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Insolvency Law and Human Rights: An Update

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Introduction

Human rights have had, until recently, a minor role to play in the administration of insolvency. Early concerns at the time the Human Rights Act 1998 was enacted of their potential application to and undoubtedly far-reaching impact on insolvency have largely been unrealised, although human rights issues have been raised in many cases. An early instance of the European Convention on Human Rights ('ECHR') being engaged was the use of Article 6, often seen in the civil and criminal procedural context, but which in insolvency has had application to the privilege against self-incrimination, as in *Saunders*,¹ where the use of compulsion in insolvency examinations was seen as potentially breaching the right to a fair trial and the privilege against self-incrimination.² Arguments around Article 8 on the right to respect for private and family life as well as the home have been canvassed in relation to personal insolvency and the sale of the secured family home forming part of the bankrupt's estate to be realised for the benefit of creditors. In *Albany*,³ where the proportionality between section 91 of the Law of Property Act 1925, which permitted an order for sale, and the right of an equitable co-owner to remain, that was adjudicated in the creditor's favour, was held compatible with the human rights position. Cases such as *Wood*⁴ have shown that the European Court of Human Rights ('ECtHR') is aware that repossession claims do constitute a potential interference with Article 8 rights, the view of the court has been

that such claims are necessary for the protection of others, not least the lender, and are thus proportionate. A recent application of Article 8 also arose in *Warner*,⁵ where disclosure of correspondence in the context of bankruptcy proceedings was objected to by third parties. In this case, the trial judge was of the view that the exception in Article 8(2), underlined by the ECtHR in *Niemietz*,⁶ would afford in many instances a defence to the claim of a breach of the right to privacy, given that the courts would, in all likelihood, acknowledge that the interests of the trustee in bankruptcy outweighed the collective interests of the other parties and that interference was thus justified.

Challenging insolvency systems

In many of the cases that have featured human rights arguments, these have largely been peripheral and directed mostly at the procedural underpinnings and administration of insolvency law, with occasional forays into substantive legal areas. Rarely have concerns been raised about the nature of the insolvency system itself, until a case before the ECtHR in 2005. In *Back*,⁷ the question was whether the debt extinguishment system operated under Finnish Law infringed Article 1 of the First Protocol to the ECHR ('Protocol Right') by constituting an unlawful deprivation of the creditor's property.⁸ The facts in brief are that the applicant agreed in 1988-89 to guarantee a bank loan given to another person, who subsequently defaulted. As guarantor, the

Notes

- 1 *Saunders v United Kingdom* (1996) 23 EHRR 313.
- 2 Article 6 is also potentially of relevance where insolvency practitioners, as a 'public authority' (exercising powers on behalf of society) act to determine the rights of insolvency participants: V. Finch, *Corporate Insolvency Law: Perspectives and Principles* (CUP, Cambridge, 2002) at 397-398.
- 3 *Albany Home Loans Ltd v Massey* [1997] 2 All ER 609.
- 4 *Wood v United Kingdom* (1997) 2 EHRLR 685.
- 5 *Warner v Verfides (Hafner et al intervening)* [2008] EWHC 2609 (Ch).
- 6 *Niemietz v Germany* (1992) 16 EHRR 97.
- 7 *Back v Finland* (Application no. 37598/97) [2005] BPIR 1.
- 8 Article 1 of Protocol No. 1 to the ECHR reads:
'Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.
The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties.'

applicant was required to pay the bank a sum of EUR 19,000. In launching proceedings against the debtor for recovery of the amount of or contribution towards the guarantee, the applicant discovered that the debtor had applied in 1995 for an adjustment of the debt under the Adjustment of the Debts of Private Individuals Act 1993. The applicant opposed the request on the ground that it might deprive him of his claim against the debtor. Nonetheless, in 1996, the District Court granted the application and adopted a repayment schedule taking into account the significant decrease in the debtor's resources due to unemployment and failed business activities. As a result, the applicant's claim against the debtor was reduced to a trifling EUR 360. The ECtHR held that there had been no violation of the Protocol Right, despite the fact that the adjustment of the debtor's debts under the legislation could engage the Protocol Right, given that the result was to almost extinguish the applicant's claim. However, the interference with the applicant's property rights could be considered justified by a public or general interest in that the Finnish legislation clearly served legitimate social and economic policies and was a proportionate tool to achieving the desirable social goal of rehabilitating debtors. Furthermore, the nature of the guarantee agreement involved the risk of financial loss that the applicant well knew when entering into the agreement and thus his claim was highly precarious in nature, notwithstanding that he may not have appreciated the possibility of the debtor applying for an adjustment of debts. Thus, the 'fault' or deprivation was not engineered by the State, while the burden imposed on the applicant by the existence of the 1993 Act could not be regarded as excessive. It appeared after this case that, if the principle could be generalised, insolvency systems were as a whole immune to the use of human rights although their procedural administration and some substantive aspects could be the subject of challenges. A recent case, adjudicated in 2008-2009, appears to throw this principle into confusion by permitting a challenge based on the Protocol Right to be brought against the introduction of particular laws governing the insolvency of financial institutions.

The case: *Druzstevní Záložna Pria*⁹

The facts

The facts of the case are complicated and the following serves as a summary of the events in this case. The first applicant was formed on 23 August 1995 as a legal entity with its registered seat in Brno, Czech Republic

under the provisions of the Credit Unions Act. The remaining eight applicants were formerly members of its management and supervisory boards. Some 633 further members of the credit union also attempted to join to the proceedings, with the Czech Republic serving as the defendant, although their claims were held inadmissible in early 2006.

The issues arising in this case for determination stemmed from the decision on 11 January 2000 by the Office for the Supervision of Credit Unions ('OSCU') to place the first applicant in receivership (*nucená správa*) for a period of six months under section 28(3)(c) of the Credit Unions Act (Act no. 87/1995). Section 28(6) applied, *mutatis mutandis*, the provisions of the Bank Act (Act no. 21/1992), which authorised receiverships without prior notice or invitation to remedy any default where transactions affecting the financial institution's clients or which could constitute a risk to the stability of the financial markets had taken place. In this light, the reasons given by the OSCU were, allegedly, the operations of the credit union concerned and its acting outside its incorporation charter by purchasing receivables from a third party in 1999, in effect entering into an unauthorised loan to a non-member. Furthermore, the credit union had entered into two contracts for the purchase of securities that were not authorised under the Credit Unions Act.

Notification of the OSCU's decision to the first applicant took place on 12 January 2000. A constitutional appeal was lodged by the credit union on 26 March 2000, relying on internal provisions permitting recourse to the Constitutional Court on grounds of substantial harm caused to the applicant's interests by the decision concerned. Following an administrative appeal, the decision itself was confirmed by the Ministry of Finance on 7 April 2000. In parallel proceedings on the same date, the credit union was the subject of a petition for bankruptcy proceedings before the Brno Regional Court, in which a number of its creditors participated. At some point after this, the first applicant also applied for judicial review of the decision, alleging that the conditions under the Credit Unions Act for the imposition of receivership had not been met.

On 1 May 2000, Act no. 100/2000 came into force, substantially amending the Credit Unions Act and transferring the rights of members of the supervisory boards of credit union to any appointed receivers, effectively preventing the directors from engaging in proceedings other than appeals against the decisions of the OSCU. The receivership was renewed on 12 July 2000 and upheld, despite a further appeal, on 9 November 2000. At the same time, the receiver was empowered to suspend payments by the credit union

Notes

⁹ *Druzstevní Záložna Pria and Others v The Czech Republic* (Application no. 72034/01) [2008] ECHR 750.

by reason of its precarious financial situation and further orders were made in the course of 2000-2001 authorising this. On 6 June 2001, the OSCU granted the receiver permission to file for the credit union's bankruptcy, although it also renewed the receivership on 12 July 2001, subsequent to the appointment of an interim bankruptcy trustee by the Regional Court on 9 July 2001. This last receivership order was upheld by the Ministry of Finance on 4 October 2001. Finally, the OSCU withdrew the credit union's licence on 19 April 2002. A claim for damages under the State Liability Act was also dismissed by the Ministry of Finance on 22 May 2002 although the claim was renewed 6 days later.

The Prague High Court dismissed a first application for judicial review on 21 June 2002, holding that the OSCU's decision to place the first applicant in receivership was properly motivated according to national legislation, and later confirmed the appointment of the interim trustee by the Brno Regional Court on 5 December 2002. Subsequent to the former order, the OSCU appointed a liquidator on 3 July 2002, the appointment being confirmed on 31 October 2002. A constitutional appeal was also brought by the credit union on 12 September 2002, which was dismissed by the Constitutional Court on 30 January 2003. Also in 2003, the Prague 1 District Court dismissed the credit union's action for damages on grounds that the law did not authorise the members of the supervisory board to bring a claim for damages. Two further applications for judicial review were initiated by the credit union with the first of these being rejected by the Supreme Administrative Court on 9 February 2004, with confirmation of this rejection by the Constitutional Court coming on 7 March 2005. It is this decision that appears to be the subject of the application to the ECtHR, although there also appeared to be further proceedings underway in the Czech Republic and a third application for judicial review remaining to be decided.

The claim and response

The first applicant claimed that the imposition of the receivership by the OCSU was an infringement of the Protocol Right and constituted a deprivation of property. In particular, the credit union claimed that the conditions required by the Credit Unions Act had not been met and that the transactions alleged to have been *ultra vires* the law and its constitution were not *per se* illegal. It was of the view that the OCSU did not justify the receivership as it had not explained why the transactions it sought to impugn either jeopardised the credit union's stability or constituted a particular harm to its members. Furthermore, the imposition of the receivership had the effect of denying the members of the credit union any opportunity to remedy any deficiencies in its operations.

The credit union also claimed that the duration of the receivership, some 30 months, was vastly beyond the permitted statutory maximum of 12 months and that, with the enactment of the amendments to the Credit Union Act, its supervisory boards were effectively disenfranchised from challenging the receivership orders. In fact, from May 2000 onwards, the first applicant stated that the receiver had ceased co-operating with the members of the board and the withdrawal of access to the credit union's books and documents prevented the members of the board from obtaining the evidence necessary to challenge the assertions put forward by the OCSU. In particular, the credit union alleged that the financial risks relied on by the OCSU in imposing the receivership order did not take account of its actual financial situation, which was allegedly healthy and would have permitted it to meet its obligations.

In its written response, the Czech Government admitted that the imposition of receivership would, *prima facie*, constitute a deprivation of property, but argued that the exception, permitting a control on the use of property, applied in the instant case. It was the Government's view that the stability of the financial markets and the interests of the shareholders were sufficient justifications for its actions that engaged the protection of the exception. It also stated that the celerity, with which it acted, even if this negated the credit union's ability to challenge the order, was entirely justified by the need to ensure market stability and the protection of depositors' interests. These, it argued were legitimate aims of the Credit Unions Act (as it applied the Banks Act) and that the actions were not illegal, but proportionate to the aim to be achieved. The Government also imputed blame for the financial crisis, to which the credit union became subject, on its management and on activities it alleged were illegal and unprofessional. In this context, the Government also referred to prosecutions it had engaged against some management members. In this light, the imposition of the receivership was a necessary step to take.

The judgment

The Sectional Court was of the view that the Protocol Right was predicated on the view that interference by a public authority with the peaceful enjoyment of possessions should be lawful, although states are permitted to control uses of property, as the exception in the second paragraph clearly states. The Court was also of the view that the principle of the rule of law was inherent in all of the provisions of the ECHR and its protocols. For the Court, the lawfulness of all legislation must be tested against whether there is effective protection in domestic law against arbitrary interference with Convention rights by a public authority. A further test for the acceptability of legislation was whether adversarial proceedings before an independent body were

available to challenge the application of the legislation. Although the Protocol Right does not dictate any particular form of procedure such proceedings should take (e.g. judicial review), the Court was of the view that the procedure should guarantee to the party challenging the application of the legislation a reasonable opportunity to present their case to a competent authority, thus enabling an effective challenge to take place. In order to determine whether the procedure does so, a view had to be taken of the judicial and/or administrative system as a whole.

In the instant case, the Court was motivated by the fact that the receiver, once in position, effectively enjoyed control over the credit union and exercised all management powers, including the power whether to grant access to the credit union's documents and accounts. Although the Czech Government did not dispute the allegation that access was not forthcoming, the Court also accepted that the law in force at the time of the receivership did not oblige the receiver to permit access. Nonetheless, the financial situation of the credit union was said to be the decisive factor in motivating the Government to impose the receivership. The Court was thus of the view that any challenge to the receivership order must rely on the documents and that access was indispensable to any right to challenge the order. Although accepting that such a right could not be absolute, the right to appeal the order would be illusory if the applicant had no opportunity to adduce evidence to support its contestation of the findings of the regulatory authority.

In the instant case, the Court looked at the fact situation: the receiver was appointed by the OSCU, a state body. The receiver was an employee of OSCU and his co-operation was necessary to challenge decisions taken by his employer. The opportunity for the applicant to challenge the OSCU's decision was therefore determined entirely by the OSCU. The Court did not appear to accept that this afforded the credit union a reasonable opportunity for a challenge to take place. In fact, it was of the view that the OSCU could frustrate the process by preventing the credit union from obtaining evidence necessary for it to mount that challenge. Furthermore, the right of appeal, such as it was, to the Ministry of Finance did not meet what was in its view strictly necessary: scrutiny by an independent tribunal. Thus, the first applicant was denied the necessary procedural guarantees to enable it to have a reasonable opportunity of bringing a challenge to a decision that affected it. In this light, the Court's declaration that the amendments to the Credit Union Act, which prevented the supervisory board from exercising any powers, also had the effect of denying the credit union the ability to mount an effective challenge, is understandable for that. Lastly, the Court took the view that, overall, the lack of sufficient guarantees against arbitrary interference by the state made the imposition of the receivership (even if done for motives that

could be regarded as proper) an unlawful deprivation of property in terms of the Protocol Right. For similar reasons, the lack of effective procedural guarantees also constituted a breach of Article 6 of the ECHR and the right to a fair trial.

Summary

This is an important decision for a number of reasons. Property rights are clearly protected by the ECHR. Interference with property rights through the enactment of legislation must meet the tests of the Protocol Right. Therefore, courts are required to consider whether the interference has any substantive justification and whether the interference is lawful and proportionate. In the instant case, the 'deprivation' occurred in the context of the appointment of a receiver under financial legislation, designed originally to enable the regulatory agency concerned to intervene in the case of a potential effect on systemic integrity. The fact that the Court decided that the receivership order could not be effectively challenged under the legislation as it stood and that this constituted an unlawful deprivation of property has a number of implications, not least an impact on whether challenges are to be permitted within the context of the exercise of regulatory supervision in the case of financial institutions experiencing difficulties. This may be seen as undesirable, particularly if the purpose for which a receiver or other agent is appointed is to conduct the efficient winding down of the activities of a delinquent financial institution and/or conduct the disposal of its business and arrange for its assets and liabilities to be transferred appropriately. In this context, enabling access to documents and accounts for the purposes of challenging the decision, as well as the possibility of prolonged judicial proceedings, at the end of which the decision may or may not be impugned, would do much to prevent the effective administration of the process.

A further, perhaps unexpected, consequence, of this decision is the impact it might have on state-led or sponsored insolvency proceedings. Examples exist in the European Union (e.g. Italy: *amministrazione controllata*), where action by a state body is a prelude to or necessary step before the commencement of court-led insolvency proceedings. Certainly, with the onset of the financial crisis in 2008, legislation was rushed in in a number of European states giving the state and/or state bodies a greater say in the administration of the insolvency process. The appointment, as in the Czech case, of a provisional administrator by the state, might, in many circumstances, lead to management being assumed by a state entity. A determination of insolvency and an application for insolvency proceedings in the public interest may only occur subsequently, with intervention by the court only coming later in the process. If, in line with this judgment, the state is required to

adhere to the standards outlined and permit challenges to its actions, the effect might be to impede state-led or sponsored proceedings from working effectively or from occurring at all, with the emphasis likely to shift to early approaches to the court and the opening of proceedings under its aegis. Although this might be regarded as desirable from the point of view of equality of arms, the effect could be to prevent state intervention on a timely basis, effective regulatory oversight and the threat of proceedings from serving as a dissuasive factor for management minded to act delinquent.

At the time the judgment became available on 31 July 2008, it was not known whether a further appeal to the Grand Chamber would be brought by the Czech Government. The expectation was certainly that an appeal would result in a number of written submissions from European Governments on behalf of their financial and corporate regulators wishing to contest the Sectional Court's approach to the deprivation issue and the potential impact on the insolvency context. As it turns out, the Registrar's Press Release on 9 February 2009 noted, without giving any particular reason, that the request for referral of the case to the Grand Chamber had been rejected and that accordingly the judgment became definitive.

Coincidentally, in the United Kingdom, the Explanatory Notes to the Banking Bill, produced on 7 October 2008, also refer to 'a number of significant human rights considerations', in particular the fact that Articles 6, 8 and 14 (prohibition on discrimination) as well as the Protocol Right are potentially engaged by the measures in the Bill making important changes to the legal and regulatory environment for banking in the United Kingdom.¹⁰ In particular, the Protocol Right is singled out as constituting a potential impediment in that the exercise of the stabilisation powers, the example given being of the compulsory transfer of shares in a distressed bank to a private sector purchaser, 'will constitute' an interference with the Protocol Right.¹¹

The Explanatory Notes go on to talk of three classes of persons affected by the exercise of the powers concerned; (i) former shareholders in the distressed bank whose shares would be compulsorily transferred, constituting a potential expropriation contrary to the Protocol Right (ii) the distressed bank itself, whose property may be subject to the same expropriation in favour of a third party, as well as (iii) creditors and third parties whose arrangements with the distressed bank are interfered with to the detriment of their contractual rights. Nonetheless, the Explanatory Notes state that interference by the state may be lawful, proportionate and justified in the public interest, where the state is in fact acting for economic and public policy reasons. The Explanatory Notes also set out the Government's view that substantive limitations on the exercise of the stabilisation powers and procedural steps required before the powers are used will mean that they are only used in instances where significant and legitimate public interest justifications exist for doing so, particularly in the public interest to protect financial stability and ensure depositor protection. Any interference with ECHR rights will be, in the Government's view, solely undertaken with a legitimate aim.¹²

Until the Czech case, the Government's view was precisely consonant with the reasoning acceptable to the ECtHR in *Back*.¹³ After this case, the result is that the question of whether the Protocol Right now governs the constitution of insolvency systems is left open. It is unfortunate that the Grand Court did not have the opportunity to pronounce on the issue, which would undoubtedly have been the subject of submissions from a number of interested parties. It remains to see whether legislation enacted in the United Kingdom and elsewhere to cope with the financial crisis will now become the subject of human rights-based challenges, the result of which may well be to throw the provisions and purpose of this legislation into doubt pending a definitive pronouncement by the ECtHR.

Notes

10 Paragraph 539.

11 Paragraph 540.

12 Paragraph 541.

13 See above note 6.

International Corporate Rescue

International Corporate Rescue addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

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