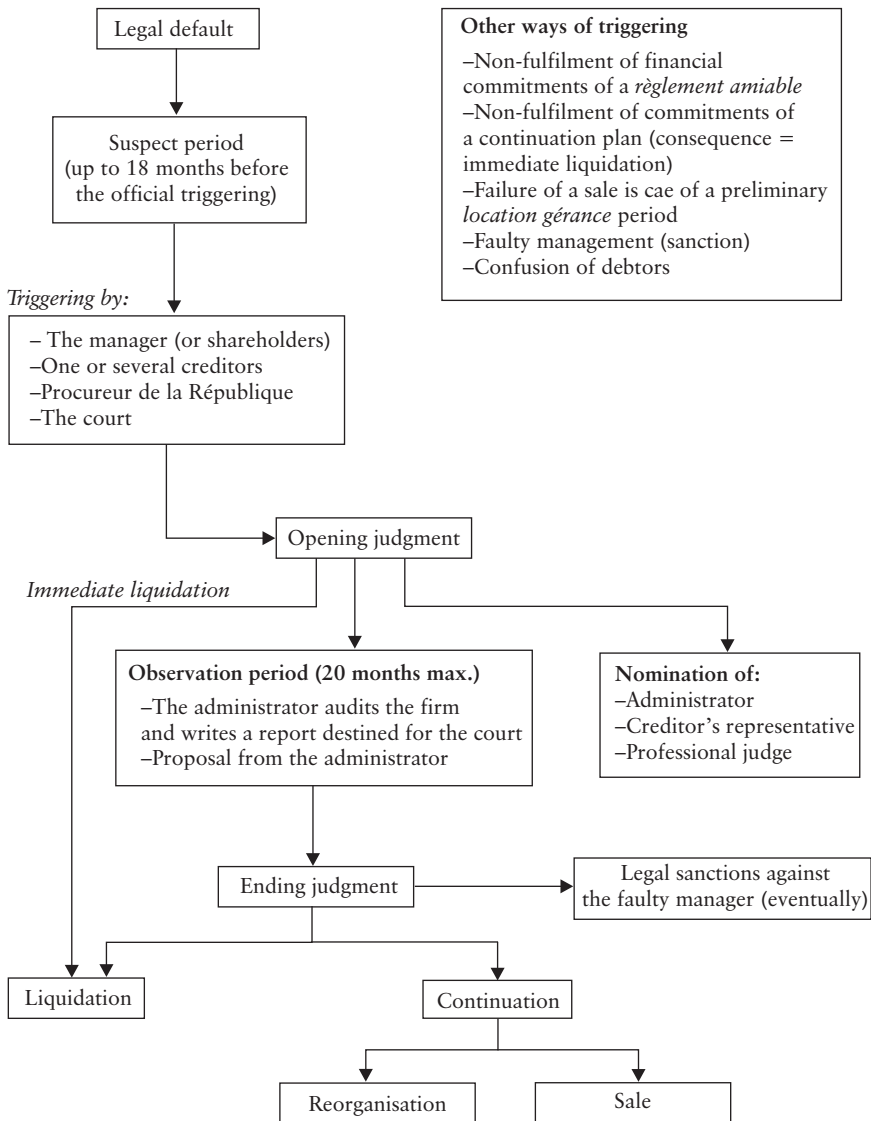


Figure A1. French corporate bankruptcy law

ment judiciaire). The second organises the piecemeal liquidation of the firm (*liquidation judiciaire*).²⁸ The bankruptcy judge asks for a stay of creditors'

²⁸ In the shadow of the process, there also exists an out-of-court settlement (*règlement amiable*): the manager, with the help of an appointed officer, negotiates with some of the claimants the payment of outstanding debts.

claims and examines all pre-default contracts which appear suspect, in the sense that they would have voluntarily caused a reduction of the firm's value prior to filing for bankruptcy (this examination covers the so-called *période suspecte*).

The 1994 legislation is very similar to the previous 1985 law. The main innovations in 1994 are: (1) a change in the absolute priority rule in case of liquidation (secured creditors are now paid before those creditors who offer credit after firms file for bankruptcy); (2) the judge may pursue agents who buy bankrupt firms in order to sell them piecemeal once the bankruptcy process is closed; and (3) the judge can immediately liquidate financially distressed firms if he considers it impossible for them to continue their operations under the protection of the law (this procedure was in practice before 1994 but was not written in the law). These changes in the law did not crucially modify the practice of commercial courts. More importantly, we expect that firms which filed for bankruptcy after the 1994 bankruptcy reform are more likely to be worth saving, because commercial courts promote prevention among financially distressed firms in the later sample (eg via the alert procedure). In other words, it is specifically the legal difference that we consider (and test) between our two samples of bankrupt firms.

The Liquidation Procedure

The liquidation process occurs either immediately or after an observation period.²⁹ Once the court has ordered liquidation, the commercial court appoints an official who liquidates all the firm's assets to clear debt in an orderly manner. The proceeds are distributed in the following order: the most recent salaries are paid first (super-privilege), followed by the administrative expenses of the collective procedure, other salaries and claims of tax authorities (privilege). Then the liquidator cancels secured debts, which are ranked above the post default creditors³⁰ (protected by article 40 of French bankruptcy law). Any remainder goes to junior claimants.

The Continuation Procedure

Continuation prevails when the commercial court estimates that a firm might be able to reorganise or to be sold as a going concern. At this time the judge stops all creditors' pursuits in order to facilitate reorganisation, because the firm's assets (collateralised or not) are essential to continuation. During this observation period (which starts when the court orders the stay

²⁹ The objective of the observation period is to seek another way to alleviate financial distress.

³⁰ The reform of bankruptcy law in 1994 changed this absolute priority order; before 1994, creditors protected by article 40 were paid before the secured creditors in all bankruptcy cases. The French legislators aimed, with the reform of 1994, to improve secured creditor's rights.

on creditors' claims, for up to six months), several measures are engaged. All creditors who offer new credit (called new money) have priority over the previous creditors, except when the firm is liquidated (see above). The debtor may either stay in place under the authority of the bankruptcy judge, or be replaced. An official, appointed by the court, formulates a reorganisation plan (causes of default, measures for carrying on, schedule of repayment of creditors), which is evaluated by the judge. After an examination of the interest of the various parties, the bankruptcy judge specifies whether the company should be reorganised according to the continuation plan elaborated by the outside official, or whether assets should be sold to a third party. In the latter case, the contracts, which are essential for the firm to continue as a going concern, are also transferred. In the event of continuation, the super-priority status of the last unpaid salaries still applies. These debts rank above all others, which are ordered as follows: 'article 40' debts, privileged debts (other salaries, tax authorities and bankruptcy costs), secured debts and finally junior claims.

Appendix 2: Comparison of Parisian and French Bankruptcies

Table A1 shows a comparison between our Parisian sample and the national population of French bankrupt firms.

Table A1. Comparison of Parisian and national populations

Corporate bankruptcies	Paris		France	
	1994	2005	1994	2005
Limited responsibility	78.2	84.4	60.8	68.0
Other legal forms	21.8	15.7	39.3	32.0
Commerce	27.3	25.6	28.9	27.0
Industry ^a	31.9	34.0	33.7	35.2
Services ^a	40.9	40.4	37.4	37.8
Continuations (reorganisations and sales)	7.1	5.6	7.0 ^b	11.0
Liquidations (immediate or not)	92.9	94.5	93.0 ^b	89.0

Sources: France, INSEE; Paris, Paris Commercial Court.

^aAgriculture, and financial services excluded.

^bFor 1995: see J Domens, 'Les défaillances d'entreprises entre 1993 et 2004', coll PME/TPE en bref, no 23 (May 2007), Ministère de l'Economie, des Finances et de l'Emploi.

Appendix 3: Templates, Codification of the Cause of Default and of the Engaged Measures

Table A2 provides the general structure of our templates. The table collects 230 variables gathered into seven different groups. Group 1 identifies the bankrupt company/group of companies. Group 2 gathers variables describing

Table A2. General structure of the templates

1. Company's identification	3b. Financial information and bankruptcy costs
Matriculation number	Declared market values of assets (triggering time)
Sector (French NAF national codification)	Verified claims by levels of priority (end of the procedure)
Geographic location	Number of creditors
Number of employees	Bankruptcy costs individual estimation (décret 85-1390 of 27 December 1985)
Legal form	
Creation date	
Manager(s): age, functions, no. of administrators...	
	3c. Engaged measures/legal measures
	Engaged measures during the bankruptcy procedure (up to 10), each of them is subject to court approval
	Identification of the legal practitioners
2. Process of default	3d. Procedure outcome
Origin of default (up to 10 cumulative causes, based on a specific codification (51 codes). The identification of causes stems from an audit engaged by the administrator.	Realised value of assets (if liquidation)
	Characteristics of the buyout plan(s) (if any), in case of a sale as a going concern (price, pros and cons of the offer, as analysed by the legal administrator)
	Characteristics of the reorganisation plan (length of the plan, repayment schedule...)
3. The bankruptcy procedure (from triggering to the final issue)	3e. Legal sanctions against managers (if any)
3a. Type of procedure	Suspect period
Type of the legal procedure (simplified or not)	Pecuniary sanctions
Date of triggering and of ending	Extra pecuniary sanctions
Identity of the bankruptcy's initiator	Type of fault
Legal issue: liquidation, sale, reorganisation	
<i>Remark: all files are closed files (with definitive recovery rates)</i>	

the bankruptcy process and the origin of default. Group 3a identifies the type of procedure—from triggering to final outcome. Group 3b provides financial information on assets and liabilities according to the type of claim. Group 3c codifies the measures enacted by the court during the observation period. Group 3d deals with the amounts recovered and the characteristics of buyout proposals (if any). Group 3e specifies legal sanctions against the managers (if any).

Table A3 sets out the codifications we used for the causes of default and the measures enacted. These are gathered into seven groups: outlets, strategy, production, finance, management, accident and external environment. The table lists the principal origins of default and the legal measures enacted by the administrator during the bankruptcy process. We set against each other the causes of default and the measures enacted by the court in order to determine whether they are connected. We also set the exogenous origins of default (accident, external environment) against the endogenous ones (strategy, production, finance or management).

Table A3. Codification of the causes of default and the engaged measures

	Origin of the default(codifications)	Measures engaged by the administrator during the bankruptcy procedure (codifications)
Outlets	[1] Brutal disappearance of customers; [2] Customer(s) in default; [3] Product(s) too expensive (selling price is too high); [4] Bad evaluation of the market; [5] Product(s) too cheap (selling price is too low); [6] Unsuitable products; [7] Obsolete products; [8] Loss of market shares (regular fall of the firm's demand).	[1] Improvement of products (extension of the range); [2] Innovation, increase of research and development; [3] Advertising, better knowledge of the market, commercial effort; [4] Lower selling prices; [5] Reorganisation of activities (abandoning unprofitable activities, developing the more profitable ones).
Strategy	[1] Youth of the company (inexperience); [2] Voluntary dissolution of the activity; [3] Failure of important projects (partnerships, investments, reorganizations); [4] Voluntary acceptance of little profitable markets (dumping...).	[1] Diversification of the economic partners; [2] Concentration on particular economic partners; [3] New shareholder in the capital; [4] Non-renewal of peculiar contracts (non profitable markets); [5] New hiring.
Production	[1] Production capacity was too strong, overinvestment; [2] Depreciation of assets (active persons); [3] Operating costs were too high (other than wages: external expenses, raw materials...); [4] Wages expenses were too high; [5] Brutal disappearance of suppliers; [6] Unsuitable process of production (obsolete); [7] Under-investment.	[1] New investments; [2] Cancellation of projects (investments); [3] Economic reorganisations (mergers and acquisitions, partnerships, alliances); [4] Increase in selling price; [5] Decrease in operating costs; [6] Firings; [7] Decrease in wages."
Finance	[1] Longer delays on accounts receivable; [2] Contagion/reported losses from subsidiaries; [3] Shorter delays on accounts payable; [4] Speculation of the company, problems due to exchange rates fluctuation; [5] Cessation of financial support from the head office/holding; [6] Lack of equity (compared to leverage/liabilities); [7] Loan refusal to the company; [8] Cessation of/reduction in previous state financial subventions to the firm; [9] Contractual interest rates are too high."	[1] Obtaining public subvention(s); [2] Sale of fixed or financial assets; [3] Sale/liquidation of inventory; [4] Recovery on accounts receivable; [5] Increasing stockholders' equity; [6] Decrease of the financial risk (less speculation...); [7] Total or partial repayment to previous creditors; [8] Rescheduling of payments, remissions of a debt (private renegotiation); [9] Attempt at informal renegotiation; [10] Cash raising from new creditors; [11] New loans; [12] Claims forgiveness from the leaders/owners."

Management	[1] Weak accounts reporting/informational system is deficient; [2] Problems of competence; [3] Disagreements among the directors/managers; [4] Excessive takings from the managers; [5] Insufficient provisions; [6] Lack of knowledge on the real level of costs of returns (causing too weak selling); [7] Bad evaluation of inventory; [8] Problems of transmission of the company/difficulties in restructuring.	[1] Improvement of the competence (training, hiring of skilled persons); [2] Appeal to outside experts; [3] Substantial change of managerial staff; [4] Change in the rules of accounting (or of the rules of management); Management: Better knowledge of the costs of returns.
Accident	[1] Fraud/embezzlement affecting the company (whatever its origin); [2] Another insolvency procedure (for other companies) is extended to the firm (same patrimonies); [3] Disputes with public partners (fiscal inquiry); [4] Disputes with private partners; [5] Death/disease/disappearance of the manager; [6] Disaster; [7] Social problems within the company.	Not applicable
External environment	“[1] Unfavorable fluctuation of the exchange rates; [2] Increase of the competition; [3] Decreasing demand to the sector; [4] <i>Force majeure</i> (war, natural catastrophe, industrial crisis, politics, bad price evolution); [5] Public policy less favorable to the sector; [6] Period of credit crunch; [7] The general level of interest rates is too high; [8] Macroeconomic increase of operating costs (raw materials, GMW ...).	Not applicable

Comments and Discussion Report

ROBERT STEVENS

FRENCH INSOLVENCY LAW is frequently described as being ‘pro-debtor’. When we are talking of corporate insolvency law this is, at best, misleading. The corporate debtor does not exist in the physical world in which you and I live. They do not laugh, they cannot sing, they do not fall in love. Corporations are legal constructs which, as such, have no inherent value. The death of a company through winding up is not something over which a single tear should be shed. When we speak of an insolvency regime being ‘pro-creditor’ or ‘pro-debtor’ we are really talking about favouring one class adversely affected by an insolvency over another; the debtor itself is neither here nor there.

The business which a corporation owns may be of value. Businesses generate wealth and sustain employment. Both the individuals working for a business and society in general have an interest in ensuring that an insolvency regime does not result in needless damage. Further, a business as a going concern may have a greater value than it would have on a break-up basis, and value may be lost for creditors collectively if the law allows a free-for-all, with all individual creditors allowed unfettered rights of enforcement.

Whether pursuing the goal of ‘social efficiency’ through the rescue of a business makes good sense either for society or for the relevant groups affected cannot be demonstrated by looking at recovery rates. Sometimes, the best outcome is for a business to be allowed to die. After many decades of production, in 2005 MG Rover ceased to produce automobiles at the Longbridge plant in Birmingham, resulting in the loss of some 6,000 jobs. For most of those affected this was devastating. However, it is not necessarily the case that further attempts to keep the business going made any sense in either economic or social policy terms. The assets of the company, in particular its human capital may, and almost certainly were, better employed elsewhere given the prevailing economic conditions at the time. Sometimes breaking up is the right thing to do.

Further demonstrating, as Professor Blazy does, that the recovery rates

for creditors from the conduct of reorganisations may be better or the same as the recovery rates for liquidations proves very little, unless the data controls for the condition of the enterprises which go into these different sorts of regime. If the sick and the dying tend to be those which enter one regime, whilst those with a heavy cold go into the other, the recovery rates will be rather different. It may be speculated that it is indeed the unhealthy which are put into liquidation.

A similar problem arises when comparing the recovery rates for creditors of the insolvency regimes of different countries. Where, as in England, it is, or at least was, usual to deal with illness outside of formal insolvency proceedings it would be expected that recovery rates would be substantially worse where companies actually go into an insolvency proceeding than they would be in those jurisdictions with a different approach. The factors relevant to recovery rates are so many and diverse, in particular differences in business culture, that demonstrating a correlation between a 'good outcome' and a particular form of insolvency regime when compared with another falls a very long way short of showing cause and effect. Criticising liquidations for their failure to achieve good outcomes is like criticising mortuaries for the number of corpses they contain. Law is of less practical relevance than most lawyers like to believe, and the primary aim should be to ensure that the insolvency proceeding is as fair as possible, and thereby gains general acceptance. Fairness cannot be assessed by looking at recovery rates. The fairer the regime, the more efficient it will tend to be.

Given these obvious difficulties in testing whether one regime is 'better' than another, the most important element to compare and seek to control is the cost involved. More money for the lawyers and accountants employed in sorting out an insolvency means less money for the creditors. Disturbingly, costs in England appear to have increased as a result of the Enterprise Act reforms.¹

Perhaps the greatest difference between English and French insolvency law is in the role of the courts. Courts in England usually have little or no role to play, something that is not apparent from the law reports. The most common form of insolvency liquidation, creditors' voluntary liquidation, involves no court order and will generally be initiated by the directors of the company. Suicide is more common than murder. Even where the liquidation is a result of a court order, the court's involvement will commonly be notional, usually nothing more than the incantation of the order. The picture is similar where what is attempted is a reorganisation of the company through administration, where the proceeding may be commenced without a court order. Indeed perhaps most astonishingly to those from other jurisdictions it may be commenced on the say-so of a secured

¹ See S Frisby, "The Effect of the Enterprise Act 2002: Empirical Research into Corporate Insolvency", ch 3 above.

creditor. One justification for this hands-off approach is that it is quick and cheap, leading to a greater return for creditors generally.

In France, by contrast, the courts play an important role both in the opening and in the conduct of insolvency proceedings. As Professor Théry explained, one reason could be that the judges in the *tribunal de commerce* are all practitioners, businessmen that have been elected to adjudicate such disputes, and so it is considered appropriate for the courts to have such a significant role.

The incoherence introduced into French insolvency law by the Financial Collateral Arrangements Directive 2002, which Professor Synvet explained, is reflected in English law. Indeed, in England the incoherence was starkly obvious as two incompatible policies were being pursued by the UK government and the Council of the European Union simultaneously.

The traditional approach of English law has been to allow security holders the freedom to continue to enforce their security even after a debtor has entered into an insolvency proceeding. The Enterprise Act 2002 placed further restrictions on the ability of a security holder to stand outside of the proceedings in this way. The secured creditor is ‘crammed down’ into the collective regime. In some cases this may achieve a greater return for creditors generally as it may prevent the piecemeal dismemberment of the assets. The Financial Collateral Arrangements Directive² pursues the policy of facilitating lending across the European Union and requires the disapplication of the restrictions on enforcement required by domestic insolvency regimes. The Directive required a large exception to be made to the Enterprise Act’s collective approach. The policies pursued by the Act and the Directive are both rational, but they are not readily commensurable one with another. The enthusiasm with which Her Majesty’s Treasury embraced the Directive was on its face incompatible with the goals of the Act as promoted by what was then Her Majesty’s Department of Trade and Industry.

Professor Synvet’s concern relating to the introduction of the trust is not, in general, shared in England. This is, no doubt, a product of the English familiarity with the trust. However, it may be questioned whether the English complacency is justified. If I have a right, whether to a tangible thing such as a car or to a debt or a share, I may be obliged to hold that right for you. If your right against my right is defeasible upon payment of a sum of money, it is a charge. If it is not so defeasible it is a trust. Why should my insolvency place restrictions upon your powers of enforcement in the former but not the latter case?

In the discussion following the presentations, the pursuit by French insolvency law of social objectives was considered further. The question was

² European Parliament and Council Directive (EC) 2002/47 of 6 June 2002 on Financial Collateral Arrangements [2002] OJ L168/43.

raised whether there was a trade-off between social objectives and financial efficiency. Professor Blazy stated that, from his research, it appeared that whether there is such a trade-off ultimately depends on the case. But, in general, there is a clear tendency to try and save employment in French cases and in cases of sales of the business as a going concern, such trade-offs are sometimes made.

Another issue that was discussed after the presentations was the question of the application or the desirability of the provisions of the Financial Collateral Directive. Professor Synvet explained that in his view the Directive should not be applied beyond what is permitted by its justification (that is to avoid systemic risk of the collapse of banks and financial institutions). This justification applies where the transaction is between regulated persons³ but not (in his view) where one of the parties is merely a commercial company and not a regulated person. The Directive provides that such a transaction falls within its scope, but Professor Synvet's view is that simple transactions will be structured in such a way that they will obtain the protection mechanisms of the Directive (so that a simple loan granted to a company would be structured as a swap. This is undesirable since in such a transaction there is no systemic risk of bank collapse, but just a risk limited to the parties involved. This view is particularly interesting from a UK perspective, since the Regulations implementing the Directive in the UK⁴ apply to transactions between all companies and not just those defined as regulated persons in the Directive.

³ As defined in Art 1(2) of the Directive.

⁴ The Financial Collateral Arrangements (No 2) Regulations 2003 (SI 2003/3226).

14

Summary

WOLF-GEORG RINGE and LOUISE GULLIFER

THIS BOOK HAS examined different aspects of insolvency from the French and English law perspectives, and has also discussed the emerging European debate on insolvency law.

It seems that one common aim for both jurisdictions is to develop insolvency law more towards a 'restructuring law'. In recent years, French insolvency law has been constantly amended by successive laws, each of them emphasising the promotion of rescue and recovery of companies in distress. Furthermore, the Cour de commerce in Paris has repeatedly promoted the treating of the financial difficulties of companies at an early stage. Yet almost 90% of the 45,000 French insolvency cases decided each year end in liquidation. Hence the steady call for new reforms in France.

The 'Perben law' of 2005,¹ for instance, introduced a new procedure modelled on Chapter 11, the *procédure de sauvegarde*.² Most notably, the new *sauvegarde* permits management to retain control over the company and provides for a more limited charge for the administrator. In fact, the *sauvegarde* mimics Chapter 11's exclusivity period by providing a time lag of 30 days prior to the constitution of the creditors' committees and a two-month time lag before the debtor must present a plan to the committees. It is remarkable that lawmakers in Europe tend to seek inspiration from US law rather than that of their European neighbour states. However, insolvency law has long been accustomed to being an area of law that is not known for strong international convergence. Given this context, it is positive to see the emergence of a number of 'legal transplants'³ in this

¹ Law no 2005-845 of 26 July 2005 on the 'safeguard' of enterprises, OJ 27 July 2005, 12187, in force on 1 January 2006. Cf PJ Omar, 'French Insolvency Law and the 2005 Reforms' [2005] *International Company and Commercial Law Review* 490.

² See on this in English language C Dupoux, 'Chapter 11 à la française: French Insolvency Reforms' (2004) 1 *International Corporate Rescue* 75.

³ On this concept, see eg A Watson, *Legal Transplants. An Approach in Comparative Law* (1st edn, 1974; 2nd edn, 1993) 21ff; D Berkowitz, K Pistor and JF Richard, 'Economic Development, Legality, and the Transplant Effect' (2003) 47 *European Economic Review* 165.

part of the law, even if they do not originate in a common European convergence.

Although it has been in force for barely two years, the *sauvegarde* law is already facing reform again. *Inter alia*, the French government wants to make the *sauvegarde* both more accessible (by mitigating the admission thresholds) and more attractive (by revisiting the criteria of managing the company during the procedure).⁴

Another objective of the *Perben law* was to encourage creditors to take part in the conciliation procedure by granting them new security rights⁵ in the form of priority that can be realised should the recovery attempt fail and the company need to be liquidated.⁶ Again, the main motivation of the French legislator was to encourage rescue attempts rather than mere liquidation.

English insolvency law, on the other hand, is still digesting the effects of the Enterprise Act 2002.⁷ As we have seen, the main aspect of this Act in the area of insolvency law was to modernise the procedure of administration to make it more efficient and accessible in order to facilitate the rescue of viable companies. Furthermore, it abolished the ability of most lenders who hold floating charges to appoint an administrative receiver.⁸

These actual and prospective reforms seem largely motivated by domestic issues and problems. However, a growing international perspective on insolvency procedures is influencing national legislation. Firstly, Community law in neighbouring areas has created the need for adaptation of insolvency rules;⁹ and secondly, the EU has also legislated in the core area of insolvency itself: the EU Insolvency Regulation¹⁰ came into force in 2002 and has facilitated cross-border insolvencies. Moreover, the Regulation has initiated debate on a common insolvency procedure for corporate groups.¹¹ As it currently stands, the Regulation does not include any rules for this problem. European businesses are trying to profit from this situation of uncertainty by interpreting the 'centre of main interests' according

⁴ See the statements of the French Minister of Justice, Rachida Dati, on 29 November 2007, <http://www.justice.gouv.fr/index.php?rubrique=10016&article=13794> accessed 23 July 2008.

⁵ New art L611-11 of the Commercial Code.

⁶ Cf P Crocq, 'The Recent Influence of Insolvency Law on the Evolution of Security in French Law', above ch 8.

⁷ S Frisby, 'In Search of a Rescue Regime: The Enterprise Act 2002' (2004) 67 *MLR* 247; J Armour, A Hsu and A Walters, 'Corporate Insolvency in the United Kingdom: The Impact of the Enterprise Act 2002', (2008) 5 *European Company and Financial Law Review* 148.

⁸ See on this the contributions by L Gullifer, 'The Reforms of the Enterprise Act 2002 and the Floating Charge as a Security Device', above ch 2, and S Frisby, 'The Effect of the Enterprise Act 2002: Empirical Research into Corporate Insolvency', above ch 3.

⁹ See eg in the context of securities, H Synvet, 'The Exclusion of Certain Creditors from the Law of Collective Proceedings', above ch 11.

¹⁰ Council Regulation (EC) 1346/2000 of 29 May 2000 on insolvency proceedings, [2000] OJ L160/1.

¹¹ On this recently see H Hirte, 'Towards a Framework for the Regulation of Corporate Groups' Insolvencies' (2008) 5 *European Company and Financial Law Review* 213.

to their needs, or even to migrate across borders in order to profit from a more attractive insolvency regime.¹²

Finally, we have observed empirical work complementing the legal debate and enriching the controversy.¹³ The character of French insolvency law as one of the most debtor-friendly regimes can lead to the accusation that it allows economically inefficient firms to reorganise, whereas pro-creditor bankruptcy models are more likely to promote liquidation. The study by Professor Blazy and others casts doubt on the unquestioned correctness of this hypothesis. It can only be welcomed as stimulating the debate on which is the correct way forward for insolvency.

In sum, we witness some international convergence—up to a certain point.¹⁴ As Professor Théry has highlighted, many differences between the two jurisdictions remain.¹⁵ These differences will offer sufficient fuel for future controversy and debate, both on the academic and on the practical level, providing employment for many lawyers. They will even incentivise companies to engage in forum shopping between the two countries. As long as European integration confines itself to harmonising conflict-of-law rules in insolvency and does not attempt a partial harmonisation of substantive insolvency law, strong incentives for forum shopping will persist.

Over the past decades, various studies have examined the differences and similarities between the procedural and substantive laws of insolvency regimes in Europe. Some of them reach the conclusion that the harmonisation of at least some aspects, if not the entirety, of insolvency law, is desirable.¹⁶ Furthermore, European states have attempted several times to reach an agreement on insolvency matters. Some of the proposals included suggestions for harmonisation of substantive insolvency law, but agreement could not ultimately be reached.¹⁷ For now, we have to live with a harmonised system of private international law and persisting differences in the substantive laws. If complete harmonisation were to become reality one day, this would certainly have a significant impact on European business in general. This project may seem unrealistic from today's perspective, but if it is worth working towards in contract and company law, why not in insolvency?

¹² See the contributions by WG Ringe, 'Strategic Insolvency Migration and Community Law', above ch 5, and G Khairallah, 'The 'Centre of the Debtor's Main Interests': Comments on the Eurofood Judgment of the ECJ', above ch 6.

¹³ See the contribution by R Blazy and others, 'How Do the Courts Choose between Different Bankruptcy Outcomes? The Results of a French Survey', above ch 12.

¹⁴ RM Goode, *Principles of Corporate Insolvency Law* (3rd edn, London, Sweet & Maxwell, 2005) 595.

¹⁵ See P Théry, 'Comment and Summary', above ch 4.

¹⁶ Eg G Ponceblanc, 'L'harmonisation des procédures collectives en Europe: espérances utopiques?' [1990] *Gazette du Palais* 588; P Woodland, 'Observations sur les orientations des droits européens de la faillite' [1984] *La Semaine Juridique* I 3137.

¹⁷ For a detailed account, see PJ Omar, *European Insolvency Law* (Aldershot, Ashgate, 2004) 49–86.

Annex

COMMERCIAL CODE

Consolidated version as of 20 March 2006

BOOK VI – Businesses in difficulty [Excerpt]

[. . .]

TITLE I**Prevention of businesses' difficulties****CHAPTER I**

Prevention of businesses' difficulties, special commission (mandat ad hoc) and composition procedure

Article L611-1

Any person registered with the Register of Commerce and Companies or the craftsmen's register as well as private law entities may join a prevention group accredited by an order of the State representative in the region. This group shall provide its members with a confidential analysis based on the economic, accounting and financial data that they must send it regularly.

Where the prevention group identifies signs of difficulty, it will inform the head of the business and may suggest that an expert provides assistance.

On motion of the State's representative, the competent public authorities shall give assistance to the accredited prevention groups. The Banque de France may also, as stipulated in an agreement, be invited to give its opinion on the financial situation of member businesses. Accredited prevention groups may also receive grants from local authorities.

Accredited prevention groups may enter into agreements with credit institutions and insurance companies in favour of their members.

Article L611-2

I—Where any deed, document or proceedings shows that a commercial company, an economic interest grouping or a sole ownership, running a trading or a craftsman's business, encounters difficulties that may undermine the continuation of its business operations, its managers may be summoned by the president of the Tribunal de commerce (commercial court) to determine the appropriate steps necessary to remedy the situation. At the end of this meeting or if the managers have not come to the meeting, the president of the court may, notwithstanding any statutory or regulatory provision to the contrary, obtain information enabling him to know the debtor's accurate economic and financial situation from statutory auditors, members and representatives of the personnel, public authorities, social security bodies and provident institutions and the bodies responsible for the centralisation of information on banking risks and payment incidents.

II—Where the managers of a commercial company do not file annual accounts within the time limits provided for by the applicable legal provisions, the president of the court may summon them to do so promptly, by means of an injunction accompanied by a periodic pecuniary penalty.

If this injunction is not complied with within the time limit provided for by a Conseil d'Etat decree, the president of the court may also enforce the provisions of the second paragraph of (I) above against the managers.

Article L611-3

The president of the Tribunal de commerce or of the Tribunal de grande instance (high court) may, at the request of the business's representative, appoint a special commissioner (*mandataire ad hoc*) whose duties he shall set out.

Article L611-4

A composition procedure is instituted before the Tribunal de commerce for the persons who carry out a commercial or craftsman's activity, who encounter an actual, or a foreseeable legal, economic or financial difficulty, and who have not been in a state of cessation of payments for more than forty-five days.

[. . .]

Article L611-11

If safeguard proceedings, reorganization proceedings or liquidation proceedings as a result are commenced, those persons who, under the approved agreement referred to under Article L611-8(II), have made a contribution of fresh funds to the debtor in order to ensure the continuation and long-term future of the business' activity will be paid, up to the amount of this sum, according to their preferential lien before all other claims prior to the commencement of the composition proceedings,

according to the rank fixed under Article L622-17(II) and Article L641-13(II). Under the same conditions, those persons who, in the approved agreement, supply new assets or services in order to ensure the continuation and long-term future of the business will be paid, for the amount of the price of the assets or services, according to their preferential lien before all claims born prior to the commencement of the composition proceedings.

This provision shall not apply to contributions made by shareholders or partners in the form of a capital increase.

Creditors that are signatories to the agreement may not benefit directly or indirectly from this provision in respect of their contributions prior to the commencement of the composition proceedings.

Article L611-12

The commencement of safeguard, reorganization or liquidation proceedings shall automatically terminate the agreement recognised or approved in compliance with Article L611-8. In this case, the creditors will recover all their claims and guarantees, after deduction of sums received, without prejudice to the provisions of Article L611-11.

Article L611-13

The duties of a special commissioner (*mandataire ad hoc*) or those of the conciliator may not be carried out by any person who has received during the last twenty-four months remuneration or payment from the debtor, from any of the debtor's creditors or from a person who controls or is controlled by the debtor within the meaning of Article L233-16, for whatever reason, directly or indirectly, other than remuneration or payment for a special commission (*mandat ad hoc*) or duties in connection with an amicable settlement or a composition carried out in favour of the same debtor or the same creditor. The person thus appointed must attest on his honour, at the moment of acceptance of his duties, that he complies with these prohibitions.

The duties of the special commissioner or those of the conciliator may not be entrusted to any Tribunal de commerce judge who is either in office or who has left office within the previous five years.

Article L611-14

Having obtained the debtor's approval, the president of the court shall determine the conditions of remuneration of the special commissioner, the conciliator and, if necessary, the expert, at the time of their appointment, on the basis of the work entailed in performing their duties. Their remuneration shall be fixed by order of the president of the court on completion of their duties.

Appeals against these decisions shall be filed with the First president of the court of appeal within a time limit to be fixed by a Conseil d'Etat decree.

Article L611-15

Any person who has taken part in the composition proceedings or in a special commission (mandat ad hoc) or who, by virtue of his duties, knows about these shall be bound by a duty of confidentiality.

[. . .]

TITLE II

The safeguard procedure

Article L620-1

This article institutes a safeguard procedure to be commenced on the petition of the debtor who is mentioned in Article L620-2 that shows difficulties that it is unable to overcome on its own and that would lead to a cessation of payments. This purpose of this procedure is to facilitate the reorganization of the business in order to allow the continuation of the economic activity, the maintenance of employment and the settlement of liabilities. The safeguard proceedings shall give rise to a plan to be confirmed by a court order at the end of an observation period and, where appropriate, to the formation of two committees of creditors, in compliance with the provisions of Articles L626-29 and L626-30.

Article L620-2

The safeguard procedure shall apply to traders, persons registered with the craftsmen's register, farmers, other persons running an independent professional activity, including an independent professional person with a statutory or regulated status or whose designation is protected, as well as private-law entities. New safeguard proceedings may not be commenced with respect to any person already subject to such proceedings or to reorganization or liquidation proceedings if the operations of the plan that it has given rise to have not been terminated or if the liquidation proceedings have not been closed.

CHAPTER I

Commencement of the safeguard proceedings

Article L621-1

The Court shall issue an order on the commencement of the proceedings after having heard in or duly summoned to the judge's chambers, the debtor, representatives of the works council or, in the absence of a works council, the employee delegates. The Court may hear any other person

whose testimony it deems useful. In addition, where the debtor is an independent professional with a statutory or regulated status or whose designation is protected, the Court will decide, if necessary, after hearing or giving notice to the supervisory body or relevant authority, under the same conditions. The Court may, before making a ruling, appoint a judge who will gather information regarding the business's financial, economic and employment situation. This judge may apply the provisions of Article L623-2. He may be advised by any expert of his choice. The hearing for the commencement of safeguard proceedings with respect to a debtor who benefits or has benefited from a special commission (*mandat ad hoc*) or from composition proceedings during the preceding eighteen months must be held in the presence of the Public prosecutor. In this case, the Court may, of its own motion or on motion of the Public prosecutor, obtain all documents and deeds relating to the special commission (*mandat ad hoc*) or the composition proceedings, notwithstanding the provisions of Article L611-15.

Article L621-2

The competent court will be the Tribunal de commerce if the debtor is a trader or he is registered with the craftsmen's register. The Tribunal de grande instance shall be competent in other cases. The commenced proceedings may be extended to one or more other persons where their assets are intermingled with those of the debtor or where the legal entity is a sham. The court that has commenced the initial proceedings shall remain competent for this purpose.

Article L621-3

The order shall commence an observation period not exceeding six months, which may be renewed once by a reasoned ruling on motion of the administrator, the debtor or the Public prosecutor. It may also be extended exceptionally, on motion of the Public prosecutor, by a reasoned ruling of the Court for a period to be fixed by a Conseil d'Etat decree. Where an agricultural business is involved, the Court may extend the observation period taking account of the current agricultural year and the practices specific to the farm's products.

Article L621-4

In the commencement order, the Court shall appoint the supervisory judge whose functions are specified in Article L621-9. It may, if need be, appoint several supervisory judges. It shall invite the works council or, in the absence of a works council, the employee delegates to appoint a representative from among the employees of the business. In the absence of a works council or employee delegates, the employees will elect a representative, who shall perform the functions attributed to these institutions by the provisions of this Title. The terms and conditions for the appointment or

election of the employees' representative shall be specified in a Conseil d'Etat decree. Where no employees' representative can be appointed or elected, a record of the default shall be drawn up by the head of the business. In the same order, without prejudice to the possibility of appointing one or more experts for duties that it shall determine, the Court shall appoint two court nominees, that is, a court nominee and an administrator, whose duties are specified in Article L622-20 and Article L622-1 respectively. It may, on motion of the Public prosecutor, appoint several court nominees or administrators. In the situation provided for in the fourth paragraph of Article L621-1, the Public prosecutor may object to the appointment of a person who had previously been appointed as a commissioner (*mandataire ad hoc*) or conciliator with regard to a special commission (*mandat ad hoc*) or composition proceedings with regard to the same debtor. However, the Court will not be bound to appoint an administrator where the proceedings relate to a debtor whose number of employees and turnover net of tax are below the thresholds provided for by a Conseil d'Etat decree. In this case, the provisions of Chapter VII of this Title shall apply. Until the issuance of the confirmation order of the plan, the Court may, on motion of the debtor, the court nominee or the Public prosecutor, decide to appoint an administrator. For the purposes of taking inventory and the valuation required by Article L622-6, the Court shall appoint an auctioneer, a bailiff, a notary or an accredited commodity broker.

Article L621-5

No relatives or affines, up to the fourth degree included, of the head of the business or the managers, if the debtor is a legal entity, may be appointed to any one of the positions provided for in Article L621-4 except where this provision prohibits the appointment of an employees' representative.

Article L621-6

The employees' representative and employees who take part in the appointment process must not have been convicted to one of the sentences provided for in Article L6 of the Electoral Code. The employees' representative must be at least eighteen years old.

The Tribunal d'instance (Magistrates' Court) that rules in final instance shall have jurisdiction on the objections raised against the appointment of the employees' representative.

Article L621-7

The Court may, of its own motion or on the initiative of the supervisory judge or on motion of the Public prosecutor, replace the administrator, the expert or the court nominee.

The Court may appoint, under the same conditions, one or more adminis-

trators or court nominees in addition to those already appointed. The administrator, the court nominee or the creditor appointed as controller may ask the supervisory judge to apply to the Court for that purpose.

Where the debtor is an independent professional person with a statutory or regulated status or whose designation is protected, the supervisory body or relevant authority, as the case may be, may apply to the Public prosecutor for the same purpose.

The debtor may ask the supervisory judge to apply to the Court for the replacement of the administrator or the expert. Under the same conditions, the creditors may request the replacement of the court nominee.

Only the works council or, in the absence of a works council, the employee delegates or, if there is none, only the business's employees may replace the employees' representative.

Article L621-8

The administrator and the court nominee shall inform the supervisory judge and the Public prosecutor of the progress of the proceedings on regular basis. The supervisory judge and the Public prosecutor may request the disclosure of all deeds and documents relating to the proceedings at any time.

The Public prosecutor shall give to the supervisory judge, on the latter's request or of his own motion, notwithstanding any legal provision to the contrary, any information he holds and which may be useful for the proceedings.

Article L621-9

The supervisory judge shall supervise the speedy progress of the proceedings and the protection of the parties' interests. Where the appointment of an expert is necessary, this may only be made by the supervisory judge, for the duties he shall determine, without affecting the powers of the Court provided for in Article L621-4 to appoint one or more experts. The terms for the remuneration of the expert shall be fixed by a Conseil d'Etat decree.

Article L621-10

The supervisory judge shall appoint up to five controllers from among those creditors requesting to be appointed.

Where he appoints several controllers, he must ensure that at least one of them is chosen from among the secured creditors and one from among the unsecured creditors.

No relatives or affines, up to the fourth degree included, of the manager or the directors of a legal entity, nor any person holding directly or indirectly all or part of the capital of the debtor or whose capital is held, in part or in

all, by that same person, may be appointed as controller or as representative of a legal entity appointed as controller.

Where the debtor is an independent professional person with a statutory or regulated status or whose designation is protected, the supervisory body or relevant authority, if any, will act as controller as of right. In this case, the supervisory judge may not appoint more than four controllers. The controller shall be held liable only in case of gross negligence. He may be represented by one of his employees or by an advocate. Any creditor appointed as controller may be removed by the Court on motion of the Public prosecutor.

Article L621-11

The controllers shall assist the court nominee in his functions and the supervisory judge in his duty of supervising the management of the business. They may consult all documents sent to the administrator and to the court nominee.

They shall observe confidentiality. Controllers shall not be paid for their duties.

Article L621-12

If it appears, after the commencement of the proceedings, that the debtor was already in a state of cessation of payments at the time of issuance of the commencement order, the Court will record this and fix the date of the cessation of payments under the conditions provided for under the second paragraph of Article L631-8. It shall convert the safeguard proceedings into reorganization proceedings. If necessary, it may modify the length of the remaining observation period. The administrator, the court nominee or the Public prosecutor may apply to the Court which may also initiate a case of its own motion. It shall rule upon the case after having heard or duly summoned the debtor.

CHAPTER II

The business during the observation period

Article L622-1

I—The management of the business shall be carried out by its manager.

II—Where the Court, in accordance with the provisions of Article L621-4, appoints one or more administrators, it will assign them to jointly or individually supervise the debtor's management operations or to assist the debtor in all or some of the management.

III—In performing his duties, the administrator must comply with the legal and contractual obligations incumbent on the head of the business.

IV—At any time, the Court may alter the administrator's duties on his motion or on motion of the court nominee or that of the Public prosecutor.

V—The administrator may operate, with his signature, the debtor's bank and Post Office accounts if the debtor is prohibited from so doing under Article 65-2 and the third paragraph of Article 68 of the Decree of 30 October 1935 on the unification of the law governing cheques.

Article L622-2

The debtor's statutory auditor may not avail himself of professional confidentiality rules in order not to meet the requests of the administrator's statutory auditor for information or documents concerning the operation, from the moment the administrator is appointed, of bank or Post Office accounts opened in the debtor's name.

Article L622-3

The debtor shall continue to carry out acts of disposal and management over his personal estate as well as to exercise rights and actions not included within the administrator's duties.

In addition, subject to the provisions of Articles L622-3 and L622-13, the daily management operations that the debtor performs alone shall be deemed valid with respect to third parties acting in good faith.

Article L622-4

As from the time of his entry into office, the administrator must either require the head of the business to carry out all acts necessary for the preservation of the business's interests against its debtors and to maintain the production capacity or do this himself as the case may be.

The administrator shall be entitled to take out, on behalf of the business, any mortgage, security, pledge or lien that the head of the business may have neglected to secure or renew.

Article L622-5

As of the issuance of the commencement order, all third party holders must hand over to the administrator or, in the absence of an administrator, to the court nominee, at the latter's request, all documents and books of account for examination.

Article L622-6

From the commencement of the proceedings, an inventory and a valuation of the debtor's estate and the guarantees encumbering it shall be made. The debtor shall add to the inventory to be given to the administrator and the court nominee a statement with respect to assets he holds that may be claimed by a third party. The debtor shall give the administrator and the court nominee a list of its creditors, the amount of its debts and the main

executory contracts. The debtor shall inform them of any pending proceedings to which it is a party. The administrator or, if none has been appointed, the court nominee may, notwithstanding any statutory or regulatory rule to the contrary, receive information enabling him to know the exact position of the debtor's estate from public authorities and bodies, provident institutions and social security, credit institutions and bodies responsible for the centralisation of information on banking risks and payment incidents. Where the debtor is an independent professional person with a statutory or regulated status or whose designation is protected, the inventory will be drawn up in the presence of a representative of the debtor's supervisory body or relevant authority, if any. The inventory may not infringe the debtor's duty of professional confidentiality under any circumstances.

The absence of an inventory shall not preclude actions for recovery or restitution.

A Conseil d'Etat decree shall define the conditions under which this article shall apply.

Article L622-7

The order commencing the proceedings shall automatically prohibit payment of claims arising prior to the issuance of the commencement order, except set-off payments of connected claims. It shall also automatically prohibit payment of claims arising after the issuance of the commencement order that are not referred to under Article L622-17, other than those claims related to the debtor's daily necessities of life and alimony claims. It shall at last forbid the conclusion and performance of a commissoria lex.

The supervisory judge may allow the head of the business or the administrator to carry out acts of disposition not included in the ordinary management of the business, to grant mortgages or collateral or to compromise or settle.

The supervisory judge may also allow them to pay debts arising prior to the issuance of the order, to withdraw a pledge or possession of a thing held lawfully, where this withdrawal is justified by the continuation of business operations.

All acts or payments carried out in violation of the provisions of this article shall be nullified on motion of any interested party or of the Public prosecutor to be submitted within a three-year period beginning with the performance of the act or the payment of the debt. Where the act has to be published, this period will run from the date of publication.

Article L622-8

When an asset encumbered with a special lien, a security or a mortgage is

sold, the portion of the price corresponding to the claims secured by these guarantees will be placed on a deposit account with the Caisse des dépôts et consignations. After the confirmation of the plan, creditors whose claims are secured by these guarantees or by a general lien shall be paid out of the proceeds according to their priority and in compliance with Article L626-22 where they are subject to the time limits provided for in the plan.

The supervisory judge may order interim payment of the whole or part of the creditors' claims of the secured on the asset. Save where the supervisory judge has issued a specially reasoned ruling or where the payment is in favour of the Treasury, benefits institutions or similar organisations, the interim payment will be subject to the presentation by its beneficiary of a guarantee provided by a credit institution.

The debtor or the administrator may offer to creditors to substitute guarantees equivalent to those existing. In the absence of agreement, the supervisory judge may order this substitution. An appeal against this order may be filed with the Court of Appeal.

Article L622-9

The business's activity shall be continued during the observation period, subject to the provisions of Articles L622-10 to L622-16.

Article L622-10

The Court may order the partial cessation of the business's operations at any time during the observation period, on motion of the debtor, administrator, court nominee, one of the controllers, the Public prosecutor or, of its own motion.

Under the same conditions, it will convert the safeguard proceedings into reorganization proceedings if the

conditions in Article L631-1 are satisfied or will order liquidation proceedings if the conditions of Article L640-1 are satisfied.

It shall rule upon the case after having heard or duly summoned the debtor, the administrator, the court nominee, the controllers, the works council, or, in the absence of a works council, the employee delegates and after having received the Public prosecutor's opinion.

When it converts the safeguard proceedings into reorganization proceedings, the Court may, if necessary, alter the length of the remaining observation period.

Article L622-11

Where the Court pronounces the judicial liquidation it will terminate the observation period and the administrator's duties, subject to the provisions of Article L641-10.

Article L622-12

Where the difficulties that were the grounds for the commencement of the proceedings disappear, the Court will terminate the proceedings at the debtor's request. It shall rule upon the case as provided by the third paragraph of Article L622-10.

Article L622-13

Only the administrator has the right to require the debtor's contracting party to perform executory contracts in exchange for the performance of the debtor's obligations. The contract shall automatically be terminated once a formal notice has been sent to the administrator that has remained unanswered within a month. Before this time limit expires, the supervisory judge may grant the administrator a shorter time limit or an extension, which may not exceed two months, to take a position.

Where the performance concerns the payment of a sum of money, it must be paid promptly, except where the administrator is given a moratorium by the other party. Based on the forecast documents in his possession, the administrator must ensure at the time he requires the performance of the contract that he will have the necessary funds at his disposal. Where the contract is to be performed over time and paid in instalments, the administrator will terminate it if he believes that he will not have the necessary funds to satisfy the obligations of the next term. In the absence of payment under the conditions set out in the preceding paragraph or if the other party does not agree to continue the contractual relationship, the contract will automatically be cancelled and the Public prosecutor, the administrator, the court nominee or a controller may apply to the Court to terminate the observation period. The other party must perform its obligations despite the non-performance by the debtor of the obligations entered into prior to the issuance of the commencement order. The non-performance of these obligations shall only give creditors a right to submission of claims. If the administrator does not make use of his right to continue the contract or he terminates it as provided for by the second paragraph, the non-performance may give rise to damages that must be claimed as liabilities due to the other party. The other party may however postpone the reimbursement of sums paid in excess by the debtor in performance of the contract until the question of damages is settled. Notwithstanding any legal rule or contractual term to the contrary, the indivisibility, termination or rescission of the contract may not result from the commencement of safeguard proceedings alone. The provisions of this article shall not apply to employment contracts.

Article L622-14

The termination of the debtor's lease rights over immovable property used in the business's operations will be recorded or ordered:

1. if the administrator decides not to continue the lease and applies for its termination. In this case, the termination shall take effect on the day of the application.

2. if the lessor requests the termination or has termination of the lease recorded due to non-payment of the rent or tenant's expenses in connection with the occupancy after the issuance of the commencement order, as the lessor may take action only at the end of a three month period from the date of issuance of the order.

If the sums are paid before this period has elapsed, there is no cause for termination. Notwithstanding any contractual term to the contrary, the absence of activity during the observation period in one or more of the properties leased by the business shall not cause the termination of the lease.

Article L622-15

Where the lease is assigned, any clause imposing a solidary liability with the assignee on the assignor shall be deemed void.

Article L622-16

In the event of safeguard proceedings, the lessor shall have a preferential lien only on the rent of the last two years preceding the issuance of the commencement order.

If the lease is terminated, the lessor will have, in addition, a preferential lien in respect of performance of the lease in the current year and damages that may be awarded by court.

If the lease is not terminated, the lessor may not demand payment of the rent yet to fall due where the guarantees given to him at the time of the contract are maintained or where those that have been given after the issuance of the commencement order are regarded as sufficient.

The supervisory judge may allow the debtor or the administrator, as the case may be, to sell movable assets furnishing the leased premises that are susceptible to deteriorate or depreciate rapidly, that are expensive to preserve or whose sale does not undermine the existence of the business or the maintenance of sufficient guarantees for the lessor.

Article L622-17

I—Claims arising in a proper manner after the issuance of the commencement order for the needs of the proceedings or the observation period or as consideration for goods and services provided to the debtor with respect to its professional or activity during this period, shall be paid as they fall due.

II—Where they are not paid as they fall due, these claims will be paid according to their preferential lien before all the other claims, whether

these are secured or not by preferential liens or guarantees, except for those claims secured by a lien provided for in Articles L143-10, L143-11, L742-6 and L751-15 of the Labour Code, those claims secured by a lien for legal fees and those claims secured by the lien created by Article L611-11 of this Code.

III—Their payment shall be made in the following order:

1. claims of wages and salaries for which funds have not been advanced in compliance with Articles L143-11-1 to L143-11-3 of the Labour Code;
2. legal fees;
3. loans and claims arising from the performance of continued contracts according to the provisions of Article L622-13 and where the other party accepts deferred payments. These loans and the moratorium shall be allowed by the supervisory judge within the limits necessary for the continuation of business operations during the observation period and shall be published. In the event of termination of a contract that had been continued in a proper manner, compensation and penalties will be excluded from this article.
4. sums that have been advanced in application of Article L143-11-1 (3°) of the Labour Code;
5. other claims, according to their priority.

IV - Unpaid claims will lose the lien provided for by this article if they have not been notified to the court nominee and the administrator, where one has been appointed or, where these persons have ceased their functions, to the plan performance supervisor or the liquidator within a year from the end of the observation period.

Article L622-18

Any sum received by the administrator or court nominee, that has not been deposited on the debtor's bank or Post Office accounts in order to continue business operations, must immediately be deposited on a deposit account with the Caisse des dépôts et consignations.

If deposits are delayed, the administrator or the court nominee must pay interest on the unpaid amounts at the legal rate of interest plus five percent.

Article L622-19

Any sum received by the association referred to under Article L143-11-4 of the Labour Code in compliance with Articles L143-11-1 to L143-11-3 of the same Code shall be declared to the tax authority.

Article L622-20

Only the court nominee appointed by the Court may act on behalf and in the general interest of the creditors. However, if the court nominee fails to

act, any creditor appointed as controller may act in the general interest of the creditors under the conditions provided for in a Conseil d'Etat decree. The court nominee shall transmit all comments that he receives from the controllers in the course of the proceedings to the supervisory judge and to the Public prosecutor. Sums recovered following actions initiated by the court nominee or, if the court nominee fails to act, by the creditor(s) appointed as controllers, become part of the debtor's estate and shall be used to pay the debtor's liabilities according to the terms provided for paying liabilities if the continuation of the business is decided.

Article L622-21

I—The issuance of the commencement order shall stay or prohibit legal actions of all creditors whose claims are not referred to under Article L622-17 (I) aimed at obtaining:

1. an order against the debtor to pay a sum of money.
2. the rescission of a contract on the grounds of non-payment of a sum of money.

II—In addition, the order shall stay or prohibit all proceedings for enforcement filed by the creditors in respect of movable and immovable properties.

III—Hence, all time limits, to be observed under the penalty of loss or rescission of rights, shall be stayed.

Article L622-22

Save the provisions of Article L625-3, any pending proceedings shall be stayed until the creditor who initiated it has filed its submission of claim. Then, they shall be resumed *ipso jure* for the sole purpose of verifying the claims and determining their amount after having duly summoned the court nominee and, as the case may be, the administrator or the plan performance supervisor appointed in compliance with Article L626-25.

Article L622-23

Legal actions and proceedings for enforcement against the debtor other than those referred to under Article

L622-21 shall be continued during the observation period after the administrator and the court nominee have been summoned or after the action is resumed at their own initiative.

Article L622-24

From the date of publication of the order, all creditors other than employees whose claims arose prior to the issuance of the commencement order shall submit their claims with the court nominee. Creditors who hold a published security or who are bound to the debtor by a published contract shall be informed personally or, where appropriate, at their

elected domicile. The time limit for submitting claims with respect to these creditors shall run from notice of this information.

The claims may be submitted by the creditor or by any employee or proxy of his choice.

The claims must be submitted even if they are not proven by a document. Those claims whose amount is not yet definitively determined shall be submitted based on an assessment. The claims of the Public Treasury, provident institutions and social security as well as claims of the institutions provided for in Article L351-21 of the Labour Code for which no order for enforcement has been issued at the time of submitting shall be admitted on a provisional basis for the amount submitted. Whatever the case, the submissions of claims by the Public Treasury and social security shall always be made subject to any taxes and other claims not proven at the date of the filing of the submission of claims. Subject to pending court and administrative proceedings, final proof must be brought within the time limit provided for in Article L624-1, under the penalty of debarment. Those institutions referred to under Article L143-11-4 of the Labour Code shall be subject to the provisions of this article for the sums paid by them as an advance and that shall be reimbursed to them under the conditions provided for claims arising prior to the issuance of the order commencing the proceedings. Claims properly arising after the issuance of the commencement order, other than those referred to under Article L622-17(I) and alimony claims, shall be subject to the provisions of this article. The time limits shall run as of the maturity date of the claim. However, creditors whose claims arise from a successive performance contract shall file the total amount of their claim under the conditions provided for by a Conseil d'Etat decree.

The time limits for submitting claims of a civil party arising from a criminal offence shall run as of a final judgment determining the amount.

Article L622-25

The submission of claim shall state the amount of the claim due on the date of issuance of the commencement order and the sums yet to fall due and their dates of maturity. It shall state the nature of the lien or security that secures the claim, if any.

Where the claim is expressed in a foreign currency, the conversion to Euros shall be made at the exchange rate prevailing on the date of the issuance of the commencement order. Unless it results from an order for enforcement, the submitted claim shall be certified genuine by the creditor. The supervisory judge may request that the statutory auditor's stamp or, failing this, the stamp of a public accountant, be affixed to the submission of claims. Any refusal to affix the stamp must be explained.

Article L622-26

If they fail to submit their claims within the time limits provided for in a Conseil d'Etat decree, the creditors will not participate in the allocation of funds and distribution of dividends unless the supervisory judge sets aside the debarment of their claims if they prove that they are not liable for the absence of submission of claims or that the debtor has deliberately omitted to mention their claim on the list provided for under the second paragraph of Article L622-6. They may then participate only in the distributions of dividends made after their request.

A motion to set aside a debarment may be filed only within a six-month period. This period shall run from the date of publication of the commencement order or, for those institutions referred to under Article L143-11-4 of the Labour Code, from the end of the period during which the claims arising from an employment contract are secured by these institutions. With respect to creditors secured by a published security or bound to the debtor by a published contract, the period shall run from the receipt of the notice delivered to them. As an exception, the period shall be extended to one year with regard to creditors who were unable to know the existence of their claim before the end of the six months period referred to above.

Article L622-27

In the event of a dispute over the whole or part of a claim other than those referred to under Article L625-1, the court nominee will inform the creditor concerned, by requesting him to give its explanations. A failure to reply within thirty days shall bar any later dispute over the court nominee's proposals.

Article L622-28

The issuance of the commencement order shall stay the legal and contractual interest, as well as any interest due to late payment and surcharges, unless it concerns interest arising from loan contracts for a period of at least one year or contracts with payments deferred for at least one year. Individuals who are sureties, co-obligors or who are bound by an independent guarantee may benefit from the provisions of this paragraph.

The issuance of the commencement order shall stay any action against individuals who are sureties, co-obligors or who are bound by an independent guarantee, until the order confirming the plan or pronouncing the liquidation. The Court may subsequently grant them a moratorium or a deferred payment period for a maximum of two years.

Creditors secured by these guarantees may take protective measures.

Article L622-29

The issuance of the commencement order shall not render unmatured

claims mature on the day of the issuance of the order. Any clause to the contrary shall be deemed not to have been written.

Article L622-30

No mortgage, pledge or lien may be registered after the issuance of the commencement order. The same shall apply to deeds and court decisions transferring or creating rights in rem except where these deeds have obtained a legal date or the decisions have become enforceable prior to the issuance of the commencement order.

However, the Public Treasury shall not lose its lien for claims that it was not required to register on the date of the issuance of the commencement order and for claims to be collected after this date if these claims have been submitted under the conditions provided for in Article L622-24.

The seller of a business, by way of exception to the provisions of the first paragraph, may register his lien.

Article L622-31

A creditor bearing obligations entered into, endorsed or guaranteed jointly and severally by two or more co-obligors subject to safeguard proceedings, may submit its claim for the par value of its claim in all cases of proceedings.

Article L622-32

Co-obligors subject to safeguard proceedings may not bring an action against each other regarding payments carried out except where the total of sums paid out in each case exceeds the total amount of the claim including the principal and other sums. In this case, the excess shall be payable, according to the order of the obligations to the co-obligors who are secured by the others.

Article L622-33

If a creditor, bearing obligations entered into solidarily by a debtor subject to safeguard proceedings, has received an advance payment on his claim from other co-obligors prior to the issuance of the commencement order, the creditor may submit its claim only after deducting the advance payment and shall retain, for the remaining sum due to it, its rights against the co-obligors or the surety. A co-obligor or surety who has made a partial payment may submit its claim up to the amount paid to discharge the debtor.

CHAPTER III

Drafting an economic, employment and environmental plan

[. . .]

CHAPTER IV

Determination of the debtor's estate

[. . .]

SECTION III

Rights of sellers of movable property, recovery claim (revendication) and restitution

Article L624-9

A recovery claim against movable property may be filed only within a three-month period from the date of publication of the order commencing the proceedings.

For assets governed by an executory contract at the commencement of the proceedings, this period shall run as of the termination or expiry of the contract.

Article L624-10

The owner of a property does not need to provide proof of ownership where the contract related to it has been published. He may claim the restitution of his property under the conditions provided for by a Conseil d'Etat decree.

Article L624-11

The lien and right of recovery created by Article 2102 (4) of the Civil Code in favour of the seller of chattels as well as the action for rescission of a contract may be exercised only within the limits of the provisions of Articles L624-12 to L624-18 of this Code.

Article L624-12

Goods may be claimed when the sale contract was rescinded prior to the issuance of the commencement order, either pursuant to a court decision or pursuant to a condition subsequent, and if they still exist in kind, wholly or partially. The recovery claim must also be admitted even if the rescission of the sale had been ordered or referred to by a court decision after the issuance of the commencement order where the action for recovery or for rescission of a contract was initiated by the seller, for a reason other than non-payment of the sales price, prior to the issuance of the commencement order.

Article L624-13

Goods sent to the debtor may be reclaimed for such time as they have not been delivered to the debtor's premises or to the agent charged with selling

them on the debtor's behalf. However, the recovery claim will not be allowable if the goods have been resold, other than fraudulently, before their arrival, on the basis of correctly established invoices or transport documents.

Article L624-14

The seller may retain goods that have not been delivered or dispatched to the debtor or to a third party acting on the debtor's behalf.

Article L624-15

Bills of exchange and any other unpaid securities given by their owner to be collected or to be specially allocated to specific payments may be reclaimed if they remain in the debtor's portfolio.

Article L624-16

Goods held by the debtor on consignment or for sale on behalf of the owner may be claimed if they still exist in kind. Assets sold with retention of title clause may be claimed if they still exist in kind at the time of the issuance of the commencement order. This clause must have been agreed upon in writing at the latest at the time of delivery. It may appear in a document governing a number of commercial operations entered into by the parties. The recovery claim in kind may be brought under the same conditions with respect to movable assets incorporated in another asset where they may be removed without damaging them. A recovery claim in kind may also be made in relation to fungible items where the debtor or any person keeping them on his behalf has in his possession assets of a similar type and the same quality. In every instance, the asset may not be recovered, if, by decision of the supervisory judge, the price is paid immediately. The supervisory judge may also, with the consent of the petitioning creditor, grant a moratorium. The payment of the price shall thus be considered equivalent to the payment of debts referred to under Article L622-17(I).

Article L624-17

The administrator with the consent of the debtor or, in the absence of an administrator, the debtor with the consent of the court nominee may approve the recovery claim or restitution claim of assets dealt with under this Section. In absence of consent or in the event of dispute, the request will be filed with the supervisory judge who will rule upon the fate of the contract based on the views of the creditor, the debtor and the court nominee.

Article L624-18

The price or portion of the price of the assets referred to under Article L624-16, which was not paid or settled in negotiable instruments or set off

in the form of credit on a current account between the debtor and the purchaser on the issuance of the order commencing the proceedings, may be claimed. Insurance payouts for lost property subrogated to the property may be claimed under the same conditions.

CHAPTER V

Payment of claims resulting from employment contracts

SECTION I

Verification of claims

Article L625-1

After verification, the court representative shall draw up, within the time limits provided for in Article L143-11-7 of the Labour Code, statements of claims resulting from an employment contract, after having heard or duly summoned the debtor. The statements of claims shall be handed over to the employees' representative under the conditions provided for in Article L625-2. They must be signed by the supervisory judge, filed with the clerk of the court and shall be submitted to the publication formalities provided for by a Conseil d'Etat decree.

An employee whose claim does not appear in whole or in part on the statements of claims may, under the penalty of debarment, bring an action before the Labour Court within two months following the date of completion of the publication formalities provided for in the preceding paragraph. He may ask the employees' representative to assist him or to represent him before the Labour Court. The debtor or the administrator, if he assumes management duties, shall be summoned.

Article L625-2

The statements of claims resulting from an employment contract shall be handed over, for verification, to the employees' representative provided for in Article L621-4 by the court nominee. The court nominee must transmit all useful documents and information to him. Where problems are encountered, the employees' representative may turn to the administrator and, where appropriate, apply to the supervisory judge. He has a duty of discretion provided for in Article L432-7 of the Labour Code. The time spent in carrying out his duties as provided for by the supervisory judge shall automatically be regarded as working time and shall be paid by the employer, the administrator or the liquidator, as the case may be, at the normal due date.

Article L625-3

Any pending proceedings before the Labour Court on the date of the order commencing the safeguard proceedings shall be continued in the presence of the court nominee or after he has been duly summoned. The court nominee shall inform the court hearing the case and the employees party to it of the commencement of the safeguard proceedings within ten days.

Article L625-4

Where the institutions referred to under Article L143-11-4 of the Labour Code refuse on whatsoever ground to pay a claim mentioned on the statements of claims resulting from an employment contract, they will inform the court representative of their refusal and the court representative shall immediately inform the employees' representative and the employee concerned. The employee concerned may bring his case before the Labour Court. The court representative, the head of the business or the administrator, when he is in charge of management duties, shall be summoned. The employee may ask the employees' representative to assist him or to represent him before the Labour Court.

Article L625-5

Litigation brought before the Labour Court in pursuant to Articles L625-1 and L625-4 shall be brought directly before the Labour Court judges.

Article L625-6

Statements of claims resulting from an employment contract, signed by the Receiver Judge, as well as the decisions of the Labour Court shall be mentioned on the list of claims handed over to the clerk's office. Any interested person, other than those referred to in Articles L625-1, L625-3 and L625-4, may bring an action or third party proceedings under the conditions provided for in a Conseil d'Etat decree.

SECTION II

Employees' lien

Article L625-7

Claims resulting from an employment contract shall be secured in the event of commencement of safeguard proceedings:

1. by the lien provided for by Articles L143-10, L143-11, L742-6 and L751-15 of the Labour Code, for the reasons and amounts defined in these articles;
2. by the lien provided for by Article 2331 (4) and Article 2375 (2) of the Civil Code.

Article L625-8

Notwithstanding the existence of any other claim, claims secured by the lien provided for by Articles L143-10, L143-11, L742-6 and L751-15 of the Labour Code must be paid by the administrator upon the order of the supervisory judge, within ten days from the date of issuance of the order commencing the safeguard proceedings, if the administrator has the necessary funds. However, before determining the amount of these claims, the administrator must immediately, with the permission of the supervisory judge and depending upon the funds available, pay to the employees, on a provisional basis, a sum equal to one month's unpaid wages, on the basis of the latest pay slip, but without exceeding the ceiling referred to in Article L143-10 of the Labour Code. If there are insufficient funds available, the sums due under the terms of the two preceding paragraphs must be paid from the first funds received.

CHAPTER VI

The safeguard plan

Article L626-1

Where there is a serious likelihood of saving the business, the Court will draw up a plan, terminating the observation period in so doing. The safeguard plan shall include, if necessary, the cessation, the addition or the assignment of one or more activities. Assignments made in compliance with this Article shall be subject to the provisions of Section I of Chapter II of Title IV. The court nominee shall carry out the duties entrusted to the liquidator under these provisions.

SECTION I

Drawing-up a draft plan

[. . .]

SECTION II

Order confirming the plan and implementation of the plan

[. . .]

SECTION III

Committees of creditors

Article L626-29

Debtors whose accounts are certified by a statutory auditor or prepared by a public accountant and whose number of employees or sales turnover

excluding tax exceeds the thresholds fixed by a Conseil d'Etat decree shall be governed by the provisions of this Section. On motion of the debtor or the administrator, the supervisory judge may allow the application of this Section where this threshold is not reached.

Article L626-30

Credit institutions and main suppliers of goods or services shall be grouped into two committees of creditors by the administrator within thirty days from the commencement order. Each supplier of goods or services shall be a member *ipso jure* of the committee of the main suppliers where its claims account for more than 5% of the total claims of suppliers. The other suppliers may be members of this committee on invitation by the administrator. The debtor shall present its proposals for the drawing up of the draft plan provided for in Article L626-2 to the committees of creditors within two months from the date on which the committees are formed, which may be extended once for two more months by the supervisory judge on motion of the debtor or the administrator. After discussion with the debtor and the administrator, the committees will vote on the draft plan, modified if necessary, at the latest within thirty days after the proposals have been sent by the debtor. The decision shall be made by each committee by a majority vote of its members, representing at least two-thirds of the total amount of the claims of all the members of the committee of creditors as indicated by the debtor and certified by its statutory auditor(s) or, where none has been appointed, prepared by its public accountant. The draft plan adopted by the committees of creditors shall be subject neither to the provisions of Article L626-12 nor to those in the second and third paragraphs of Article L626-18. Local authorities and their public bodies may not be members of the committee of main suppliers.

Article L626-31

Where the draft plan has been adopted by the committee of creditors according to the provisions of Article L626-30, the court will ensure that the interests of all of the creditors are sufficiently protected. In this case, the court shall confirm the plan with respect to the adopted draft and in the manner provided for under Section 2 of this Chapter. Its decision shall make binding the proposals accepted by each committee to all their members. Notwithstanding the provisions of Article L626-26, substantial modifications in the goals or means of the plan confirmed by the court in accordance with the first paragraph may occur only in the manner provided for under this Section.

Article L626-32

Where there are bondholders, the administrator shall summon representatives of the body of bondholders, if any, within fifteen days from the date

the draft plan is sent to the committees in order to outline it to them. Representatives of the bondholders shall thereafter convene a general meeting of bondholders within fifteen days in order to decide on the draft. However, the failure to act or the absence of any representative of the bondholders is properly recorded by the supervisory judge, the administrator will convene the general meeting of bondholders.

The decision may relate to the total or partial abandonment of the bondholders' claims.

Article L626-33

Creditors who are not members of the committees of creditors formed in compliance with Article L626-30 shall be consulted in the manner provided for under Articles L626-5 to L626-7. The administrator shall perform to this end the duties entrusted to the court nominee by these provisions.

The provisions of the plan regarding the creditors who are not members of the committees of creditors formed in compliance with Article L626-30 shall be confirmed in the manner provided for under Articles L626-12 and L626-18 to L626-20.

Article L626-34

Where one or other of the committees of creditors has not ruled upon the draft plan within the set time limits, where a committee of creditors has rejected the proposals presented to it by the debtor or where the court has not adopted the plan in compliance with Article L626-31, the proceedings will be resumed to prepare a plan in the manner provided for in Articles L626-5 to L626-7 in order to adopt it in the manner provided for under Articles L626-12 and L626-18 to L626-20. The proceedings will be resumed in the same manner where the debtor has not presented any proposals for a plan to the committees of creditors within the set time limits.

Article L626-35

A Conseil d'Etat decree shall determine the conditions for the application of this Section.

[. . .]

Index

Note: French law is shown by insertion of '(France)'

administration

- changes, 21–7, 45–7, 212
- duties of care, 24–5
- empirical analysis, 49–65
- English law, 19, 208, 212
- French law, 7, 130

administrative receivership, 21–7, 45–7,

- 49–65, 70, 181, 212
- collective procedure and, 25
- duties, 23–4
- effects of reforms, 26–7, 49–65
- limitations of reforms, 25–6
- overlap with liquidation, 34–5

Anwachsung, 76, 86, 94–5, 96

Armour, J, 56, 98

assurance générale des salaires (AGS), 16

Austria, *Insolvenzgeld* funding, 87–8

bankruptcy *see* insolvency and insolvency law
Business Recovery Professionals (R3), 48

centre des intérêts principaux see under
COMI

centre of debtor's main interests *see under*
COMI

centre of main interests *see under* COMI
Centros case, 99, 107, 126–7

Code de commerce *see under* Commercial
Code (France)

collective procedures (France) (*see also*
insolvency, French law) 137–53,
159–80

- background, 137–40
- debts remission, 150–2
- declaration of claim, 145–7
- definition, 138–40, 159–60
- development of law, 160–2
- discontinuance/stay of actions, 141–3
- diversification, 162–4
- exclusion, 159–80
 - assessment, 175–9
 - background, 159–65
 - conclusion, 180

consistency, 176–8

financial collateral arrangements, 172–3

foreign collective procedures, 175

interbank settlement, 171–2

legitimacy, 178–9

lex concursus, 174–5

property owner status, 165–8

securitisation of debt/receivables, 173–4

set-offs, 174–5

statutory, 170–5

technical, 165–70

third party property, 168–70

trusts, 163, 169–70, 209

US/German/English comparison, 177–8

financial collateral arrangements, 172–3

foreign collective procedures, 175

guarantee, 137–8, 152

effects on, 153

interbank settlement, 171–2

interest cessation, 149–50

and international developments, 25

lex concursus, 174–5

set-offs, 174–5

surety

amount, 149–52

discharge, 144–9

right to sue, 140–9

time limits for payment, 143–4

see also guarantee *above*

third party property, 168–70

time limits for payment, 141*n*

surety claim, 143–4

trusts, 163, 169–70, 209

unjustified support and, 147–9

COMI

centre of debtor's main interests (France),
111, 112

concept, 113–16

conflict-of-laws and, 113–15, 124–5

criterion application, 117–21

forum shopping and, 123

judgment-opening recognition, 119–21

jurisdiction determination and, 117–18,
122

substantive definition, 115–16

COMI – *continued*

- centre of main interests (EU)
 - company/insolvency law and, 103
 - EC law conformity, 104–6
 - forum shopping and, 106–8, 123
 - fundamental freedoms and *see* freedom of establishment
 - justification for, 103–9
 - migration of, 75–79, 80–2
 - obscurity of, 102–3
 - standard, 72–5, 79–80, 84–5, 86–7, 96–7, 98–104
- Commercial Code (France)
 - 1807, 2
 - Act of 28 May 1838, 2
 - Act of 4 March 1889, 3
 - Decree of 20 May 1955, 3
 - Act of 13 July 1967, 3–4
 - Act of 25 January 1985, 4–5
 - Act of 1 March 1984, 4
 - Act of 10 June 1994, 5
 - Act of 26 July 2005, 5–9
 - administration, 7
 - background, 5–6
 - conciliation procedure, 6
 - preventative provisions, 6
 - reform, 8–9
 - registered office, 111, 114–15
 - safeguard proceedings, 6–7
 - winding-up, 7–8
- company migration *see under* forum shopping
- conciliation procedure (France), 6
- corporate bankruptcy *see* insolvency
- corporate insolvency *see* insolvency
- creditor protection, 89, 94–7, 126
- creditors
 - floating charge and, 27–9
 - protection
 - comparison, 88–9, 90
 - forum shopping and, 94–7
- creditors (France), 12–6, 69–70
 - employees' guarantees, 15–16
 - individual, 90
 - prior/subsequent, 12–14
 - protection, 88–9
 - secured/unsecured, 14–15
 - suspect period, 12
- Daily assignment, 68–9
- Daisytek case see Isa Daisytek case*
- debtors (France), 9–11
 - see also* COMI, centre of debtors main interests (France)
 - directors' personal situation, 10–11
 - extension of proceedings, 9–10
 - over-indebtedness, 10
- Deutsche Nickel*, 77–9, 87, 89
- directors (France), personal situation, 10–11

- Eidenmüller, H, 90, 102
- employee protection, 15–6, 28–30, 62–4, 88, 107, 131, 181–3, 188–98, 210
- employees' guarantees (France), 15–16
- Enterprise Act 2002, 21–9, 89, 181, 208–9, 212
 - administrative receivership/administration, 21–7
 - effects, 45–65
 - see also* insolvency, outcomes research
 - establishment, 79, 96, 111, 115, 124, 126
 - see also* freedom of establishment
 - Eurofood case*, 79–80, 85–6, 96, 100, 102, 108, 111–22
 - COMI definition, 116
 - judgment-opening recognition and, 119–21
 - jurisdiction determination and, 117–18, 122, 124
- financial collateral arrangements, 172–3
- fixed charge, 37–43
 - characterisation, 37–9
 - charged assets and, 39–40
 - control and, 40–1
 - invoice discounting and, 42–3
 - substitution power and, 41
 - see also* floating charge
- floating charge, 17–21, 43–4
 - administrative receivership, 21–2, 212
 - background, 17–18
 - disadvantages, 19–21
 - effects, 18–19
 - liquidation costs and, 30–1, 35–7
 - priority of creditors, 27–9
 - as security, 43–4
 - see also* fixed charge
- forum shopping, 71–109
 - background, 71–2
 - and centre of main interests *see under* COMI
 - COMI and, 106–8
 - COMI (debtor) and, 123, 125–7
 - company groups, 73–5
 - company migration, 75–80
 - conclusion, 109
 - creditors
 - as initiators, 93–4
 - protection, 94–7
 - definition, 72–3
 - efficiency issues, 91–3
 - home-state principle, violation, 99–102
 - insolvency
 - filing and, 80–2
 - regime disparities and, 87–90
 - outlook, 82–3
 - regulation attempts, 83–7
- France
 - employee protection, 88, 181–98

insolvency law *see* insolvency, French law
 legislation summary, 1–2
 freedom of establishment
 COMI approach, confirmity, 99–104
 EC law conform solution, 104–6
 scope of, 98–9

Germany

Anwachsung, 76, 86, 94–5, 96
 insolvent individuals, 90
Insolvenzgeld funding, 87–8
Insolvenzordnung, 27, 178, 181
 stay of action, 177

Guyon, Y, 68

Hans Brochier case, 78–9, 80, 85
 head office, 79, 80, 85, 86, 101–2, 104
 home-state principle, violation, 99–102

individual insolvency *see under* insolvency
 insolvency, insolvency law

see also collective proceedings
 disguised liquidations, 58–60
 EC law, 111–12

French law

comparisons, 67–70, 181–2, 208–9
 continuation procedure, 200–1
 employment preservation, 188–92
 legislation overview, 1–9, 184, 198–201
 liquidation procedure, 200
 overview, 1–9
procédure de sauvegarde *see* safeguard
 proceedings
 scope of application, 9–10
 security and insolvency 129–36,
 137–153
 social objectives, 209–10
 individual insolvency, 10, 80–2, 90,
 139–40, 143–53
 international convergence, 212–13
 jurisdiction disparities, 87–90
 objectives, 90–1

outcomes of insolvency survey

ANOVA tests, 192
 average recovery rates, 193, 194–5
 Tables
 background, 181–4
 conclusion, 198
 data collection, 185–6, 201–3
 default causes codification, 203, 204–5
 Table
 estimates, 190, 191 Table
 LOGIT regression analysis, 188, 190
 methodology, 185–6
 Parisian/French comparison, 184–6,
 201
 questions, 182–4
 sample structure, 187 table, 188
 SIRENE database, 185–6

social/financial efficiencies, 192–7,
 207–8
 terminology, 186, 188
 outcomes research, 49–51
 background, 45–6, 64–5
 lessons, 53–5
 methodology, 49–54
 pre-packs
 employment preservation and, 62–4, 65
 incidence, 60–2
 as private arrangement, 69
 project, 51–3
 strategy, 47–9
 receivables financing, 56–8
 restructuring emphasis, 211
 security and insolvency 129–36, 137–153,
 155–8

insolvency outcomes *see* insolvency,
 outcomes research

Insolvenzgeld funding, 87–8
 interbank settlement, 171–2
Isa Daisytek case, 73–5, 114, 117, 118, 119,
 121

judgment-opening recognition, 119–21
 jurisdiction disparities, 87–90

La Porta, R, 89

lex rhodia de jactu, 67–8

letterbox companies, 79, 100, 105, 115–6,
 124

liquidation costs, 29–37
 policy issues, 33–5
 practical issues, 35–7
 preferential debts and, 29–31
 statutory interpretation, 31–3

Merger Directive (EU), 82–3

Napoleon I, 2

Outcomes Project, 49–51

outcomes project *see under* insolvency

pre-packs *see under* insolvency
 preferential creditors, 27–9
 preventative provisions (France), 6
procédure de sauvegarde *see* safeguard
 proceedings

R3 (Business Recovery Professionals), 48
 real seat, real seat theory, 101–2, 124
 receivables financing, 56–8
 receiver, receivership *see* administrative
 receivership
Recovery (magazine), 48
 regime disparities, 87–90

- registered office
 - and COMI, 72, 78–80, 84, 104, 108, 111–22, 123–4
 - as actual situation, 115–16
 - conflict-of-laws and, 114–15, 124–5
 - in France, 111
 - transfer, 83, 95, 107, 126
- rescue culture, 22–3
- safeguard proceedings (France), 5–7, 8–9, 11, 14, 89, 130, 136, 153, 211–2
- Saint-Alary-Houin, C, 176
- Schefenacker* (company), 75–7, 89, 126
- security (France), 129–36
 - conciliation preference, 131–2, 157–8
 - developments, 129–30
 - enforceability, 156–7
 - English law comparison, 155–8
 - ethical security, 133
 - guarantee, 137–153
 - excessive, 157
 - methods of realising, 135–6
 - movable and, 134
 - priority limitation, 132
 - proportionality, 158
- sauvegarde* *see* safeguard proceedings
- siège réel* *see* real seat
- superprivilege*, 15
- Sussman, O, 108
- United Kingdom
 - creditor protection, 89
 - employee protection, 88
- United States
 - ‘chapter 11’, 6–7, 74, 177, 211
 - forum shopping debate, 92–3
 - stay of action, 177
- winding-up (France), 7–8