INSOL Europe Technical Series

Comparative and International Insolvency Law Central Themes and Thoughts

Papers from the Honours Class ‘Comparative and International Insolvency Law’,
organised at Leiden Law School, the Netherlands,
March – June 2009.

ANTHON VERWEIJ LL.M.
PhD fellow Centre for Business Studies, Leiden Law School

and

PROFESSOR BOB WESSELS
Professor of International Insolvency Law, Leiden Law School

Editors

INSOL EUROPE
Nottingham · Paris

9. *Some Thoughts and Suggestions on Applicable Law in International Insolvency Cases*
Ian F. Fletcher
Reporters: Uyanga Dorlig and Armelle Lodé
Page 62-64

9. Some Thoughts and Suggestions on Applicable Law in International Insolvency Cases

Ian F. Fletcher

Reporters: Uyanga Dorlig and Armelle Lodé

The first part of this lecture provides a singular analysis of the set-off rights under the EC Regulation Insolvency Proceedings. Set-off can be defined as a discharge of reciprocal obligations to the extent of the smaller obligation. The second part of the lecture focuses on some issues related to the changes in the legal system in England and Wales that came about with the adoption of the UNCITRAL Model Law in 2006.
The EC Insolvency Regulation deals with the law applicable to set-off in Articles 4 and 6, respectively. It is a two-stage process. Firstly, Article 4 establishes the application of the law of the state where the proceedings are opened (lex fori concursus); if this law accepts the doctrine of set-off, then the process ends here. Secondly, if the lex concursus would not allow a set-off, Article 6 may produce a different outcome. This article states: "The opening of the insolvency proceedings shall not affect the right of creditors to demand the set-off of their claims against the claims of the debtor, where such a set-off is permitted by the law applicable to the insolvent's debtor claim." Therefore, if the lex fori concursus denies the set-off, the party that wishes to claim the benefit of set-off is able to invoke Article 6 of the Insolvency Regulation if the law governing the insolvent's debtor claim does recognize it. The rules regarding set-off depend on the law and policy of the country. For instance, in the United Kingdom it is mandatory in the event of the debtor's insolvency: nobody can by-pass the obligation of set-off when the parties have mutual monetary obligations. It is automatic and a matter of public policy. That is why the drafters of the Regulation thought it was better to create an exception to Article 4(2)d. It is therefore a two-stage process, but with a one-way option.

Subsequently, the question arises as to how to determine the applicable law. As far as the European Community is concerned, currently the courts of the Member States are required to apply the choice of law rules contained in the Rome Convention of June 19, 1980. From December 17, 2009 the Member States (with the exception of Denmark) will have a common set of rules on contractual matters based on the Rome I Regulation.[1] Therefore, a look at the conflict of rule provisions in Article 3 and Article 4, respectively, concerning the applicable law - based upon the parties' choice or, alternatively, in the absence of an effective choice made by the parties - will generally suffice. If this solution is considered, on the whole, to be satisfactory from a Community standpoint, what about the perspective of non-Community countries? Forum shopping can easily intrude at this juncture. Indeed, a party to a transaction, whether from within or outside the E.U., may try to exploit the generosity of the choice of law process in contractual matters. The co-contractor could plan to choose a governing law for the contract that happens to be a law that allows set-off, despite there being no sound reasons otherwise to select this specific law because it has no substantial relationship with the parties or transaction.

The American Law Institute (ALI) and the International Insolvency Institute (III) are more circumspect about the governing law of the contract freely chosen by the parties and invoked by them. In the Global Principles project of ALI and III, professor Wessels and I try to anticipate the potential exploitation of a provision such as Article 6 of the EC Insolvency Regulation by proposing its adaptation through the inclusion of a balancing

[1] Regulation (EC) No 593/2008 of the European Parliament and the Council of 17 June 2008 on the law applicable to contractual obligations, Official Journal of 6 July 2008 L177/6.

rule. When the parties to a transaction have made an express choice of law and if there is a valid rationale linked to business logic to apply the law of a country that has a more favourable rule on set-off and to retain its effects in the event that one party becomes insolvent, a rule such as Article 6(1) of the Insolvency Regulation could apply. However, if the parties choose a law only for the tactical benefit deriving from the set-off rule (and there are otherwise no reasons to use the chosen law, because it has no substantial relationship with the parties or transaction), this is a blatantly evasive abuse of the choice of law privilege. Here the parties' autonomy should be overridden with a default rule, namely that the law of the proceedings should be allowed to prevail.

Instead of using this balancing rule, alternative solutions can be chosen, which could either be more or less stringent. Firstly, a suggestion has been made involving an absolute refusal of any exception whatsoever. For instance, the UNCITRAL Legislative Guide on Insolvency Law, adopted by UNCITRAL on 25 June 2004, advocates an almost total negation of any exception to the lex concursus. Secondly, some authors have proposed an even more rigorous rule, prohibiting the selection of another law than the lex concursus in the absence of valid and coherent reasons (e.g. business logic) for such a choice.

There is further controversy surrounding Article 6 of the Insolvency Regulation. According to my interpretation of this provision the law applicable to the insolvent debtor's claim can be the law of any country, not only the law of a Member State of the European Community. There is no reference in Article 6(1) to a "law of another Member State". In the Virgos-Schmidt Report[2], the authors make the contention that "by systemic interpretation" Article 6 must be read as being confined to situations where the alternative law is the law of a Member State. This argument cannot be accepted. Indeed, in cases where there was a choice of law the Community has allowed parties to choose the law of any jurisdiction and not only the law of a Member State. Article 2 of the above-mentioned Rome Convention[3] (which is identical to Article 2 of the Rome I Regulation, which will supersede the Convention as of December 2009) provides such a rule. The Convention (and also, in due course, the Regulation) can only bind the courts of the contracting states. However, both texts clearly state the principle that the applicable law determined by use of the rules (of the Convention or Regulation) shall apply *whether or not it is a law of a Contracting (or Member) State*. Therefore we have a globally open-minded rule regarding applicable law in matters of contractual obligations that is operative within the courts of states throughout the European Community. In transposing this approach to the context of the Insolvency Regulation, in the absence of any explicit language in the Article itself that limits the formula to "the law of a Member State", there is no reason to rephrase the text of Article 6 so as to include a restriction that was not expressed when the text was drawn up. It is also significant that in the original draft versions of Article 6 the various texts made explicit reference to "the law of a Contracting State" but that this restricting choice of words was later abandoned at a point when the rule was converted into something that focuses on the law of the insolvent debtor's claim. The drafters of the final version of the text did not want to allow any possibility to base the claim to set-off on the contractual relationship under which the non-insolvent party occupies the position of creditor vis-à-vis the insolvent debtor.
This raises the question whether, in designing a rule on set-off for potential application throughout the world, as part of the ALI-III Global Principles project, the rule embodied in Article 6 of the EC Regulation is the right rule to have. Should there be an exclusive focus on this one side of the contractual relationship rather than on the one that involves the creditor? In my view it is certainly better than a situation in which the benefit of set-

---

[2] Miguel Virgos and Etienne Schmidt *Report on the Regulation on the Insolvency Proceedings*, Council 6500/96. The Virgos-Schmidt Report was the principal Report on the EU Convention on Insolvency Proceedings
[3] Convention N°80/934/ECC on the law applicable to contractual obligations opened for signature in Rome on 19 June 1980; OJ L 266 of 9.10.1980

off is allowed only if one can prove that both the debtor's claim law and the creditor's claim law permit set-off.

The argument in favour of allowing the exception contained in Article 6 of the Insolvency Regulation is that creditors are expecting protection, because they are exposed to the risk of insolvency of the other party to the transaction and it is very harsh to take away that protection. Therefore, for that proposition to be fully attainable, it ought to be part of the law of set-off at a national level that the creditor should be required to show that he genuinely founded a reasonable expectation on the concept of set-off being available to him. Regrettably, in English insolvency law (to take but one example) there is no such precondition: set-off is accorded automatically. Although English courts used to defend the practice of permitting set-off on the ground that it is based on doing equal justice to both parties and on respecting the reasonable exceptions of being able to obtain this protection, the law itself - as enacted and as judicially applied - does not make it a condition of being able to claim the set-off that the party has to show that this was the basis on which the contractual relationship developed. Therefore, it is by no means a clear-cut situation in which we can argue that, based upon justice and fairness, all arguments point in one direction. Nevertheless the present rule is understandable and in line with the tendency in modern analysis to place emphasis on the need to protect legitimate and reasonable expectations and, consequently, on the need for a stable rule that enables the creditor to rely upon the provisions of a single system of law.

Article 13 of the Insolvency Regulation is likely to be used more often and its importance will grow over time, even if it has not been applied very frequently to date.
This provision is designed to provide a defensive position for parties whose previous expectations were based upon having taken part in a transaction in circumstances where the transaction was valid and unimpeachable, even after the insolvency of the other party, according to the system of law that governed the transaction itself.
Here legitimate expectations as they stood at the time of the transaction are in peril of being overridden, according to Article 4 of the Insolvency Regulation, by the fact that the insolvency law under which the other party is subsequently the subject of proceedings has a different rule as to how the transaction would stand. Article 13 forces the effect of Article 4(2)(m) to be displaced in carefully defined circumstances. The beneficiary of the transaction must first provide proof that the said act is subject to the law of another Member State than that of the insolvency proceedings (i.e. he must show that the law of another Member State is the law applying to the transaction) and must then demonstrate that the law in question does not provide any means for challenging that act in the relevant case. Therefore, in first instance a liquidator would invoke an avoidance rule belonging to the *lex concursus*, and the defendant would then need to show that under the law that governs the act (both the general law and the insolvency law) none of the grounds for challenging that act will succeed in the actual circumstances of the case.
Technically, this defence is very difficult to achieve because the defendant in effect has to go through the hypothetical exercise of proving to the court where the challenge is brought that the liquidator's claim cannot succeed, not only under the insolvency law of the system that has been targeted but also under its general law, including both the statutory law and case law. Moreover, it can be very hard to prove negative grounds again and again. The defence has to prove to a foreign judge that the particular system, on its correct application to the facts, does not produce any outcome under which the transaction could be overturned. In practice this can be very time consuming and costly, involving expert evidence adduced from both sides.

For these reasons, Article 13 is by no means a push-over defence. It entails many technical difficulties, but it must be retained and is worth keeping because it offers a way to protect genuine and legitimate expectations.