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Security Interests and the European Insolvency Regulation 2000

by
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Introduction[1]

It may be a redundancy to say that debt is necessary for companies to initiate and expand business or that credit is indeed the lifeblood of commerce. For those reasons, the management of credit and protection of creditors' interests are subjects dear to the hearts of all creditors. The giving of credit is normally the subject of express contractual arrangements between debtor and creditor that provide how the credit is to be repaid. Where the transaction foresees the acquisition of an asset for the needs of the business, the contract will often link in protection of the creditor's interest by making conditional, as alternatives exercisable on the occurrence of pre-determined events, either the repayment of the debt or the surrender of the asset representing the value of the debt. The assumption of risk is as much inherent in the debtor-creditor relationship as the notion of debt. The repartition of risk is, however, a delicate subject and likely to provoke many of the difficulties in the drafting of an agreement reflecting the interests of both parties to the transaction.

With insolvency as a realistic prospect in mind, the interest comes in assessing how creditors meet the challenges posed by the risks of undertaking business. For businesses fortunate enough to be financially well positioned, credit may be obtained often without terms other than the undertaking to repay. Prudence would dictate, however, that in a globalised economy subject to periodic downswings, no debtor is totally immune from the effects of insolvency, even where this is by virtue of the knock-on effect of third party insolvencies where these parties are themselves debtors of the borrowing company. This caution is often reflected in the standard terms of agreements and general conditions of lending applicable in the business sector to all businesses operating on the borrowing market. The ability of borrowers to negotiate individual terms is often severely circumscribed, even for companies demonstrating financial acumen and many of the indicia of reliability. It goes without saying that the riskier the perception of the venture, the greater the caution exercised by the lender.

Beyond the immediate contractual arena, the mechanisms most frequently used to protect creditors' interests are varieties of security, by which is meant an interest in property or its equivalent, giving the creditor the choice to reclaim the indebtedness due represented in the form of a physical asset or a sum of money of corresponding value. It also enables greater certainty in connection with the enjoyment or enforcement of a right to be obtained.

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[1] This article appears in a considerably extended form as 'Insolvency, Security Interests and Creditor Protection', Chapter 8 in Davies (ed.), Security Interests in Mobile Equipment (2002) Ashgate.

Security is as much a part of the bargain that is struck between debtor and creditor as the other terms of the agreement, many of which deal with conventional matters such as payment of interest, reflecting often an element of risk, redemption provisions or penalties as well as provisions governing the relationship of the agreement to other agreements with the same or different creditors. Nevertheless, the major clauses in any agreement will deal with the nature of the security, the assets reflecting the security, restrictions on modifying business activity or assets subject to the security as well as provisions governing the realisation of the security and creditors' remedies in the event of default exercisable directly over the affected assets.

To the extent that security is the linchpin around which borrowing arrangements revolve, it is necessary to understand that whether security attaches to the debt arrangement and what form this security takes may be a determining factor in creditors' attitudes to the insolvency process. Also of relevance to jurisdictions that allow private recovery measures such as receivership, the enforcement of contractually provided security will also dictate what insolvency measures may be available to the debtor. In any event, security is fundamental in that it will often also dictate the outcome for other creditors participating in the process because it allows for legitimate avoidance of the pari passu rule providing for equal treatment of all creditors. The general interest, it may be said, in insolvency for allowing for this rule to be bypassed is that creditors would not easily engage in lending arrangements without this guarantee that the indebtedness owed them could be recovered without having to compete with other creditors. This in turn affects the risk calculation in any lending transaction and allows for the perpetuation of a culture of lending at levels of interest accessible to most businesses.

The Concept of Security

Security usually attaches to assets. To the extent that there is a classification of assets into real or personal, security may be similarly categorised according to its use in connexion with specific types of assets. This is more usually the case in relation to real property, where the antiquity of security arrangements over this type of property often means that there is a more developed framework governing security in this context with, quite often, more formalities attendant on any transaction. As will be seen below, other forms of security may attach indifferently to groups of assets. Security in general may be divided into traditional security rights and modern types of security, created as a result of an acknowledgement that traditional rights may not be flexible enough to deal with the volume of business transacted by companies in this age and the impact of their trade levels on financing needs. Other considerations in relation to security that will be dealt with below include the attitude of lenders to debt resulting in constraints on the types of financing to which borrowers may have recourse.

The comparison in this article is largely between the laws of England and Wales, representing the common law position, and those of France, representing the civil law tradition. The protection of real property and other assets by the use of a security is of course intended to guarantee the debt owed to the creditor. There are two varieties of security in France, which have traditionally been used by creditors to preserve their interests over particular assets belonging to their debtor and which are commonly found as a means of assisting business lending. These are the mortgage, commonly found in cases of specific protection of real property interests and the legal charge, which applies to all varieties of property. The equivalents in England and Wales are, on the one hand, the similarly titled mortgage and, on the other, the pledge and the contractual lien, which both have features akin to the legal charge in French law. In addition, the law in England and Wales also recognised the equitable charge, a form of security that, because of the differing legal histories of both jurisdictions, has no direct equivalent in French law. This separate development of equitable principles also affects the mortgage and lien, which have equitable equivalents. All of the above forms of security are termed true security to distinguish them from varieties of quasi-security and other rights aimed at boosting security interests but which do not amount to security in the classic sense. Later developments in France have also used traditional concepts for the development of what might be termed modern security methods.

Security Interests in the French Context

It has been said that the French law of property, as set out in the Civil Code of 1804, is based on the concepts of Roman Law, which match the needs of a predominantly agricultural society. At the time the Civil Code was promulgated, France, in the aftermath of a revolution that was a costly and resource consuming exercise, could be said to be an agricultural-based society. In France, as far as general security is concerned, it appears that the terminology and framework of security is still couched in the language of the early 19th century and it may be said with some justification that the values of security are still firmly linked to the ownership and enjoyment of real property interests. Although, in principle, the rights of a creditor vis-à-vis the debtor, where these are secured against property, are considered to be in the nature of personal rights, the nature of these rights can be equated to those existing in real property. Thus, although these rights are often dealt with as part of the section of the Civil Code that talks of special contracts, they may need to be registered and comply with the type of notice requirements more often found in the context of land so as to be fully effective against third parties. An example may be found in the case of leases, which because of their incidence on land come close to being interests in land, especially in the agricultural and business contexts.

The mortgage (or ‘hypothèque’) is defined in Article 2114 of the Civil Code as being a physical right over real property which covers an obligation contracted by the debtor and may be created according to Articles 2116-7 by operation of law, by a decision of a court or by agreement between the parties. A mortgage may, nevertheless, only be taken out over property that can be subject to sale as part of a commercial transaction although Article 2118 does provide that a mortgage may extend to a right of enjoyment attaching to that property. Complex notice requirements govern the creation of mortgage rights which rank according to the date on which the mortgage was registered or, for registrations on the same date, according to the date of the contracts giving rise to the mortgage. The limitations of the mortgage are that it is to be found exclusively in the real property context and is limited to property already in existence, as mortgages may not by virtue of Article 2130 be created over future assets. Thus the availability of the mortgage as a financing tool is clearly seen as being restricted to those companies that already have a substantial asset base including real property elements.

In the French system, the legal charge (or 'nantissement') exists in two varieties: the 'gage' for moveables and 'antichrèse' for immoveables and is a variation on the classical pledge. It is a security created by a deed in which the debtor provides, according to Article 2071, a specified asset to the creditor as security for his debt. It gives the creditor the right to be paid out of proceeds resulting from the use of the property, in preference to other creditors. The effectiveness of this type of charge is subject to it being created by deed, which must contain details of the property subject to the charge and, where the charge applies to incorporeal property, this deed must be the subject of express notification to the debtor. Although the effectiveness of a legal charge may be subject in certain instances to physical transfer of the property to the creditor or to a bailee, who holds it on behalf of the creditor, generally there is no need under Article 2076 for the debtor to be dispossessed of the asset over which security is enjoyed. It is thus an instrument that is found widely and is available also for creation of security over debts under Article 2081. Nevertheless, it is a cumbersome instrument, which must relate to a specified asset subject to the security and entails the creation of separate charges if types of property are considered distinct or come into existence at different times. This was very much the case in relation to the Eurotunnel project, which is said to have required separate securities over rolling stock, bank accounts, intellectual property rights, receivables and equity in subsidiaries.

The difficulties with traditional security relate, in the case of the mortgage, to the limitation to real property already in existence and, in the case of the legal charge, to the need to specify the particular assets to which the charge relates. Given the absence of a generic charge that could relate to the totality of assets, it may be argued that French business has been considerably hampered in its ability to raise finance adequately. Nevertheless, an early law provided a partial solution to the problem by allowing the grant of a legal charge over the goodwill (or 'fonds de commerce') of the business. The definition of goodwill outlined in Article 9 of the Law of 17 March 1909 was limited to the company name and trademark, furniture and machinery, client lists and any intellectual property rights, including copyrights, industrial designs and patents, associated with the business. A number of means have been used over the years to address this situation, notably by using the technique known in French as 'debt-mobilisation' (or 'mobilisation de créances). This refers to the technique of using debts, to which the company is or becomes entitled, as a species of security against other loans granted usually by financial institutions. The use of a legal charge backed by a debt was one such method. Other techniques were also developed. Thus there were the examples of the use of bills of exchange guaranteeing payment at a fixed date as consideration for loans, the use of rediscounting by banks, the issue of bills by banks backed by debt and assignment of debt. In this last example, although the transfer of receivables to a third party was permitted, it was limited to instances where the debt was itself guaranteed by a mortgage or legal charge created over real property. In addition, there was a complicated procedure, which involved using the services of a notary public and the execution of deeds. As a species of financing, with the costs frequently outweighing any advantage, it has rapidly lost popularity.

The needs of business were not really served until the early 1980s, when concerted lobbying by financial institutions and businesses alike inspired the Government to produce Law no. 81-1 of 2 January 1981, sponsored by Senator Dailly and which ever since has been referred to by his name. The law states as its purpose the facilitating of credit to business and contains in 16 relatively succinct articles a framework that has astonished commentators by the remarkable success it has experienced in the French business context. In brief, the law allows any financial institutions to have made in their favour and delivered a document of title (or 'bordereau'), which will entitle the institution to any debt owed by a third party to the debtor. The document of title must include certain mandatory details permitting the identification of the parties and the debts to which the document relates. Failure to include these mandatory details is strictly sanctioned as the law renders any purported transfers void and ineffective. With the transfer, any security or guarantee attached to it is automatically transferred for the benefit of the financial institution. One point of note is that the law permits creditors to issue instruments on the back of receivables designed to allow the assignment of a part of eventual proceeds. This technique permits wider participation in the financing operation and spreads the risk attendant by regenerating cash flow for the credit institution. Assignments of title under this law are now very common and the use of the technique is widespread.

Security Interests in the English and Welsh Context

In England and Wales, security in its essence developed from the use of real property as a means of representing to the creditor the availability of an asset to satisfy the loan. The extension of security to personal property, intangible property and collections of property are developments with which the common law is familiar, but which normally rely on the identification of the asset to be encumbered, often through incorporation by express reference in the contract. The institutions of the trust, floating charge and receivership, although deriving from original ideas associated with land law, have been reused in innovative and creative ways. In this context, the development of the floating charge, a species of charge capable of attaching to an indifferent collection of assets that may fluctuate in content during the currency of the charge, may be fairly described as allowing for the most flexible of all arrangements by which the debtor has full power to control and dispose of the assets subject to the charge provided the asset base does not diminish overall.

The position in England and Wales with regard to mortgages has some resonances with the French system, although the nature of the mortgage is wider in that it may be a conveyance of a legal or equitable interest in property generally, subject to a reconveyance of the property upon repayment of the loan. Sections 85-87 of the Law of Property Act 1925 apply special rules to the creation of legal mortgages of land and there are generally requirements of writing in relation to many forms of mortgages. Legal mortgages are broadly defined as mortgages where the formalities have been complied with in relation to the type of property in question. The equitable mortgage arises either because the interest is an equitable one in the property or because the formalities have not been complied with in full for the creation of a legal mortgage but it would be inequitable to deprive one of the parties concerned of the benefits of any arrangement. In substance, the mortgage is mostly found in the real property context and is similarly available to businesses with assets that are capable of being mortgaged as security for lending arrangements. The position in both jurisdictions may be fairly characterised, in relation to mortgages, as one that favours the borrower with a pre-existing asset base. The major difference in England and Wales is, however, that mortgages can extend to future assets and future indebtedness, thus greatly increasing its remit and making it a very widely used form of security.

The position in England and Wales with respect to other charges displays similarities to the French system. The pledge as a form of security is essentially the delivery of possession of the asset to the creditor without a transfer of ownership taking place, a situation the opposite to that of a mortgage. The requirement for delivery renders some assets, including land and those not subject to physical delivery, normally incapable of being pledged. The notion of physical delivery has, however, been mitigated by the categorisation of delivery as being constituted by actual or constructive delivery, allowing for the delivery of a representation that the assets are held to the benefit of the creditor by the debtor or a third party. The similarities to the types of legal charge in French law that require delivery up to the creditor are unmistakeable, perhaps a tribute to the common inheritance from Roman law principles. The lien, although it appears also at common law and in some statutory provisions, is primarily a contractual provision allowing for the right to retain property belonging to another until a debt has been satisfied. In its usual form, it is likened to a passive right of retention that continues only for so long as the creditor possesses the property. As a species of financing, the lien presents certain inconveniences, particularly because it is normally incapable of assignment. Insofar as the pledge and contractual lien may be comparable, a lien is in principle merely a power to detain property while the pledge carries with it an implied power of sale, allowing the creditor to deal with the property should the debtor default.

The position with regard to the equitable forms of security, which also include equitable liens, mortgages and charges cannot be compared to that prevailing in France. The equitable lien or mortgage represents the recognition of a right that would otherwise be held inadmissible because of some defect at common law that would render title otherwise incapable of enforcement. The equitable charge exists because it does not involve the transfer of possession, one of the hallmarks of the common law development of security interests, or of ownership. It merely represents the right of the creditor to have an asset belonging to the debtor dedicated to the settlement of the indebtedness, the discharge occurring when the debtor voluntary surrenders the asset or is forced to disgorge it by order of court. The right to appoint a receiver to recover the asset also serves to aid the discharge. The equitable charge is at the base the origin of the floating charge, this having developed by contrast to the fixed charge applying to nominated assets by extending to classes of assets constituting a fund. The interest of the floating as opposed to the fixed charge is in the nature of the creditor's participation, disposals under the fixed charge requiring consent, while those under a floating charge are normally at the disposal of the debtor until such time as the charge crystallises on the occurrence of a determining event. It may be argued that the development of the floating charge represents a considerable advance on earlier security methods that has avoided the need, as in France, for legislative intervention to adopt modern security techniques.

A Comparison of Security Interests

A number of conclusions may be drawn from the outline of the two systems above. It may be first said that the French law of property is still firmly linked to the values associated with real property in a way that English and Welsh law has been able to move away from. If this view is the correct one, then it would follow that security and the protection of creditors' interests is similarly imbued with notions more properly associated with land and real rights and remains so despite the changing needs of business, thus creating a system that might be fairly described as static, and this despite later legislation introducing new security techniques. It is certainly true in all jurisdictions that new businesses, especially start-up and new technology enterprises, experience annual statistics of failure that are alarming. Some of these failures will be due to the ordinary risks inherent in conducting business in novel and untested conditions. Some, however, will undoubtedly occur because of the difficulties in securing adequate finance. Here, the underlying framework for security is of the utmost importance in facilitating methods for raising business finance. The best position for business is indeed where this framework contains a range of methods permitting finance to be tailored to the needs and situation of the business. In comparing both jurisdictions, the range of security seems to be wider in the English and Welsh context and allows for security to cater to a wide variety of assets. The flexible use of the mortgage and floating charge seem to especially assist this.

In this context, it may be argued that French law lacks the flexibility to adapt financing techniques because of the often very conventional setting for business in France. This situation is dictated for the most part by the orthodoxy of the security available and the attitudes of institutional lenders. The point must also be made that lenders in France may be subject to insolvency liabilities because of the development of principles governing the over- or under-supply of credit, leading to an orthodox approach in lending decisions because of greater risks attendant on the usual business of lending. Undoubtedly, there is a profound impact on business at large and the level of entrepreneurship and a consequent effect on the competitiveness of the French economy as a whole. Part of this impact may stem from macro-economic decisions as to the appropriate level of interest rates governing lending conditions, part lies at a more fundamental level where the interface between law and business operates. Without appropriate security methods, creditors and debtors cannot agree financing initiatives that lie outside the framework the laws of that jurisdiction provide, leading often to loans being negotiated across frontiers relying on more favourable techniques being available elsewhere. Nevertheless, this form of competition is ineffective if the assets available for security lie within the jurisdiction and remain subject to orthodox rules for recovery and debt-settlement.

It is for this reason that, independently of the recourse to financing and security that creditors and debtors may enjoy by being able to seek the most favourable conditions in other jurisdictions, the arguments around security still return firmly to considerations of domestic law. The examples afforded by the laws of these two jurisdictions of very contrasting antecedents and legal cultures illustrates in miniature the difficulties faced by creditors and debtors seeking the best arrangements for their financing initiatives. It may also be mentioned here for sake of completeness that both jurisdictions are familiar with quasi-security concepts, including the use of set-off and retention of title arrangements, and also have systems boosting security, for example the widespread use of personal and third-party guarantees covering indebtedness. Nevertheless, the systems for security acquisition in the two jurisdictions mentioned may be fairly taken as being at different parts of the spectrum in terms of facilitating business finance. Because domestic law is firmly at the heart of creating security, it should be firmly underlined that it also frequently determines the remedies to which creditors will be entitled in seeking to enforce their security.

Conflict of Laws governing Security Interests

The view of the jurisdictions treated above with regard to the security interests created by the other has been the subject of occasional litigation and academic analysis. The assumption made by many commentators is that, according to accepted principles of private international law, the nature of the asset over which security is taken will dictate principles of recognition. Thus, the lex loci will govern the creation of security over real property while the lex rei sitae will govern the rules governing the creation of security interests over other varieties of property. Recognition and enforcement depend therefore on the valid creation of security according to domestic rules as a prerequisite. This will be subject to traditional doctrines governing the recognition and enforcement process which allow for exceptions on grounds of public policy, especially failure to comply with mandatory rules governing the creation of security as well as notice and registration requirements. This is especially true where the security purports to affect assets other than in the jurisdiction where it is created or is intended to affect the position of third parties located elsewhere.

The cross-border effect of security is complex and largely outside the purview of this article. Nevertheless, it may be noted that much of the commentary dealing with private international law issues in the context of security, focuses on the position of the floating charge, a species of charge that as stated above is not known in French law. The difficulty from the perspective of the commentators is what the French courts will do confronted with a creditor seeking to enforce security in this form over assets located within the jurisdiction. Collins cites the case of Re Maudslay, Sons and Field,[2] illustrating the refusal of the court in England and Wales to restrain creditors from pursuing the attachment of a debt owed to the company by a French company. This was even though a floating charge entitled a debenture holder as principal creditor to assert rights over all debts owed to the company wherever situated, as French law required that the assignment of the debt represented by the floating charge had to be in writing, be registered in France and be notified to the French debtor. This represents a position that recognises that the effectiveness of security in another jurisdiction may be subject to rules of a mandatory nature and consequently its validity may have to be tested by the rules in operation in another jurisdiction.

Dahan states that recognition of the floating charge is dependent on whether the French judge can assimilate it by using a process of reasoning to some right recognisable by a French court.[3] In this respect, the relationship of the floating charge to the institution of the receiver or administrative receivership may be of interest. A French judge confronted with a creditor exercising a right through the appointment of a receiver might wish to base recognition on assimilation with an institution of insolvency. This is problematic as it will depend on whether the purpose of the receiver is seen as being solely to collect the debt owed to the creditor or to manage, as the deemed agent of the company, the assets of the debtor for the purpose of a reconstruction or rescue procedure. In the event that the floating charge is not considered to be an insolvency-related matter, it will be necessary for a French court to decide whether, as a species of guarantee, the floating charge is by way of being a real right in nature or a simple obligation. The answer to this question will also dictate what law applies then to the floating charge, that of the asset over which the real right is to be exercised or of the contract that creates it. Unfortunately, Dahan also states that case-law is relatively sparse, there being only a limited number of instances in which the floating charge could have been raised as an issue. Indeed, one of the cases cited was decided on the question of the exéquatur and the other was settled by the parties.[4]

As a summary, it may be stated that private international law rules differ sufficiently from jurisdiction to jurisdiction to make the task of the creditor seeking to assert security a difficult one. This is one of the reasons behind the development of international instruments designed to resolve problems of conflict of laws. The development of such an instrument at European level is

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[2][1900] 1 Ch 602 in Collins, Floating Charges and Conflict of Laws (1978) 27 ICLQ 691 at 707.

[3]Dahan, La Floating Charge: Reconnaissance en France d'une sûreté anglaise (1996) 2 Journal de Droit International 381 at 388-390.

[4]Ibid at 385.

the subject of the next section. Nevertheless, as will be seen, it is not always evident that a solution will be found so as to avoid the application of domestic legal principles and for that reason reference to these principles may still be required.

Security Interests in the European Context

The European Regulation on Insolvency Proceedings of 29 May 2000 (‘Regulation’) is a regional project in the insolvency law field that stems from the conclusion of a convention on 23 November 1995 by member states of the European Community (later Union) whose purpose was to construct a framework for handling cross-border insolvencies within the European Community. This draft seemed set to create a new framework for dealing with what had by then become a noticeable phenomenon of cross-border insolvencies but failed to secure the signature of the British Conservative Government that had withdrawn co-operation from European institutions at that time. Despite this apparent setback, some member states of the European Community still desired the conclusion of an instrument in this area to govern the cross-border insolvency framework and, after many years of speculation over the possibility of the convention project being revived, the project received a new lease of life through an initiative jointly proposed by Finland and Germany and submitted to the Council of the European Union on 26 May 1999.

The Regulation incorporates, with some necessary textual amendments, the terms of the previous European Insolvency Convention. Nevertheless, because of the legal basis on which it has been adopted, Title IV of the EC Treaty provisions governing judicial co-operation in civil matters, the United Kingdom and Ireland were required to opt in to arrangements while Denmark remains outside the ambit of the Regulation. The Regulation is intended to apply widely to a number of types of proceedings, irrespective of whether the debtor has incorporated status and whether the debt arises in the course of trade. Exceptions are contained, however, for a number of diverse bodies. These include insurance undertakings, credit institutions, investment undertakings holding funds or securities for third parties and collective investment undertakings. Legislation has, in fact, already appeared in the shape of two Directives of 19 March 2001 and 4 April 2001 covering the position of insurance undertakings and credit institutions respectively and there are further proposals mooted for the remaining bodies.

The Regulation is intended to operate by allowing for the maintenance of simultaneous proceedings termed ‘main’ and ‘secondary’ proceedings. The definition in Article 3 of which proceedings are ‘main’ or ‘secondary’ is also of importance given that only ‘main’ proceedings may include rescue-type proceedings, while ‘secondary’ proceedings are limited to liquidation measures. As a basic rule, insolvency proceedings may be opened in the member state where the debtor has the centre of his main interests. Insolvency proceedings opened in this jurisdiction are deemed to have universal scope and encompass all the debtor's assets. In order to control the proliferation of proceedings, secondary jurisdiction to hear cases is qualified by limiting occasions when independent territorial proceedings may be opened to two specific instances: first, where proceedings are for the benefit of local creditors or creditors of a local establishment and, second, where main proceedings cannot be opened for any reason. This has the benefit of preventing territorial proceedings operating in order to further a localised grab-rule without some form of supervision or control. The Regulation also makes explicit the rule that the existence of main proceedings, once opened, results in all other territorial proceedings being converted to secondary proceedings.

The Protection of Creditors and Security Interests

The Regulation is intended generally to have a wide scope of application with many of the rules referring to co-ordination between proceedings. However, there is an acknowledgment in the text that widely differing laws apply across member states in relation to property. In practice, this makes it almost impossible to introduce insolvency proceedings with universal scope covering the totality of a debtor's assets in member states because of the difficulty in securing homogeneous treatment of assets. Drawing a line between the extreme positions of universality and territoriality, the Regulation recognises that strict application of the law of any member state where proceedings are opened to these assets would lead to insuperable problems and likely conflicts.

The specific example cited in support of the framework the Regulation introduces is that of security interests. The distinction to be made with regard to select groups of creditors, principally those with preferential claims, also remains of fundamental importance. For that reason, in situations of particular conflict, these will be managed by special references to the relevant governing law. This will be the case of certain significant rights and legal relationships, rights in rem and contracts of employment being cited as examples. The Regulation acknowledges in its preamble the continuing competing principles and the attractiveness of territoriality by permitting the opening of domestic proceedings with coverage limited to locally situated assets alongside other principal proceedings with universal scope. The benefits heralded by the Regulation are chiefly to enable creditors to avoid over-centralisation of insolvency proceedings to their detriment by being able to rely on a locally created instrument evidencing rights. Despite the potential for fragmentation, the original draft Regulation stated that mandatory rules of co-ordination for all proceedings would avoid the tendency to over-centralisation of proceedings.

Creditors receive, besides the debtor and employees, explicit mention in the Regulation, confirming their central status to the success of any rescue arrangements. Information is felt to be the key to ensuring their active participation. The existence of the decision opening proceedings with regard to any debtor and its content must be notified in other member states. This is a mandatory requirement for the principal liquidator to fulfil. For business considerations, it may also, where there is an establishment in the member state concerned, be the subject of a ruling making notification compulsory. Prior notification is not, however, felt to be a pre-condition for recognition of foreign proceedings. This may not sit easily with the provision on protection of third parties also contained in the Regulation in situations where these parties are unaware of proceedings. This provision deems that persons acting in good faith effecting payment on account of any transaction with the debtor, where this payment should have been made to the liquidator, are taken to have been discharged from any further obligation in this respect. The difficulty for creditors here is that these payments, even if reintegrating the asset base, may by being subject to further claims fall outside those assets which are distributable.

In relation to how creditors may further assert their rights, all creditors, wherever domiciled in the Community, have the right to assert their individual claims in any of the insolvency proceedings that may be pending in relation to their debtor. This provision will also benefit tax authorities and social insurance institutions, which may extend their reach across national boundaries, and is an important departure from the practice in many jurisdictions with regard to the (non-) recognition of foreign penal and revenue laws. In practice, despite the notice requirements, only diligent creditors will be able to take advantage of these provisions and there well may be a cost-element prohibiting smaller creditors from participating in more than local proceedings. Nevertheless, in order to ensure equal treatment of creditors, there is an attempt to co-ordinate overall distribution of proceeds by requiring creditors to account for dividends received in other proceedings. Under this arrangement, the Regulation states that creditors may only participate in the distribution of total assets in other proceedings if creditors with the same standing have obtained the same proportion of their claims.

The Resolution of Conflict of Laws

As noted above, the Regulation does contain a number of exceptions to the general principle that the law of the ‘main’ proceeding will govern the conduct of the insolvency. This is because the Regulation recognises that there will be cases in which strict adherence to this principle will interfere with the rules under which transactions are carried out in other member states and that parties’ legitimate expectations and the overriding requirement for certainty of transactions in other member states will need to be met by providing for some exceptions from the general rule. The exceptions relate to particular rights, recognised as being useful in the insolvency context, to particular categories of transactions and to particular classes of participants in insolvency.

Two forms of particular rights recognised as meriting exceptions from the general rule relate to rights in rem and the exercise of rights of set off, both considered as useful guarantees for the granting of credit. These rights are especially protected because they permit credit to be obtained in conditions not otherwise possible without the presence of a guarantee, even though the effect of this type of security is to insulate holders against the risks of insolvency affecting the debtor and interference by third parties with contractual arrangements governing the supply of credit. Balz states that the issue of security was particularly sensitive during negotiations leading up to the adoption of the predecessor convention. An unconditional application of the law of the state where proceedings were opened would not have been possible because of differences in the treatment of the rights of security holders, with some systems, the example being given of the French, interfering substantially with these rights for the purpose of securing rehabilitation of the debtor. Others, he states, however, leave security substantially unaffected and concentrate on rescue aspects that reschedule unsecured and non-priority debt only. For that reason, although allowing the law of the opening state to govern would assist the overall administration of the estate, complexity would be created by the potential application of two insolvency laws in tandem to the same assets subject to the security.[5]

In fact, the Regulation states in Article 5(1) that insolvency proceedings may not affect third party rights in rem in respect of any property situated in another member state at the time insolvency proceedings are initiated. Third party rights in rem are defined in Article 5(2) to include rights in relation to the disposal of assets under liens and mortgages, the right guaranteed by an assignment of security, the right to restitution from possessors or users in cases where use is contrary to the owner's wishes as well as rights in rem to the beneficial use of assets. As defined, these rights also include rights in relation to specified assets as well as collections of assets, as would be the case with the creation of a floating charge. Virgos, co-author of a commentary that accompanied the 1995 predecessor convention, has stated explicitly that floating charges of the type recognised in Great Britain and Ireland would qualify as rights in rem.[6] The assumption is made by Dahan that, despite the omission of the institutions of receivership from the ambit of the convention, a fact situation replicated in its successor regulation, the holder of a floating charge will continue to enjoy a right over assets that would be recognised under the lex rei sitae and which, as the convention provides, were located in that jurisdiction. Nevertheless, any effect the charge purports to have over assets located elsewhere would continue to be governed by recognition rules applied by the jurisdiction in question. Thus, if France were the location of principal proceedings, the floating charge holder would be required to prove the debt in these proceedings and could not exercise the charge over assets in France that would be subject to these proceedings. In this instance, the application of English and Welsh law would effectively be limited to assets within the jurisdiction.[7]

Also included as rights in rem are any rights defined by Article 5(3) as being subject to registration on a public register for purposes of being enforceable against other parties. An exception is, however, provided, in cases where an action is brought on a point covered by Article 4(2)(m) relating to void, voidable and unenforceable rights. The proprietor of the right in rem can therefore continue to assert his right to separate settlement of his claim, which may rely on separation of the security on which the right depends from other

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[5]Balz, The European Union Convention on Insolvency Proceedings (1996) 70 ABLJ 485 at 509.

[6]Virgos and Schmit Report (1995) at para. 104; also Virgos, The 1995 European Community Convention on Insolvency Proceedings: An Insider's View, Forum Internationale No. 25, The Hague, March 1998 at para. 40.

[7]Dahan, op. cit. at 402-3.

assets. In order to more effectively deal with rights in rem, the liquidator may request the opening of secondary insolvency proceedings in the jurisdiction concerned if the debtor has an establishment there or deal with the security under preservation orders made in the context of principal insolvency proceedings. Proceeds from the sale of the security are first used to settle with the creditor, whose right in rem it is, before any surplus reverts to the asset fund.

As mentioned above, the situation of quasi-security is also covered with set-offs being expressly held in Article 6(1) as unaffected by the opening of insolvency proceedings where these set-offs would be recognised under the law applicable to the debtor's claim against the creditor. As a result, a creditor normally entitled to exercise this type of claim will be permitted to do so, even if it is not available under the law of the jurisdiction where proceedings are opened. The Regulation states that set off acquires as a result the status of a guarantee on which the creditor concerned can rely when the claim eventually arises. In cases of reservation of title, Article 7(1) provides that insolvency proceedings may not affect the rights of a seller where the assets are situated at the time proceedings are opened in another member state. Where it is the seller who is the subject of insolvency proceedings, Article 7(2) also states that this fact may not be used as grounds for the resolution of the contract and does not prevent the acquisition of title by the purchaser where the good are in another member state. Both set-offs and reservation of title clauses are also subject to the exception made for void, voidable and unenforceable acts.

The preservation of many domestic law rules is expressly stated in the Regulation as applying in cases of assets often found underlying security. For example, Article 8 provides that the law of the member state in which the property is situated expressly governs real property. The protection of specific interests, for examples those of contractual occupiers of property and general interests protected by the state where the property is found justifies this particular exception. Special rules are also provided in situations dealing with securities, which under Article 9 are determined by the law governing the financial market issuing the securities. The aim of this provision is to avoid any modification of the mechanisms for the regulation and settlement of transactions on organised financial markets so as to secure confidence in the integrity of payment or settlement systems. Furthermore, the law applying to rights over immovable property, a ship or aircraft that are subject to registration is under Article 11 that of the member state under whose authority the register is maintained. The same laws will also, according to Article 14, govern the disposal by the debtor of any property of these types. National rules are preserved in relation to issues governing acts detrimental to creditors, where these acts take place in another member state than where proceedings are opened. However, if the rules of that member state permit challenges to these acts, the main jurisdiction may also decide under Article 13 on the void nature, voidability or unenforceability of that act. The effect of insolvency proceedings on other litigation, however, is under Article 15 a matter exclusively for the member state where the lawsuit is pending.

Summary

The protection of security and related interests lies at the heart of the lending agreement. To the extent that creditors are able to exercise effective control over their interests and to rely on recovery of the lending or associated security, creditors will readily engage in lending transactions, a fact that has consequences on the economic plane for the growth of the economy and wealth creation overall through the operation of economic forces. The creation of security interests varies from jurisdiction to jurisdiction, with even essential elements such as the use of particular assets, contractual arrangements, recovery procedures and formalities being different in nature. The comparison above between the laws in operation in both France and England and Wales reveals that security is dependent on the cultural-historical context and the development of legal systems that may be dependent on very different legal antecedents. Nevertheless, modern business practice is very reliant on the ability of businesses to transact across frontiers, a fact that is not lost on legislators who may be keen to ensure that their legal systems afford appropriate legal instruments that assist businesses and encourage the use of the laws and the courts of that jurisdiction as, respectively, underlying rules governing the contract and dispute-resolving fora.

It may be recognised, however, that even modern economies may not have developed instruments that fully match the expectations and needs of business. To the extent that domestic laws continue to govern the availability of security instruments, there may be a temptation for businesses to shop elsewhere for instruments more appropriate for their needs. Nevertheless, this will not always prove to be the most efficient method for mobilising security where assets are located in jurisdictions that insist on the application of local security techniques to these assets and/or restrict the extension of foreign security methods to these assets. Conflict of laws problems may be readily seen to arise in this situation where creditors may be relying on a species of security that has no direct local equivalent or whose effect is limited by the need to observe domestic rules before recognition and enforcement may be obtained. The regulation of security by therefore regulating instances of conflict of laws, especially in the context of insolvency, becomes very important. The instrument that purports to do so, and which would be relied upon to resolve any potential conflicts between the two jurisdictions covered, nevertheless returns the matter of rights in rem to domestic legal rules, thus reviving the potential for conflict. This may be an unavoidable situation, given the difficulties in extending domestic rules to foreign assets, but may still be seen as an impediment to the proper organisation of security. In the final analysis, creditors are still required to be astute when creating security and further developments in this area, perhaps by way of harmonising recognition of cross-border security interests, may be desirable.

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