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Stojevic case

Today I will argue that the 'head office functions' theory is the best way for determining international jurisdiction. Of course I will demonstrate my point of view by referring to recent case law. The first topic I would like to discuss is the Stojevic case, with its Austrian¹ and English judgements.² In the latter case the English Registrar made some rulings in the dispute between Stojevic and Komerčni Banka. This Registrar, who is a gentleman, rejected criticisms by the Higher Regional Court in Vienna and Professor Doctor Paulus, which were directed at the lady registrar who opened the bankruptcy proceedings. With regard to Professor Doctor Paulus, the Registrar's judgement was that his criticism was couched in quite inappropriate language and appeared to have been made without any reference to or proper appreciation of the UK 1986 rules that, in the Registrar's view, were clearly designed to - and did - ensure a fair legal process! The further suggestion by Professor Doctor Paulus that the English bankruptcy court effectively engaged in judicial forum shopping was also held to be wholly unwarranted.

In the first round of the Stojevic case, the Austrian courts were confronted with the fact that an English court had opened main proceedings in respect of Stojevic. Stojevic was a Croatian national resident of Vienna who had a company in London. Stojevic was found by the Commercial Court in London to have used this company for committing a massive fraud against a Czech bank. It was a real international affair. The Czech bank Komerčni Banka brought insolvency proceedings, an involuntary bankruptcy petition, against Stojevic before the bankruptcy Registrar at London's High Court. In England, as in many countries, if there is no very serious defence at a hearing concerning the opening of insolvency proceedings, this hearing is not much more than a formality. The opening of insolvency proceedings is on the list of a Registrar who deals all day with different kinds of bankruptcy proceedings. Therefore time is limited and when the Registrar, after reading all the papers, is convinced that everything seems in order he will decide to open main proceedings.

In the Stojevic case, however, things were a bit more complicated than this, because Stojevic did turn up and opposed the opening of insolvency proceedings. Apparently he failed to produce his evidence in time, though. Obviously the Registrar Judge thought he was not serious or not seriously defending the petition and went ahead with opening the insolvency proceedings. The reason why the above-mentioned Registrar, who three years later dealt with my application on behalf of Stojevic (I acted as Stojevic's lead counsel) to set aside the opening, was so upset was that he felt that there had been a flagrant attack on the Registrar who opened the insolvency proceedings against Stojevic. Of course Professor Paulus didn't mean to be personally insulting and his criticism was part of his general criticism at that time of the English courts, which he regarded as imperialist because they opened many main proceedings regarding foreign registered companies.

What actually happened in the Stojevic case was that when another creditor went to an Austrian court a few days after the opening of insolvency proceedings in London and

¹ District Court of Vienna, March 2005, EuLF 3-2005, II-108; NZI 2005, 465, Stojevic

² High Court of Justice 27 March 2006 (unreported) Z19849-2002 (Stojevic)

requested the opening of involuntary main proceedings in the Stojevic case in Vienna, no one mentioned that Stojevic had already been declared bankrupt in London. Although this was not supposed to be possible under the Regulation, there were now two proceedings taking place at the same time, each of which claimed to be the main proceeding in the Stojevic case. This, of course, caused a very serious problem in the Austrian courts. For tactical reasons, though, no one applied to set aside the opening of bankruptcy proceedings in Austria or to have them treated as secondary proceedings.

The interesting aspect of the Stojevic case was that, under Austrian law, in main proceedings all of a debtor's property passes on in its entirety to the trustee in the insolvency proceedings. One property item of interest was Stojevic's claim against the very same Czech bank Komerčni Banka that had him declared bankrupt in England. Stojevic felt that the Czech bank was fraudulent and he wanted to sue it in Austria for exactly the same damages that it had sought against him in London. Stojevic managed to persuade the trustee responsible for the insolvency proceedings in Vienna to do what the Austrians call 'separate' and what in England would be called 'assigning' or 'transferring' Stojevic's rights against the Czech bank from his own bankruptcy estate back to Stojevic personally. Obviously, Komerčni Banka was opposed to this, but it was the English trustee in the English main insolvency proceedings who argued the case against separation in Austria. Unfortunately there were no assets in either the English or Austrian proceedings because Stojevic did not have any apparent assets, even though the bank had evidence that he seemed to have a very nice lifestyle in Vienna.

In the Austrian courts a battle took place when the trustee of the Austrian insolvency proceedings agreed to separate Stojevic's claim against the Czech bank, which allowed Stojevic to sue in Austria. The English trustee appealed this decision at the Court of Appeal. It was within this context that the Austrian Court of Appeal started to look at how the apparent main proceedings in Austria related to the apparent main proceedings in England. The Austrian Court of Appeal decided that *de facto* the Austrian proceedings, which were opened second, had to be treated as a kind of secondary proceedings. The effects of the Austrian insolvency proceedings should be limited to Austrian territory. This decision was upheld by the Austrian Supreme Court.

The Court of Appeal in Austria also thought that Stojevic's claim could be separated, but that the effects of the Austrian bankruptcy were limited to the boundaries of Austria. The Supreme Court in Austria rejected this and referred to Article 2(g) of the Regulation. This article clearly states that the location of the claim against the Czech bank Komerčni Banka corresponds to the location of the centre of main interest of the party that is required to meet the claim. The party that was required to meet Stojevic's claim, if it were valid, was the Czech bank, which was located in the Czech Republic.

So if the English insolvency proceedings are treated as having a universal scope (with the exception of Austria) and the Austrian insolvency proceedings as being territorial, then the claim against the Czech bank by Stojevic is located in the Czech Republic and belongs to the main proceedings in England and *de facto* not to the territorial proceedings in Austria. On this basis the Supreme Court in Austria set aside the decision to separate Stojevic's claim. Within this context implied criticism was given regarding the speed at which the English courts opened insolvency proceedings without looking at the facts. Professor Paulus wrote a commentary in German on the Austrian Court of Appeal's negative comment about the English courts, which was translated into English. This was done at a time when Professor Paulus deemed the English courts to be imperialistic and he gave his characteristically tough criticism on the English courts, which led to the strong defence by the Registrar who set aside the opening of insolvency proceedings after an application that I argued before him.

The interesting practical problem is that in every European country an insolvency judge has very little to go by when he or she has to decide on the opening of insolvency proceedings if there is either an undefended bankruptcy or a bankruptcy proceeding where the debtor fails to put in proper evidence. There is not much scope to do his or her own investigation and an insolvency judge has to look at the evidence that is in front of him or her. For example, the evidence that Stojevic lived at a particular address in London later turned out to be false. In fact, as it turned out, there was evidence that the Czech bank Komerční Banka knew that the real habitual residence of Stojevic was in Vienna. This was one of the arguments used to try to get the opening of the insolvency proceedings in England set aside three years after these proceedings were opened.

In fact, all of this demonstrates that Professor Paulus' original criticism was quite wrong. If insolvency proceedings are opened in England, a debtor or creditor can come back to England much later and set aside this opening. In most continental jurisdictions, however, if more than three weeks have passed since the insolvency proceedings were opened, these proceedings are irreversible. So in that sense there is much better control in England, i.e. a much better chance of setting aside an unjustified opening, than in most other EU countries.

Head office functions theory

The following remarks are related to the head office functions theory. In order to understand the head office functions theory one must first understand its context. The head office functions theory is inherently connected with the question of the allocation of international jurisdiction between member states of the European Union, which is governed by Article 3 of the Regulation. In the original member states that were effected by the Regulation there were two very distinct and rival theories of where insolvency proceedings should take place. These rival theories were the registered office theory, which was followed by the Anglo-Saxon countries in particular, and the real seat theory, which was used by most of the continental countries. Obviously, in terms of business realities, the registered office approach has become increasingly outdated. What needs to be remembered is that most of the text of the Regulation was copied almost word for word from the draft convention of 1995 on insolvency proceedings. This draft convention had been the subject of negotiation for more than twenty-five years and by the time it became a Regulation in 2000, it was completely out of date in the sense that it focused on bankruptcy and liquidation.

Fortunately the world has moved on a great deal and nowadays insolvency law and its practitioners are focussing more and more on rescue and reconstruction, which have won precedence over bankruptcy and liquidation. Business has moved on as well, though. Offshore registration has been on the rise continuously; an increasing number of companies are registered in countries that are different from the ones where they actually do business or from where they are run.

Article 3 of the Regulation, which governs the allocation of international jurisdiction, in fact represents a compromise between the registered office approach and the real seat theory. In substance the real seat theory wins out because of the new autonomous concept of the centre of main interests, which is similar to the real seat theory. It should be kept in mind, though, that there is a presumption based on the registered office. This was a convenient presumption at the time when the insolvency convention was drafted, in the early '90s. For example, in paragraph 75 of the Virgós/Schmit Report it is mentioned that the registered office will normally correspond to the head office, which in the past was probably correct. But by 2000, though globalisation hadn't yet reached its peak, societies had become ever more intertwined and therefore this assumption was becoming increasingly less accurate in many cases.

The head office functions test was developed not long after the Regulation came into force in 2002. This test resulted from the collapse of Enron. Although it seems like a long time ago, the Enron affair was a big deal at the time. Enron was a large US group but, not unusually, it had European subgroup headquarters, which were located in London. All of the Enron companies registered in Europe were run from the European headquarters in London.

There was a company called Enron Directo, which was registered in Spain. This company did day-to-day business in Spain selling electricity, but unfortunately became insolvent and insolvency proceedings had to be opened. The question then arose: where should the proceedings take place under the Regulation? The Regulation was new and there wasn't any case law at the time, so we looked at the Virgós/Schmit Report. In paragraph 75 of this report, which has five subparagraphs, the concept of the centre of main interest starts to unfold. The first subparagraph is a sort of general principle that tries to explain what the centre of main interest is. It states: "The concept of the centre of main interest must be interpreted as the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties." This sentence was copied word for word in recital 13 of the Regulation.

This, of course, demands some further explanation about how the Regulation came into being and how it is structured. Originally the Insolvency Convention was to become a treaty and didn't have recitals. In order to explain to people what the treaty actually wanted to say the Virgós/Schmit Report was written. When the Insolvency Convention of 1995 eventually failed, the Virgós/Schmit Report never acquired any kind of official status. When the Regulation came into force in 2002, there was a need for some explanatory recitals at the beginning of the Regulation since there wasn't going to be an official report explaining what it was all about. So what they did was take various bits and pieces out of the Virgós/Schmit Report, like the first part of paragraph 75, and just quote it as a recital. The recitals were a mixture of a kind of general explanation why the Regulation was being passed as well as explanatory bits that were taken out of context and lacked the additional explanation that the drafters set out in the report. An example is recital 13, which just singles out that first subparagraph. However, the actual subparagraph that deals with corporate entities or legal persons is the last, the fifth subparagraph, which states: "Where companies or legal persons are concerned, the Convention presumes, unless proved to the contrary, that the debtor's centre of main interest is the place of his registered office. This place normally corresponds to the debtor's head office."

What Virgós and Schmit are trying to say is that you have a presumption based on the place of the registered office, because that is where the head office is normally located. Some twenty-five years earlier this was generally accepted as true and it gives you the underlying idea of the presumption that a company's registered office normally corresponds with its head office. Then the following question immediately comes to mind: in what cases can this presumption of the registered office being the head office of a company be rebutted? What sort of evidence do you need in order to rebut the presumption? You need to provide evidence that a company's head office is located elsewhere. Nowadays the place of registration of a company or its 'head office' may be nominal only. At this location you may find nothing more than a registration plate, whereas the actual head office functions might be performed somewhere else. Therefore what was really important was not just the location of a nominal head office, but whether or not head office functions were actually carried out in the place of registration. This led to the invention of the head office functions test, which I derived from this approach. The head office functions test was tried out on a London judge, who accepted it in the Enron

Directo case.³ One has to bear in mind, though, that there was no case law at the time, not in English anyway. Unfortunately there was no ruling in this case.

What happened next was that in another, now well-known case, the Daisytek case⁴, the head office functions test was mentioned before another judge. Yet again this was a case of a US group with European subgroup headquarters located in England. Only this time these were situated in a less well-known city in England, called Bradford. The head office functions for the whole group of Daisytek companies located within Europe, including the German and French companies in particular, were performed there and it was not just a nominal head office. Local counsel at the court hearing in Leeds gave the judge a copy of my written arguments, which had been successful in the Enron Directo case, and the judge subsequently approved this approach.

Therefore in the Daisytek case, based on the head office functions approach, the judge in Leeds found that the presumption regarding the French and German companies was rebutted on the basis of evidence showing that the head office functions were carried out in Bradford, England, and not in France or Germany.

Why is the head office functions test the best approach? How could one justify this approach? It is the best approach because it gives the best pragmatic answer in the sense that it corresponds to the way in which a company or a group companies nowadays is actually run or directed prior to insolvency. For example, if you try to reorganise or rescue a company or a group of companies when it's insolvent, you have to deal with the same kind of people as the company did before, like bankers, employees, suppliers and so on. And the most convenient place to deal with them is the place where they were dealt with before. Also, this often ties in with the law governing the contracts of employees, lines of credit, et cetera. So, from a pragmatic point of view it is actually the best solution.

In England judges are strict and they have not relied on the purely pragmatic reasons for using the head office functions test, but in fact this solution works well and effectively. If English judges had relied on pragmatism, Professor Paulus would no doubt at the time (he has modified his views since) have said not only that they were imperialistic but also that they were imperialistic on pragmatic grounds! Interestingly enough, though, the French courts have actually mentioned the pragmatic sense of the head office functions approach in their reasoning. This has happened in a couple of cases, including a case called MPOTEC⁵ that was brought before the Tribunal de Commerce of Nanterre. Also some pragmatic justifications along these lines were made in the Eurotunnel case⁶, which was judged by the Paris Commercial Court. And then there is a more recent case decided upon by the Tribunal de Commerce of Beaune on 16 July 2008, the Sobieski case⁷, which related to a Polish registered limited company that was part of the French Belvedere group. In fact, as you have mentioned to me, there was also a Dutch case where the reasoning of the mind of management theory or head office approach was followed, called the Henzo case⁸, which was judged by the Court of Roermond on 18 November 2008.

³ High Court London 4 June 2002 (unreported) (Enron Directo Sociedad Limitada)

⁴ High Court of Justice Leeds 16 May 2003, B.C.C. 562; JOR 2003/287 (Daisytek)

⁵ *MPOTEC GmbH*, [2006] BCC 681, Tribunal de Commerce of Nanterre.

⁶ *Eurotunnel Finance Ltd*, Paris Commercial Court, 2 August 2006.

⁷ *Sobieski Sp. Zo O*, Tribunal de Commerce of Beaune, 16 July 2008 (a Polish registered company that is part of the French Belvedere SA group).

⁸ District Court of Roermond 17 November 2008, JOR 2009/55.

Groups of companies

In most of these cases there are group situations, which presents special problems for the Regulation. This is largely due to the fact that the text of the Regulation is very outdated. Paragraph 76 of the Virgós/Schmit Report contains a very charming statement in this regard, right after the explanation of the concept of a company's centre of main interests. Virgós obviously understands the problem of groups and paragraph 76 of the report states: "the convention offers no rule for groups or affiliated companies." Subsequently it just mentions that drawing up a European norm on associated companies could be the answer to solve this problem. However, at this time not even a proposal for a norm on associated companies in the EU has been made. Therefore this is one of those situations where the legislatures have left practitioners and even academics completely high and dry. Neither help nor a decent solution is given. So this is one of these areas where legal practice has tried to make things work. To try to do so in the ever-globalising world in which we live today, an imaginative and flexible approach to the statute is required. Nowadays huge groups of companies like Enron, Daisytec and, very recently, Nortel can be found all around the world.

One pragmatic aspect is particularly important in a group situation. Prior to the insolvency of a group of companies the whole group is usually run from the same, either global or regional, headquarters. Quite often the way in which you run a group of companies is not strictly along the lines of the separate corporate entities. For example: there was a huge group called Federal Mogul, which was a listed company in the US and had a subgroup in the UK called TNT. Some years ago this group of companies faced multiple claims that had to do with asbestos. Unfortunately it only had limited insurance coverage and these claims were threatening the whole group. As it turned out, although there were a number of distinct American, English and other legal entities, the group had actually divided the business into divisions that ran right across the individual corporate entities. This is how a worldwide global business is run nowadays. Therefore, treating a group of companies on an entity-by-entity basis would be completely impracticable when it comes to a group's rescue or reconstruction. In fact, it was recognised in England that the reality of all of this was that the group traded as a unity and not so much as separate individual entities. Therefore, the head office functions test or approach is an essential part of the solution for dealing with the reality that we are confronted with at present.

The biggest challenge for groups of companies is the effect of the Eurofood⁹ decision by the European Court of Justice (ECJ), because this ruling is binding in all of the member states. The first thing we need to bear in mind is that, unlike the companies in all other cases, Eurofood was not a trading company. Eurofood was simply a sort of nameplate type of company. It was a finance vehicle in Ireland that was part of the Parmalat group, which is a huge corporate group making chocolate milk and other dairy products on a global scale.

Parmalat unfortunately suffered losses for many years. If you sustain losses for a long period of time you obviously need to hide them, which is what they did. They bribed their bankers and auditors and hid billions of losses; some four billion, which is a fair chunk, were conveniently hidden in the Cayman Islands. Then they created a black hole and forged a bank balance that they showed to the auditors, each year mentioning that they had some four billion in cash in the Caymans. The forgery was unravelled, and the four billion was not there.

As far as Eurofood was concerned, Ireland – were Eurofood was registered – used to be a poor country before it joined the European Union and became very rich as a result of the

⁹ ECJ 2 May 2006, no. C-341/04, Eurofood

European Union. When it was a poor country the European Union allowed it to have a special tax break and there is a special low tax zone in the docks area of Dublin that has a few modern buildings and lots of nameplates. All of these companies are not real companies, they are just vehicles for raising money and none of these companies are allowed to do business in Ireland itself. They can only do business abroad and they profit from very low tax rates. Eurofood was one of these companies and even carried the letters IFSC in its official name. IFSC stands for International Financial Service Centre, which was this special type of low tax company.

Now Eurofood only took part in three transactions, all of which involved raising money for Parmalat as one would expect. The real credit risk, however, was with Parmalat. The directors, in order to comply with Irish (tax) formalities, were only nominally in Ireland and the Italian directors joined the Irish directors by telephone if they couldn't be bothered to fly to Dublin themselves. As stated before, Eurofood was a true nameplate company: it had no employees whatsoever and there was no office being leased, except for offices supplied by the bankers of the Bank of America. There was no question of a pragmatic need for Eurofood to be part of some kind of rescue or reconstruction scheme. It was very convenient to be included in the global rescue or reconstruction effort, which is what the special administrator of the Parmalat group did, but for a company such as this there was no absolute necessity for it.

There is a very important point that many people have overlooked: when the matter went to the ECJ the head office functions argument was actually put forward, but it was not mentioned clearly anywhere in the ECJ judgement. The reason behind this is that the ECJ took a very strict view on the way it was going to pass judgement. This was the first really important case under the Regulation and the judges were going to answer the questions very strictly and in the way in which they were posed. There were five questions to be answered and none of them regarded the head office functions. Therefore the ECJ was not going to say anything overtly on the head office functions approach. What is very interesting, however, is what Advocate General Jacobs¹⁰ states in paragraphs 111 and 112. He is referring to my arguments of the head office functions test and says it's a very good approach. But then the Advocate General continues to say that it has no relevance to the case. The reason why the test had no relevance to the case was the way in which the questions were asked by the Irish Supreme Court. They simply did not involve that aspect, but nevertheless it was a very odd case indeed since no trading took place and no head office functions were carried out in any usual sense. Eurofood was completely an operation without substance.

Now there is certainly nothing in the ECJ judgement that contradicts the head office functions test. The ECJ only said two things about the centre of main interests and rebutting the presumption. The first thing was that to rebut the presumption you have to have facts that are objective; the second thing was that they have to be ascertainable by third parties. Those words can also be found in recital 13 of the Regulation and in paragraph 75 of the Virgós/Schmit Report. It was not exactly rocket science the ECJ was indulging in.

Bear in mind that in the *Daisytek* case there were some eight criteria that were mentioned in the judgement of the Court in Leeds and at least two or three of them are not ascertainable by third parties, for instance senior people who were only being employed with the approval of Bradford. If the objective factors added here and these eight criteria were applied in Eurofood, probably three or four would drop out. Collecting as many factors as can be found is not a realistic approach. I have never favoured this approach and it certainly was not the approach used in *Enron Directo*. But judges cannot be

¹⁰ 27 September, Advocate General Jacobs' opinion, C-341/04 (*Eurofood IFSC Ltd.*), ZIP 42/2005, 1878

stopped from acting like stamp collectors, gathering factors because they feel more comfortable that way. Therefore they just add as many factors as they can. However, from an analytical or academic point of view obviously you have to focus on the objective factors of the subject and remove factors that are not ascertainable by third parties.