Coping with Business Failure and Bankruptcy in the European Union.

A Case Study on the Failure of Market Integration

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I. Introduction

A. Background and Context of Cross-Border Insolvency

Insolvency laws and regulations play a hugely important role in the economy and wider society, given that a defining characteristic of a market economy is the use of competitive methods in order to achieve maximum profit. Indeed, the risk of business failure is an essential feature of economic activity, and the sole way to avoid this risk is by not doing business at all.

The failure of a company affects a wide range of interests, and thus, insolvency legislation closely interacts with other areas of law. It is therefore of increasing importance, not only in its own right, but also in its impact and influence on a host of other sectors, such as employment, tort, environmental, pension and banking law. With the accelerated growth in international trade in recent decades, the paradigm of national economies has been transformed into a more open, increasingly interconnected and interdependent arena. While increased globalisation can be perceived as a benefit during solvent periods of trading, the impact of insolvency proceedings is no longer limited by geographic frontiers. It can have devastating effects on stakeholders in a number of Member States, each of which may claim to be competent in governing the entire insolvency proceeding or, at least, in liquidating domestic assets and protecting domestic creditors. In the European arena, therefore, the question arises as to which jurisdiction should be competent to govern insolvencies.

The 2008 financial crisis and the following global economic downturn adversely affected businesses around the world, resulting in financial difficulties for many firms. The consequent increase in the number of insolvencies highlights the need for corporate bankruptcy laws to liquidate unviable firms and reorganise viable ones, so as to maximise the total value of proceeds

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received by creditors, shareholders, employees and other stakeholders.

After the debtor becomes insolvent, the relationship between corporate stakeholders changes dramatically: shareholders become the residual claimants of corporate activities. Usually, creditors cannot coordinate themselves and, therefore, often collect their debts individually, seizing the debtor's assets as soon as financial distress becomes apparent. This “race to the grab” leads to inefficient outcomes for the creditors as a group, especially if the going concern value of debtors' assets is higher. Indeed, the probability of a successful rescue is reduced because there are returns for secured creditors in liquidation, which may reduce returns over a longer period of time. Moreover, as it affects many areas of the legal landscape in adjusting rights among creditors and other owners, bankruptcy law must address issues in a wide variety of disciplines, including employment law, environmental law, and tax law. Further, it must reconcile the rights of secured creditors with other property claimants. All of these stakeholders have contractual or statutory rights to assert claims against a debtor and their assets, and as such, are inevitably affected by bankruptcy law.

These issues of variability surrounding bankruptcy law are complex when confined to one jurisdiction, but they inevitably become even more delicate when the debtor's creditors and assets are spread over different European countries. This results in insolvencies having cross-border implications. In that case, the conceptual matrix of private international law can be applied so as to identify the issues which may have to be resolved, *i.e.* (1) in which jurisdictions may insolvency proceedings be opened?; (2) what country’s bankruptcy law should be applied?; (3) what international effects should be accorded to these proceedings conducted in a particular country?

B. The Underlying Issue: Diversity of National Bankruptcy Laws

Because of the complex, and comprehensive nature of, the practical difficulties encountered in a cross-border case may be considerably greater than those found in the more usual context of international litigation between solvent parties. Indeed, even though it is possible to depict the factual elements of insolvency in global terms which are internationally understood, national attitudes towards bankruptcy are extremely diverse, since the consequences for the debtors vary greatly from one country to another. Bankruptcy law can be described as “meta-law”, since it impacts upon the entire patrimony of the debtor and the range of parties and legal interests involved is extremely extensive. Therefore, the link between insolvency law and public policy within a country is an intimate one and as such, despite numerous general resemblances, national insolvency laws and procedures differ significantly.

Over the last decades, the increasing frequency and extent of European cross-border insolvency cases have exposed the limitations of the existing body of law in this field, both at national and EU levels. When one examines the parts of each country's private international law dealing with insolvency, the conflicting views are even more deeply-rooted than in any other types of conflict of laws.

II. Outline

This paper generally focuses on the efforts at EU level to provide a legal framework for dealing with cross-border bankruptcies, notably through the European Council Regulation on Insolvency Proceedings of 2000. It explores the issue of the harmonisation of corporate insolvency and rescue law at European level, and the tensions between different solutions for the reform of cross-border insolvency and business rescue.

The first section examines the adequacy of the existing rules against the framework of EU law, as the Regulation was adopted under Title IV of the EC Treaty. It will be determined whether the legal basis chosen for the harmonisation of insolvency law within the EU was the most suitable option, and whether the choice of this form of regulation effectively promotes the proper functioning of the Internal Market.

Secondly, the paper looks at the specific issue of primary and secondary proceedings, since the Regulation was oriented more towards facilitating liquidation than rehabilitation. This section is located within the broader doctrinal distinction between universal and territorial approaches to resolution of international conflict of laws.

Finally, the latest European reforms are considered. More than ten years after the adoption of the Regulation, the European Commission has linked its amendment with the EU's current primary concern of promoting economic recovery and sustainable growth. The paper examines the Commission's efforts towards achieving EU ideals underpinning the Regulation's reforms, assessing whether the new Regulation fits within the aim of promoting the efficient functioning of the Single Market.

III. Setting the Scene: Insolvency Law in the European Union

A. An Efficient European Insolvency Law: Towards the Smooth Functioning of the Internal Market

The original purpose of the Treaty of Rome in establishing the European Community was to design fundamental principles providing for the free movement of goods, services, labour and capital. These freedoms in turn required the free flow of commerce and the creation of a Single Market, as this was to enhance trading across national boundaries. In this context, the point was made that a functioning bankruptcy system was essential to any economy that aspired to achieve the freedoms of establishment of business and the free flow of commerce. Effectively, the failure of businesses was accepted as a factor that could affect the proper functioning of the internal market.

At European level, both the European Community (later Union) and the Council of Europe have been active in drafting texts seeking to regulate cross-border insolvencies; indeed, the 1980s and 1990s saw a substantial growth in this area. The background to European initiatives in insolvency is a particularly long and arduous one, illustrating the complexity in dealing with the diversity of domestic regimes within Europe and the rise of European firms, as opposed to solely domestic ones.

The nature of European insolvency is such as to raise a considerable number of issues – including priorities of creditors or social security matters – the resolution of which may bring national systems into conflict: "The diversity of laws applicable to the transactions of a single company is nowhere more important than at the time of insolvency, when their consequences are felt."[1] Therefore, the process of integration of the Internal Market required a coherent, harmonised body of insolvency law, capable of addressing the European dimension of firms and its cross-border implications, as interaction between companies located in different Member States became increasingly common.

The main text regarding insolvencies with cross-border implications is the European Council Regulation on Insolvency Proceedings of 29 May 2000, which entered into force on 31 May 2002 (EIR).[2] The European institutions had two grounds upon which to base the legal harmonisation of insolvency law. On the one hand, Article 50 of the TFEU states that the Parliament and the Council are empowered to enact harmonising directives so as to promote freedom of establishment across

[1] P. Omar, *European Insolvency Law* (Ashgate, 2004), at p. 15.
[2] Council Regulation 1346/2000/EC of 29 May 2000 on insolvency proceedings, OJ L160/1, 29 May 2000, at Recital 33. The Regulation does not apply to Denmark.

the EU. Alternatively, Article 81 TFEU grants the EU the competence to adopt measures of approximation of Member States' laws in the sector of judicial cooperation in civil matters with cross-border implications. Pursuant to this second article, the EU is thus competent to enact Regulations in the field of private international law, which are directly applicable in the Member States. The latter, therefore, was chosen as the legal basis for the harmonisation of insolvency law within the EU, as it was felt that the use of the Regulation form was necessary to promote the proper functioning of the Internal Market. Indeed, as firms do not restrict their activities to the territory of their home jurisdiction and often have creditors and assets in different jurisdictions, if the firm becomes insolvent, each of the Member States involved would have a legitimate interest in regulating the insolvency. The nationality of the debtor or their place of incorporation is irrelevant. The EIR still applies.[3]

B. Purpose of the European Insolvency Regulation

The EIR therefore sought to introduce rules for dealing with insolvencies with a cross-border element, particularly because companies' international activities profoundly impact the economy of the EU. A need for regulation by common rules applicable throughout the Single Market was quickly realised, with the result that only a supranational measure co-ordinating European proceedings was deemed to have the necessary weight to harmonise insolvency law. The aim was to create a level playing field and to remove unequal domestic barriers.[4]

The preamble and the thirty-three paragraphs of the EIR describe the objectives that justified an action at European level, establishing a procedure that is directly applicable in the Member States. Generally, the preamble and Recitals therein refer to the stated global aim of the EU, *i.e.* to create a single legal area based on the ideals of freedom, security and justice.[5] Thus, the essential purposes of the EIR are:

(1) to allow for the proper functioning of the Internal Market, which requires efficient and effective cross-border insolvency proceedings;
(2) to coordinate the measures taken over the insolvent debtor's assets; and
(3) to avoid forum shopping.

[3] See Re BRAC Rent-A-Car International Inc [2003] 1 WLR 1421 where the UK courts were declared to have jurisdiction, as the Centre of Main Interest [COMI] of the company was located in the UK, even though the company was incorporated in the US. See also Re Ci4net.com Inc [2005] BCC 277 where two companies incorporated in Jersey and the US were held to have their COMI in England.

[4] Insolvency Regulation, at Recital 5.

[5] Insolvency Regulation, at Recital 1. This is the statement common to Title IV and the Third Pillar on Justice and Home Affairs, as amended by the Treaty of Amsterdam.

The EIR is the product of a long and complex negotiation process. A more coherent body of substantive insolvency law at EU level could not be created because of the numerous disparities between national insolvency laws.[6] Thus, the EIR stands as an instrument harmonising *procedural* law exclusively, and rests on the provisions governing jurisdiction for opening insolvency proceedings. In many respects, the Regulation can be regarded purely as a mechanism for dealing with the kinds of difficulties raised under conflict of law principles, i.e. choice of forum and choice of law, as it does not seek to harmonise insolvency law across jurisdictions in any way. The Regulation focuses on the facilitation of reciprocal recognition and enforcement of insolvency proceedings.

C. Jurisdictional Issues under the Regulation

1. *The Universalism vs Territorialism Paradigm*

In order to achieve proper functioning within the Internal Market, two approaches have traditionally been deployed to solve the issues generated by cross-border insolvencies: "universality" and "territoriality."

The main principle underlying the EIR is that of the "universality" of insolvency proceedings. This principle requires that when insolvency proceedings are commenced in relation to a debtor, then those proceedings should compromise all of that debtor's assets, wherever they may be located in the Member States, and that no further insolvency proceedings should be permitted to be commenced. The administration of the insolvency estate is conducted under the auspices of a single judicial authority, which would normally be in the country of incorporation. Under the universalist approach, the law of the State where the debtor has his domicile (or registered office) and where the insolvency proceedings have been opened, will be applied to administer or liquidate the whole estate. This is often referred to as *lex concursus* and *lex forum concursus*. Professor Bob Wessels explains it as such: "the law (lex) of the country where a court (forum) opened insolvency proceeding (dealing with the concurring claims of creditors: *concursus)* and which court is charged with conducting the proceedings."[7]

The general principle of universality has been compromised in the Regulation, including some elements of territoriality, since it is possible to open of one or more sets of insolvency

[6] See Insolvency Regulation, at Recital 11.
[7] Bob Wessels, "Cross-Border Insolvency Law in Europe: Present Status and Future Prospects" (2008) 11 Potchefstroom Electronic Law Journal 1, at 5.

proceedings, having territorial effect, in other Member States where the debtor has an "establishment".[8] The territoriality model, is based on the idea that the insolvency proceedings only have effects within the jurisdiction of the State and within the territory of which they have been opened. Therefore, insolvency proceedings have an exclusively territorial focus. Following this model, assets in other countries will not be affected by these territorial proceedings, and the administrator or liquidator appointed does not have any powers outside his jurisdiction. Territorialism, therefore, stems from the traditional notion of State sovereignty, *ie* that a State has exclusive control over its own territory.

Territoriality may seem more realistic than universalism, both in its objective and in its practice. Insolvency proceedings with global effects opened in one Member State, are going to face difficulties in having their extra-territorial elements recognised in other States, as national interests will be at stake. Universalism goes as far as to ask countries to relinquish the control they have over a situation happening within their borders. Moreover, universalism requires States to have a mutual understanding and accord as to the factors to be used in the exercise of universal jurisdiction. This proves to be difficult, as some countries see the State of incorporation as the basis of universal jurisdiction, whereas others ground it in the country's principal place of business. Thus, as explained by Wessels, "[t]hese points of departure form both ends on a scale."[9] However, most European States have implemented a mixed model, generally referred to as "modified" universality, which the EIR has similarly, and appropriately, adopted.

Article 3(2) proceedings are limited in effect to the particular Member State in which they are commenced and are subject to rules of coordination with the main proceedings. Nevertheless, they represent a major incursion on the principle of universality. There is in principle no limit on the number of Article 3(2) proceedings which may be commenced; if a debtor has a number of establishments in different Member States then a corresponding number of territorial insolvency proceedings can be commenced in each of those states.

The second main important element is that Article 3(2) insolvency proceedings can be commenced even if main insolvency proceedings have previously been commenced in relation to the debtor. However, if main insolvency proceedings have already commenced, then Article 3(3) provides that the local insolvency proceedings can only be winding-up proceedings – as opposed to rescue

[8] As defined in Article 2(h).
[9] Bob Wessels, "Cross-Border Insolvency Law in Europe: Present Status and Future Prospects" (2008) 11 Potchefstroom Electronic Law Journal 1, at 5.

proceedings. The restriction of secondary proceedings to winding-up proceedings can have unpleasant consequences.

Moreover, the ability to open secondary proceedings in member States where a debtor has an establishment, notwithstanding that main proceedings have already been opened in the Member State where the debtor has its COMI, may be problematic in practice. The initiation of secondary proceedings introduces multiple insolvency proceedings in relation to the debtor which will inevitably lead to increased costs and may also prejudice the successful achievement of the purposes of the main insolvency proceedings.

To conclude, the phenomenon of cross-border insolvencies is comprised of competing rights and interests, competing forms and competing laws. Neither universalism nor territorialism is considered to be adequate in the context of a European commerce framework. The EIR therefore melds the two concepts into what is called “modified” universalism, “a system of satellite secondary bankruptcies which revolve around and give assistance to a main core proceeding.”[10]

2. *Modified Universalism in the EIR and the Concept of the “Centre of Main Interest”*

In the EU, insolvency law is under the exclusive jurisdiction of the Member States, but the EIR has introduced a unified choice-of-law and choice-of-forum model, since these are not at the disposal of the debtor company. The EIR combines this approach with the universality principle.

Despite its prospective wide scope, Recital 11 of the EIR acknowledges that different bankruptcy laws are applied across the Member States, rendering it difficult to introduce proceedings with pure universal breadth, encompassing the whole of the debtor’s assets.[11] The philosophy behind the enactment of the EIR was that a harmonised body of bankruptcy law with pan-European extra-territorial effects was more effective than a collection of disparate national proceedings in terms of returns for the various stakeholders, particularly creditors. Nonetheless, because of the differing political views across the EU, such a comprehensive harmonisation did not occur, and the EIR was therefore not based on a purely universalist model.

Pursuant to the EIR, insolvency proceedings should begin in the Member State where the “centre

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[10] Gordon Johnson, “The European Union Convention on Insolvency Proceedings: A Critique of the Convention's Corporate Rescue Paradigm” (1996) 5 INSOL International Insolvency Review 80.

[11] Recital 11 states: “This Regulation acknowledges the fact that as a result of widely differing substantive laws it is not practical to introduce insolvency proceedings with universal scope in the entire Community. The application without exception of the law of the State of opening of proceedings would, against this background, frequently lead to difficulties…”

of main interest" (COMI) of the debtor is.[12] This general rule follows the universalism approach, as insolvency proceedings opened in that jurisdiction are deemed to have universal effects, comprising the whole of the debtor's assets. This is due to the fact that one of the first concerns of the EIR is to avoid legal uncertainties and forum shopping.[13]

The concept of COMI has evolved over time. Nevertheless, Recital 13 of the EIR has since added clarity to this area, stating that a debtor's COMI is in the country where he "conducts the administration of his interests on a regular basis." The COMI and the relevant competent jurisdiction need to be ascertainable by third parties in order to: (1) avoid uncertainties, and (2) enable creditors to predict the applicable law in case of their debtor's bankruptcy, so that they may assess the risk of trading with them. Based on this definition, the COMI is a factual criterion that needs to be assessed on a case-by-case basis. In order to increase predictability, a firm's COMI is presumed to be in the State of the registered office, unless the contrary is proven.[14] Based on the ECJ's case law, proving that the COMI is different from the registered office requires two elements. A debtor must show that: (a) the corporate headquarters are not located in the State of the registered office; and (b) this fact was ascertainable by third parties.[15]

At first glance, the EIR could be perceived as embedded within the concept of universalism, at least in terms of procedural law. However, the approach taken is actually more complex, and some exceptions to universalism can be found within the EIR, which strive to protect the diversity of interests arising in an insolvency. The first and most obvious exception to the universality approach is the possibility of opening secondary proceedings with territorial effects in parallel to the main bankruptcy proceedings. These secondary territorial proceedings can be opened in any Member State in which the debtor has an "establishment."[16] Pursuant to this rule, whenever a firm has establishments in different countries, each of them has competence to open secondary proceedings so that the distribution of assets located in their territory will be based on their domestic bankruptcy legislation. Even though the effects of secondary proceedings are limited to the assets found within the territory of that jurisdiction, this is a significant breach of the logic of the universality principle. Secondary territorial proceedings can erode the outcome of the main proceedings, especially because they are limited to winding-up proceedings and induce a "race to the grab" by local creditors.

[12] Insolvency Regulation, at Article 3(1).
[13] Insolvency Regulation, at Recital 4.
[14] Insolvency Regulation, at Article 3.
[15] Case C-341/04 Eurofood IFSC Ltd [2006] ECR-I 1078 (ECJ).
[16] Insolvency Regulation, at Article 2.

The decision to open secondary proceedings is usually brought about where: (1) secondary proceedings benefit local creditors, and: (2) main proceedings cannot be opened under the law of the Member State where the debtor's COMI is located. These restrictive rules have the advantage of concentrating assets for creditors' distribution, rather than of allowing for the opening of territorial proceedings in any jurisdiction. This latter scenario would be detrimental as it would dissipate the assets on costs and fees, since several proceedings, in several courts of different countries would be opened at the same time.

From the above, it is clear that the possibility of opening territorial proceedings in two or more jurisdictions with different bankruptcy laws means that this universal model has been partially eroded and abandoned, and replaced by a "modified" universality approach.

3. *Conclusion: Main Drawbacks of European Insolvency Law*

The EIR has established a uniform procedural framework regarding the opening of insolvency proceedings. It makes provision for a mandatory set of jurisdictional rules, thereby enhancing the harmonisation of insolvency law provisions. It improves harmonisation notably because of its direct applicability in the different Member States, *ie* its automatic binding effects in all Member States, without requiring any transposition through domestic legislation. Based on the above explanation, it can be argued that the Regulation has played a significant role in the development of a harmonised set of insolvency rules, governing cross-border insolvency cases. Nevertheless, despite this commitment to uniformity and unity, some significant drawbacks persist, which have diminished the overall impact of the Regulation.

First, the choice of the EIR's legal basis, Title IV of the EC Treaty, was not the most appropriate in terms of the uniform application of bankruptcy law in the EU, as three Member States (Denmark, Ireland and the United Kingdom) secured opt-out provisions.[17]

Secondly, the Member State in which the debtor company has its COMI is competent to govern the main insolvency proceedings, and the law of this country will be applied to all creditors and assets, regardless of their location. This is of great importance because this Member State will be competent also to regulate distribution criteria. Nonetheless, even though the EIR states that the COMI is where the debtor "conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties," the EIR did not reach its initial goal of creating a well-ordered system granting legal certainty. First, a number of exceptions to the rule of the COMI are

[17] The United Kingdom and Ireland have since exercised their right to opt-in.

provided for in the EIR, so as to preserve Member States' interests in regulating local issues and assets. Additionally, the evolution of EU case law on companies' freedom of establishment has allowed different forms of forum shopping to develop.

IV. Corporate Mobility, Regulatory Arbitrage and Insolvency Law

At its very core, the objective of the EIR was to avoid forum shopping. Despite this goal, two assumptions were inferred by the EIR drafters: (1) European firms do not substantially spread their activities outside their home State and, therefore, their COMI would be easily determined; (2) European firms could not reincorporate from one Member State to another without first liquidating the business. These hypotheses are no longer realistic, however, notably due to the process of European integration, and the development of EU law providing for the freedom of establishment of corporations. These developments have placed the EIR in a functional crisis.

Company law and insolvency law interact with each other to form coherent regulatory systems at a national level. Nevertheless, the increase in corporate mobility has the potential to tear these systems apart as inconsistencies in the application of private international rules fail to create a complete regulatory framework. European companies have competitively expanded their activities across the EU. This needs to be celebrated as a success of market integration - a step towards the Single Internal Market. However, the situation needs to be carefully regulated because this extension of activities increases uncertainties as to the location of a corporation's COMI due to the vagueness surrounding single internal market regulation. If the presumption regarding the location of the COMI is not rebutted, the same Member State will be competent to deal with both company and insolvency issues. However, this provides legal certainty only insofar as discrepancies between the registered office and the real COMI are limited and cross-border mobility of the registered office is made difficult. In light of the interconnectivity of businesses today, the development of EU law and the evolution of ECJ case law, these assertions are neither accurate nor pragmatic, especially given the description of corporate mobility as "the very essence of the internal market," the heart of European company law.[18]

[18] Klaus Hopt, "The European Company Law Action Plan: An Introduction" in Hopt and Geens eds., *The European Company Law Action Plan Revisited* (Leuven University Press, 2010), at 18.

Beginning with the decision in *Centros*[19] in 1999, the ECJ has developed a mutual recognition approach for EU-incorporated companies, holding that a company's headquarters can be located in a Member State different from the state of incorporation. It based its decision on Articles 49 and 54 TFEU, ruling that companies can conduct their business entirely from a Member State different from the State of incorporation, since TFEU contains a very broad mandate to tolerate companies formed under foreign law operating within their territory. The Court made clear that this recognition of foreign-incorporated companies does not require them to carry out activities in their jurisdiction of incorporation: a corporation's choice of company law is "inherent in the exercise, in a single market, of the freedom of establishment."[20] It followed that the line of cases prompted by *Centros* opened the door to choice-of-law, and thus regulatory arbitrage across the EU.

Additionally, since 2005, re-incorporations within the EU have been made easier due to Directive 2005/56/EC, which regulates cross-border mergers: a company can incorporate a shell company and merge into it, from one Member State to another.[21] Finally, in 2008, the ECJ definitively declared that companies' freedom of establishment grants corporations the right to reincorporate from one Member State to another.[22]

Regarding insolvency, the COMI is determined in the moment at which insolvency is filed. As a consequence, if a company reincorporates in another Member State, it will indirectly select the applicable insolvency law, unless creditors can prove that the COMI is still located in the jurisdiction of the company's formation. Therefore, even though one of the primary aims of the EIR was to avoid forum shopping, this development of EU law has transformed the legal landscape and opened possibilities for achieving that exact purpose.

Following this evolution, the EIR has been transformed into a sort of optional regime, as the premise that the COMI and the registered office coincide is no longer realistic. Therefore, the presumption of the location of the COMI does not produce the effects envisaged by the EIR drafters, because debtors can now indirectly choose the forum and law applicable to their

[19] Case C-212/97 Centros Ltd v Erhervsog Selskabsstyrelsen [1999] ECR I-1459 (ECJ). See also Case C-208/00 Überseering BV v NordicConstruction Company Baumanagement GmbH [2002] ECR I-9919 (ECJ); Case C-167/01 Kamer van Joophandel en Fabrieken voor Amsterdam v Inspire Art [2003] ECR I-1095 (ECJ)

[20] Case C-167/01 Kamer van Joophandel en Fabrieken voor Amsterdam v Inspire Art [2003] ECR I-1095 (ECJ), at para. 121. See also Case C-212/97 Centros Ltd v Erhervsog Selskabsstyrelsen [1999] ECR I-1459 (ECJ), at para. 27.

[21] Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies, OJ L 310/1.

[22] Case C-210/06 CARTESIO Oktato es Szolgaltato [2008] ECR I-09641 (ECJ).

potential future insolvency, which precludes creditors from legal certainty and predictability. Evidently, this is hugely inconvenient and impedes development, particularly with respect to the promotion of the recent "rescue culture." Professor John Armour argues that corporate rescue procedures are critical for ensuring regulatory competition at the EU level. He contends that it is desirable to permit companies to select their own company law regime, and further to select the associated corporate insolvency law, so as to adhere a better "fit" with their corporate governance requirements.[23]

At first glance, the EU bankruptcy regime does not permit debtors to choose their preferred insolvency forum and law, yet a second look reveals a number of uncertainties. First, although the main insolvency proceedings are conducted in the jurisdiction where the COMI is located, the EIR allows for secondary proceedings with territorial effects to be opened in other Member States where the debtor has an establishment. Additionally, the development of EU law alongside the ECJ's jurisprudence has enabled forum and law shopping, because companies can reincorporate in another Member State by means of cross-border mergers. Thus, the EIR has been described as,

> a hidden choice model, whereby corporations can opt for their preferred insolvency law by transferring their registered office into another Member State, unless creditors give evidence that the COMI is still in the original country.[24]

V. The Reform of the Insolvency Regulation

A. *Incentives for Reform*

The EIR had been in force for close to 15 years and its achievement needs to be measured against its initial aims: (a) the promotion of the smooth functioning of the Internal Market;[25] (b) the avoidance of forum shopping;[26] (c) the improved efficiency and effectiveness of European cross-border insolvencies;[27] and (d) the introduction of uniform rules on conflict of law.[28] Compared to

[23] John Armour, "Who Should Make Corporate Law: EC Legislation versus Regulatory Competition" (2005) 58 Current Legal Problems 369
[24] Federico Mucciarelli, "Not Just Efficiency: Insolvency Law in the EU and Its Political Dimension" (2013) 14 EBOLR 175, at p.38.
[25] Insolvency Regulation, at Recital 2.
[26] Insolvency Regulation, at Recital 4.
[27] Insolvency Regulation, at Recital 8.
[28] Insolvency Regulation, at Recital 23.

the fragmented and uncertain pre-EIR system, the regime has been welcomed as a positive innovation in terms of cross-border bankruptcies. European insolvencies have become more predictable, not least due to the modified universality model having introduced more clarity.

However, the EIR did not harmonise substantive insolvency laws within the EU. Instead, the Regulation confined itself to harmonising procedural international rules regarding conflicts of law in insolvency matters. This is due to the fact that domestic insolvency regimes touch upon a multitude of individual rights and a balance must be struck between protecting creditors' rights and safeguarding debtors' interests. Consequently, the scope of the EIR was limited to *how* such rules were to be implemented and administered at a national level, as opposed to the substance of rules that would be passed.

Additionally, as it fails to make provision for the insolvency of groups of companies and lacks a clear definition for the concept of COMI, the Regulation renders the coordination of proceedings difficult to organise and ultimately hinders corporate rescue. As Professor Ian Fletcher observed,

> [i]nternational insolvency law has arrived at the threshold of an exciting period of development… There is now a necessity to build bridges between the individual national systems, and to create adaptable structures that will enable communication and cooperation to take place in response to the particular elements present within each case - [this], requires a new vision, and new modes of thought, from all participants.[29]

B. Substance of the Reform

In the EU, the focus is now placed on rescue. In March 2014 the Commission adopted a Recommendation outlining a series of common principles for national insolvency procedures for businesses in financial difficulty. The objective is to shift the focus away from liquidation towards encouraging viable businesses to restructure at an early stage so as to prevent insolvency.[30]

The Commission based its Recommendation on an International Association of Restructuring, Insolvency, and Bankruptcy Professionals ("INSOL") Study,[31] which found large gaps between the laws of the Member States. For example, in several countries, liquidation is still the most common

[29] Ian Fletcher, Insolvency in Private International Law, National and International Approaches (Oxford University Press, 1999), at 370.
[30] Commission Recommendation of 12 March 2014 on a new approach to business failure and insolvency.
[31] INSOL Europe, Study on a new approach to business failure and insolvency - Comparative legal analysis of the Member States'
relevant provisions and practices, 12 May 2014.

outcome and this conflicts with the EU objective of helping ailing companies to recover. Therefore, the aim of the 2014 Recommendation was to implement frameworks that strengthen the rescue culture of viable companies:

> [e]vidence suggests that failed entrepreneurs learn from their mistakes and are generally more successful the second time around. Up to 18% of all entrepreneurs who go on to be successful have failed in their first venture.[32]

The Recommendation primarily addressed two critical points: (1) the prevention of failures and (2) the concept of a second-chance, *i.e.* the possibility for a failing business to recover and be offered a fresh start. The INSOL Study noted that enterprises do not enjoy the same latitude or flexibility to handle and assess financial difficulties everywhere in the EU. This is why the Commission decided to implement fast, effective and low cost measures to enable companies to restructure at an early stage.

From 2009 to 2011, an average of 200,000 firms went bankrupt per year in the EU, resulting in direct job losses each year of 1.7 billion.[33] Therefore, it is no surprise that the European Parliament raised the issue of reforming the Regulation in October 2011. The first step involved requesting INSOL Europe[34] to deliver a report on the feasibility of such harmonisation.[35] Published in April 2010, the INSOL Report stated that the differences in insolvency rules between Member States allowed firms to undertake forum shopping, which jeopardises legal transparency and predictability and decreases the chances of restructuring insolvent firms. Subsequently, it was proposed that domestic insolvency laws across Member States be harmonised. In response to the INSOL Report, the European Parliament adopted a Resolution requesting the European Commission to submit one or more legislative proposals aimed at partially harmonising insolvency law in the EU and at amending the Insolvency Regulation.[36]

The European Commission placed the amendment of the Regulation in its 2012 Work Programme and linked it with the EU's current main concern "to promote economic recovery and sustainable

[32] European Commission Press Release, "Giving Honest Businesses a Second Chance: Commission Proposes Modern Insolvency Rules" <http://europa.eu/rapid/press-release_IP-12-1354_en.htm?locale=en>.
[33] Creditreform, Insolvencies in Europe 2009/10 (Creditreform Economic Research Unit, 2010).
[34] The Association of European Insolvency Practitioners and Scholars.
[35] Directorate General for Internal Policies, Harmonisation of Insolvency Law at EU Level, The INSOL Report (Policy Department Citizens' Rights and Constitutional Affairs, 2010) <http://www.europarl.europa.eu/meetdocs/2009_2014/documents/empl/dv/empl_study_insolvencyproceedings_/empl_study_insolvencyproceedings_en.pdf> (visited 31 January 2015)
[36] European Parliament Resolution of 15 November 2011 with recommendations to the Commission on insolvency proceedings in the context of EU company law.

growth, a higher investment rate and the preservation of employment," as determined in the Europe 2020 strategy. In evaluating the practical application of the European Insolvency Regulation, the Commission acknowledged that while it is generally considered to operate successfully in facilitating cross-border insolvency proceedings within the EU, some issues concerning its functioning emerged. Specifically, "[i]t does not sufficiently reflect current EU priorities and national practices in insolvency law, in particular in promoting the rescue of firms in difficulty."[37]

Recently, in March 2014, the Commission adopted a Recommendation regarding a new approach to business failure and insolvency, emphasising that Member States will have to enact further insolvency law procedures to facilitate the restructuring of businesses.[38] According to the Commission, a business, which initiates restructuring soon rather later, will have lower costs and a higher success rate. The Commission also noted that during the adoption of restructuring plans, creditors should be involved, especially those individuals who are likely to be affected by the plan and to encourage new financing. Finally, the Commission recommended giving more power to judicial bodies, which need to ensure that dissenting creditors do not face greater loss than they would have in the alternative scenario.

It has been noted that the Recommendation can be viewed from two angles. First, it may be seen as a politically expedient way to try and deal with the issues, while there is not yet enough support shared across the Member States to publish a legally binding directive or regulation. Secondly, however, the current reforms in some insolvency laws *(e.g.* those of France, the Netherlands, and Spain) may be an indicator that some kind of harmonisation of insolvency law across EU Member States is taking place.

C. Evaluation of the New Regulation 2015/848

On 20 May 2015 the European Parliament approved the new European Insolvency Regulation in the text adopted by the Council at first reading on 12 March. The Regulation has been published on the Official Journal of the EU of 5 June 2015, as Regulation (EU) 2015/848 of 20 May 2015 on insolvency

[37] European Commission, Impact Assessment on Revision of Regulation (EC) No 1346/2000 on Insolvency Proceedings [SWD (2012) 417 final] 12 December 2012.
[38] Commission Recommendation of 12 March 2014 on a new approach to business failure and insolvency.

proceedings. This marks the end of a revision process which started with the Commission's proposal of 12 December 2012.[39]

The primary aim of the revision was to improve the operation of the EIR with a view to ensuring the smooth functioning of the internal market and its resilience in economic crises, having regard to national insolvency laws and to the case law of the ECJ on the old Insolvency Regulation.[40]

The general impression is that the system created by the EIR works well overall, and that an extensive reform is not needed. Indeed, reform could instead be destabilising. However, it is clear that partial revision is beneficial for improving the practical operation of the Regulation. In short, the revised text: (a) extends the EIR's scope to proceedings aimed at giving the debtor as "second chance"; (b) strengthens the current jurisdictional framework in terms of certainty and clarity; (c) improves the coordination among insolvency proceedings opened in respect of the same debtor and strikes a better balance between efficient insolvency administration and protection of local creditors; (d) reinforces the publicity of the proceedings by compelling Member States to provide for insolvency registers and by providing for the interconnection of national registers; (e) deals with the management of multiple insolvency proceedings relating to groups of companies.

In relation to the EIR, there was no specific mention of the important European ideals and objectives in the preamble or body of the Regulation, aside from a brief declaration that the Internal Market necessitated such an initiative in the field of cross-border insolvencies. The new Regulation provides greater elaboration in this regard, as it affirms that the aspiration is to ensure the smooth functioning of the Internal Market and to allow for more flexibility in time of economic crises, so as to promote business survival. Reference is made to the Europe 2020 strategy, and to the EU's current political priorities of promoting economic recovery and sustainable growth, encouraging a higher investment rate, and preserving employment.

Nevertheless, the reform is quite limited since it affects procedural, rather than *substantive* change. Essentially, it is confined to the extension of the existing Europe-wide recognition of a larger category of restructuring proceedings, in particular pre-insolvency mechanisms.

The Commission has not departed from the framework of the existing Regulation, and the proposals do not divert from the current regime too much. The view still prevails that as a result of widely different substantive laws, it is impractical to introduce insolvency proceedings with

[39] Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast) OJ. L 141.

[40]

universal scope throughout the entire EU. For example, the new Regulation enables liquidators to commit themselves to respecting distribution and priority rights which local creditors would have had if secondary proceedings had been opened. Whilst this solution is flexible and pragmatic, it is in fact a further limitation on the universality principle, because it emphasises how Member States are still protecting their own creditors' priorities. This bias, or indeed favouritism, also highlights the divergence between countries that place a strong emphasis on liquidation, while others focus on business restructuring and rescue. However, as mentioned above, business survival is an area that the Commission has recognised as particularly important in a Communication on a new European approach to business failure and insolvency:

The European Union is taking action to promote economic recovery, boost investment and safeguard employment. It is a high political priority to take measures to create sustainable growth and prosperity.

VI. Conclusion

Regarding proposals for reform of cross-border insolvency in the EU, typically two opposing arguments are presented: on the one hand, whether there ought to be a community commitment to reach full harmonisation of insolvency law, and on the other, whether companies ought to be granted the scope to choose the insolvency law of their preference. The latter is referred to as the "choice model." Neither solution has been recommended by EU institutions in their amendment project, yet they shed some light on potential developments.

For efficiency reasons, some legal commentators have pointed out that regulatory arbitrage and forum shopping need to be regulated in a transparent way, and should not to be uniformly prohibited, as the current Regulation requires. It is believed that under such a "choice model," companies would not be bound by inefficient domestic proceedings, but instead, could opt for another Member State's more efficient legislation, or, if such foreign law allowed, a restructuring could be made impossible under the original national law. Companies could then make use of the legal diversity available across the EU and avoid inefficient domestic procedures.

To implement such a choice model in the EU, two options are available. The first solution would involve disregarding the applicable company law and allowing free choice of insolvency law to companies. The second possibility, more popular among legal scholars, would be to replace the

COMI criterion, with the registered office determining the law and forum. Both alternatives would introduce more predictability *ex ante* for creditors, who would be better able to predict the legal rules and therefore adjust the cost of credit more efficiently.

However, the choice model is not without its weaknesses. This is because a company, by choosing the applicable insolvency law, would change its risk profile, having previously been taken into account by the creditors when negotiating the credit contract. This should not pose a problem for adjusting creditors who can protect themselves through covenants or guarantees, yet non-adjusting creditors may be at a real disadvantage because they cannot adjust the terms of their loan to reflect the effect on them of this choice of bankruptcy law. Thus, although this “choice model” produces several advantages, notably the possibility for companies to choose the most efficient regulation, it also introduces legitimacy issues and comes at a substantial social cost.

A fully harmonised body of insolvency law would, on the other hand, block negative externalities generated by the Member States' national legislations. Under the current Regulation, the Member State in which the debtor's COMI is located has jurisdiction over the matter and its legislation applies to assets and creditors, even those situated in another Member State. This situation can produce negative externalities, specifically by causing negative economic outcomes for Member States' non-parties to the insolvency issue at stake, and more generally by producing widespread spillover effects.

As such, full harmonisation of corporate insolvency law would be a desirable choice, and it is further justified by the subsidiarity principle underpinning EU law. If certain issues are better dealt with at supranational level, the EU is given competence in the matter and harmonisation is justified by the need to internalise negative externalities. Spillover effects would be avoided by implementing identical rules regarding creditors' priorities across the EU, so that all creditors would know *ex ante* and with certainty, which principles apply in case of default. By leaving the issue of full harmonisation of corporate insolvency to the EU, European policy-makers would certainly have to consider the interests of non-adjusting creditors, in order to obtain their political support.

Yet full harmonisation is not always perceived as the best solution either, notably because European populations' preferences are heterogeneous, and vary greatly from one Member State to another. In these cases smaller territorial units may be better equipped to address local interests and needs.

What is more, full harmonisation of insolvency law does not seem possible under the current EU legislative mechanisms. The so-called "democratic deficit" of European institutions and the EU decision-making mechanism raise scepticism about the potential of EU institutions to enact redistributive insolvency laws. Pursuant to the TFEU, instruments related to the harmonisation of laws should be adopted following the ordinary legislative procedure,[41] which requires negotiations between the Commission, the Council and the Parliament, and reflects the dual basis of democratic legitimacy in the EU institutions, *i.e.* involving both the Member States through the Commission and the Council, and the citizens through the European Parliament. The complex voting process calls for a broad consensus to be reached among Member States, and due to the nature of insolvency law, the harmonisation of such rules is quite likely to protect strong interests groups, *i.e.* those able to bargain at the highest EU level.

Thus, a fully harmonised body of EU corporate insolvency law will most likely alter the manner in which Member States currently balance values and interests. This could hinder the process of total harmonisation, which, ultimately, is not only an issue of efficiency, but mainly of politics and European integration.

[41] Article 294 TFEU (ex Article 251 EC).