

THE CHOICE OF INSOLVENCY REGIME IN HYBRID PROCEEDING BY ENTREPRENEURS

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ABSTRACT:*The paper examines the possibility to change insolvency status through hybrid insolvency proceeding. The main problem of European insolvency law is that hybrid proceeding is not regulated. The EU proposal of insolvency regulation has included into its scope hybrid proceeding in opt-out way. So the paper also focuses on the possibility to change insolvency status in the proposal. The paper is based on factual analysis of legislation and structural analysis of judicature. The paper shows effective ways of changing insolvency status and the legal uncertainty concerning this change. Furthermore, the paper confirms the hypothesis that the regulation of hybrid proceeding is needed and proposes ways of regulation. Moreover, the outcomes of paper could be used by other subjects such as judges, lawyers and entrepreneurs. The paper does not involve the economic impact of proposed regulation on the EU and member states, which could be a suggestion for future research.*

KEYWORDS: *Regulation, Pre-Insolvency proceeding, COMI*

JEL CLASSIFICATION: *G33, G35*

1. INTRODUCTION

Entrepreneurs are subjects that carry on business on their own responsibility with the aim of profit. Entrepreneurs bear liability for their business decision and also bring the innovation. Cross-border international business organizations are created in the world of international trade and multinational enterprises. Around half of enterprises survive less than five years, and around 200 000 firms go bankrupt in the European Union each year (European Commission, 2014). Probably a quarter of these bankruptcies have a cross-border element. Therefore, these subjects are limited by legislation that sets rules for the case of default of entrepreneurs. In Europe, the entrepreneurs are limited especially by the national legislation and the European legislation. The clear rules for the default of entrepreneurs lead to higher market outcomes.

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This paper deals with the influence of European Insolvency law on entrepreneurs in the time of commencing insolvency proceeding. Especially, the paper examines the possibility to change insolvency status through the pre-insolvency or hybrid insolvency proceeding.

1.1. European insolvency law

The European insolvency law involves international jurisdiction rules, recognition of opening insolvency proceeding rules and rules concerning the cooperation between courts and insolvency trustees. Most of these rules are involved in EU Insolvency Regulation. On the one hand, the enacting of European insolvency regulation was an important step in the coordination of cross – border insolvency proceedings in the European Union and on the other hand new phenomena appeared. One of them – the question of forum shopping - was triggering in the last few years. In the last years, companies have been trying to move insolvency status in order to achieve better insolvency jurisdiction. The EU Insolvency Regulation shall apply to collective insolvency proceedings which entail the partial or total divestment of a debtor and the appointment of a liquidator (EU Insolvency Regulation, art. 1). The regime of EU Insolvency Regulation excludes insolvency proceedings concerning insurance undertakings, credit institutions, investment undertakings which provide services involving the holding of funds or securities for third parties, or collective investment undertakings (EU Insolvency Regulation art. 1).

1.2. COMI

COMI is the abbreviation for the term “centre of main interest” that is used as a criterion for setting an applicable law. The EU Insolvency Regulation sets the applicable law according to the principle *lex fori concursus*. So, there is applicable national law of the European Union Member state on opened insolvency proceeding.

The EU Insolvency Regulation stated:

The courts of the Member State within the territory of which the centre of a debtor's main interests is situated shall have jurisdiction to open insolvency proceedings. In the case of a company or legal person, the place of the registered office shall be presumed to be the centre of its main interests in the absence of proof to the contrary.

So Article 3 of EU Insolvency Regulation also sets that insolvency proceeding shall be commence in the European Union Member State within its territory is debtor's COMI. This Article also sets fiction about the centre of main interest in register office of debtor. EU Insolvency Regulation in Recital 13 has stated that the centre of main interests should correspond to the place where the debtor conducts the administration of his interest on a regular basis and this place is therefore ascertainable by third parties.

The European Court of Justice used this Recital 13 as a definition of COMI. It is important to mention that this Recital 13 has provided only the clarification of COMI, not any definition. For companies or legal persons, there is the additional provision in Article 3 which should determine the location of COMI. It is possible to rebut the fiction about the COMI. The burden of proof will rest upon any person wishing to show where the COMI is. The issue was considered by the European Court of Justice in the case of Eurofood, in which the location of the COMI of the company in question was central to the question whether jurisdiction to open main insolvency proceedings was vested in the

courts of the state of the company's incorporation, or in those of the state in which the COMI of its parent company was located.

1.3. The time of opening the proceedings

As mentioned above, the EU Insolvency Regulation is applicable on opened cross-border insolvency proceeding. In Article 2, the EU Insolvency Regulation deals with the question of the time at which insolvency proceedings are held. This question is important because the time of opening of proceedings is the time at which the judgment about insolvency becomes effective in other European Union Member states and is the moment at which we are not able to speak about pre-insolvency proceeding.

There exist ideal situations in which only one single proceeding with a universal effect is commenced (Moss, Fletcher, Isaacs, 2009, p. 246). Also, there is no definition of the concept of opening in the EU Insolvency Regulation. Therefore, the word 'opening' should have been judged in the autonomous sense used in the EU Insolvency Regulation. The commencing of the main insolvency proceeding in one Member state causes the impossibility of opening another main insolvency proceeding in other Member states.

1.4. Pre- insolvency or hybrid proceedings

As mentioned above, the EU Insolvency Regulation is applicable on collective proceedings which entail the partial or total divestment of a debtor and the appointment of a liquidator. In some national legislations there are insolvency proceedings that do not fall under the definition of insolvency proceedings in the EU Insolvency Regulation. Usually, these insolvency proceedings are called hybrid proceeding or pre-insolvency proceeding and could be characterized as quasi-collective proceedings under the supervision of a court or an administrative authority which gives a debtor in financial difficulties the opportunity to restructure and avoid the traditional insolvency proceeding. Furthermore, the debtor has some control over its assets and affairs in these proceedings.

These proceedings are for example schemes of arrangement (Companies Act 2006, part 26) in United Kingdom, *Postępowanie naprawcze*¹ (Bankruptcy and Rehabilitation Law 2003, Art. 492-521) in Poland, *Schutzschirmverfahren*² (Insolvency proceeding Act, 1999, Section 270b) in Germany, *moratorium*³ (Insolvency Act, 2006, Section 125).

The main problem resulting from the fact that a substantial number of pre-insolvency and hybrid proceedings are currently not covered by the EU Insolvency Regulation is that their effects could not be recognized in the European Union Members states. Judges in the United Kingdom argue that schemes of arrangement are recognized in European Union Members states, because there are under the scope of Brussels regulation. The opinions on recognition of hybrid proceedings are different; moreover, this uncertainty could thwart the efforts to rescue the company because of the debtors who are unwilling to engage in the relevant procedures if their cross-border recognition is not ensured.

¹ Rehabilitation proceeding

² protective shield proceedings

³ protective stay

1.5. Scheme of arrangement

The scheme of arrangement is a statutory procedure pursuant Companies Act 2006, part 26. This hybrid procedure has become popular for overseas companies in last few years as a restructuring tool. As mentioned above, it could be uncertain whether the proceeding will be recognized in the European Union Member states. The companies are trying to use hybrid proceeding tools in the United Kingdom because it is easier to establish close connection to English law in accordance with the rules of international private law, without the need to prove COMI.

The English Court has the power to sanction a scheme of arrangement if the overseas company is liable under Insolvency Act 1986. The Insolvency Act extends the court's winding-up jurisdiction to unregistered companies (Insolvency Act 1986, Section 221) with the condition that there is sufficient connection with England and Wales. There is a reasonable possibility that if a winding-up order is made, it is of benefit to those applying for the winding-up order and one or more persons interested in the distribution of the assets of the company must be persons over whom the court can exercise jurisdiction.

2. THE STATE OF KNOWLEDGE

The EU Insolvency Regulation was enacted on 29th May 2002. It is also the point when this area of law is subject of research. Usually, the theory focuses on the problem of COMI and the problem of recognition of commenced insolvency proceeding. These problems are solved by Duuresma-Keplinger, H., C., Duuresma, D., Chalupsky, E., 2002, as one of the first publication on EU Insolvency Regulation. Wessels, B. 2006 examined the EU Insolvency Regulation and also analyzed the impact of Eurofood decision on COMI. Moss, Fletcher and Isaacs, 2009 and Kaczor, A., 2010 focused especially on COMI, forum shopping and the applicable law on insolvency proceedings. Eidenmueller, H., 2005 analyzed the choice of the insolvency status according EU Insolvency Regulation. The issue of COMI and the applicable law according EU Insolvency Regulation is solved also by Czech authors, Bělohávek, A., 2007a, Bělohávek, A., 2007b, Brodec, J., 2008, Kozák, J. et al. 2013. Eidenmueller, H., 2013 reviewed a proposal of amendment of the EU Insolvency Regulation and concluded that EU Insolvency Regulation could not regulate hybrid insolvency proceedings.

Fox, I., 2011 and Goldrein A., 2011 focused on the issue of forum shopping and the possibility of changing insolvency status through schemes of arrangement. The possibilities of cross-border restructuring of companies is solved by Solveig, L., 2007.

Varriale, Gemma, 2013 examined the impact of proposal of EU Insolvency Regulation on the schemes of arrangement and tried to foresee future development of this institute.

There is consensus that COMI is a proper and suitable tool to determine the applicable law on insolvency proceeding. The questionable part is setting the COMI for the company's group. The legal theory also suggests how to prevent forum shopping. Some authors (Moss, Fletcher, Isaacs 2009, Eidenmueller, 2005) differentiated between bad and good forum shopping and tried to focus on preventing bad forum shopping. The difference is that in the case of bad forum shopping, the insolvency status changed for the fraudulent reason, usually to avoid creditors; in good forum shopping, insolvency status changed for the restructuring and rehabilitation of debtors. The literature and research

have focused mostly on issues of COMI in European insolvency law and pre-insolvency proceeding has not been analyzed completely yet.

3. THE OBJECTIVES OF CHANGING LEX FORI

The paper examines the possibility to change the insolvency status through the pre-insolvency or hybrid insolvency proceeding. Especially, paper focuses on the changing of insolvency status through English tool - scheme of arrangement. The paper identifies and analyses the sanctioned scheme of arrangement and tries to find the common points related to the realization of this proceeding. The main problem of the European insolvency law is that hybrid proceeding is not regulated through any regulation or any direction, thereby the paper also approaches the issue of recognition of the arrangement scheme. The new proposal of the EU Insolvency Regulation has tried to include into its scope pre-insolvency or hybrid proceeding. There is no theoretical consensus whether the proposed definition of the scope of EU Insolvency Regulation will be the optimal solution.

The paper is based on factual analysis of legislation and structural analysis of court decisions. The paper uses standard legal interpretation methods including logical, teleological and structural interpretation of legal rules. Also, the legal rules are applied to individual decisions of the court. The paper also analyzes individual decisions concerning the sanctioned scheme of arrangement. It deduces some common rules for the process of the sanctioning scheme of arrangement. The paper analyzes the possibilities of changing the insolvency statutes.

The paper focuses on the hypothesis of whether the scheme of arrangement is a convenient tool for restructuring and rehabilitation of overseas companies in the United Kingdom.

Also the paper tests whether the scheme of arrangement might be regulated under the EU Insolvency Regulation and whether the regulation of hybrid proceeding is needed.

The paper shows the legal uncertainty surrounding the cross-border aspect of pre-insolvency proceeding and also proposes possible solution for legislators.

The paper analyzes some English cases such as Vita Group [2010], Gallery Capital [2010], La Seda de Barcelona SA [2010], Tele Columbus GmbH [2010], Wind Hellas [2010], Metrovacesa SA [2011], Rodenstock GmbH [2011], Cortefiel SA [2012], Eircom [2012], Estro Group [2012], Global Investment House [2012], NEF Telecom B.V. [2012], PrimaCom [2012], Seat Pagine [2012], Vivacom [2012], Deutsche Annigton Immobilien [2013], Icopal as and others [2013], Magyar Telecom [2013], Orizonia [2013] and Vietnam Shipbuilding Industry groups [2013]. The analysis is focused on the connection criteria, the development of this tools and its popularity in overseas countries.

4. FORUM SHOPPING IN RULES AND COURT DECISIONS

4.1. The change of the insolvency status

As mentioned above, the insolvency status is set in the time of the opening of the insolvency proceeding. When the companies or debtors want to change the insolvency status, they must fulfill the legal requirements. According to the EU Insolvency Regulation, it is important that the COMI is located within the territory of the European Union Member states. This principle is applied to the insolvency proceeding in the scope

of the EU Insolvency Regulation. There are also hybrid proceedings that do not fall within the scope of the EU Insolvency Regulation, and the connection to the law of the European Union Member states is regulated by national legislation. The European Court of Justice stated that the EU Insolvency Regulation is not able to use for national procedure which are not listed in Annex (Ulf Kazimierz Radziejewski C-461/11). This is also the case of the scheme of arrangement in the United Kingdom law.

With regard to the above, there are two main possibilities to change the insolvency status in the European Union Member states. First, changing the debtor's COMI, second, fulfilling the condition of national legislation by the debtor in case that specific insolvency proceeding is not regulated by the EU Insolvency Regulation.

4.2. Is the scheme of arrangement convenient tool for forum shopping?

The criteria for the application of the arrangement scheme according to the English law are very flexible. The Companies Act 2006 is based on the criterion of sufficient connection which is developed by English judges. The English Court has the power to sanction a scheme of arrangement if the overseas company is liable to be wound up and if there is sufficient connection with England and Wales. The sufficient connection could be based on assets within the jurisdiction, an exclusive English law and jurisdiction clauses in the debt documents or COMI within the jurisdiction.

The following Figure 1 shows the sufficient connection criterion on the analyzed judgments.

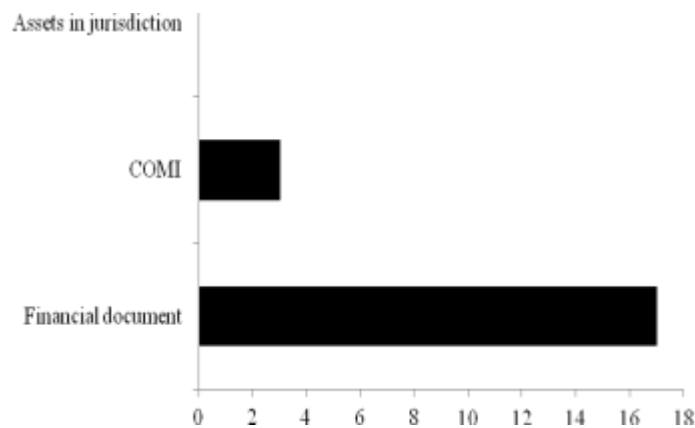


Figure 1 The number of schemes of arrangement according to the type of sufficient connection

Source: author's own elaboration based on bailii.org

In most cases the sufficient connection is based on financial documents. It concerns the following cases: Vita Group [2010], La Seda de Barcelona SA [2010], Tele Columbus GmbH [2010], Metrovacesa SA [2011], Rodenstock GmbH [2011], Cortefiel SA [2012], Eircom [2012], Estro Group [2012], Global Investment House [2012], NEF Telecom B.V.

[2012], PrimaCom [2012], Seat Pagine [2012], Vivacom [2012], Deutsche Annigton Immobilien [2013], Icopal as and others [2013], Orizonia [2013], Vietnam Shipbuilding Industry groups [2013]. The reason is that the governing law of the financial document is very flexible and it is easy to change this governing law. Also, COMI was used in the analyzed judgments as criterion to create connection to the United Kingdom. It concerns the following cases: Gallery Capital [2010], Wind Hellas [2010], Magyar Telecom [2013]. In these cases, the company's financial documents were usually governed by the New York law and for companies it was more convenient to transfer COMI to London. Probably the companies did not want to get rid of favorable loan terms. Also, the New York law recognizes the English scheme of arrangement.

The second point of judgments analysis is the development of the arrangement scheme in the English judicature and their popularity in overseas countries. Figure 2 shows the number of cases in each year.

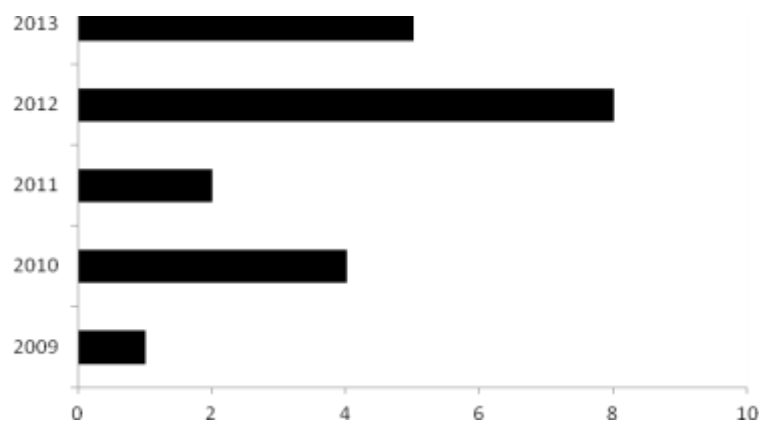


Figure 2 The number of schemes of arrangement in different years

Source: author's own elaboration based on bailii.org

There is no continuous development. The number of the approved schemes of arrangement is rather random and more depends on the actual conditions. The largest number of sanctioned schemes of arrangement is in 2012. There is no provable relationship.

Figure 3 shows the country of origin of the debtors who claimed for schemes of arrangement.

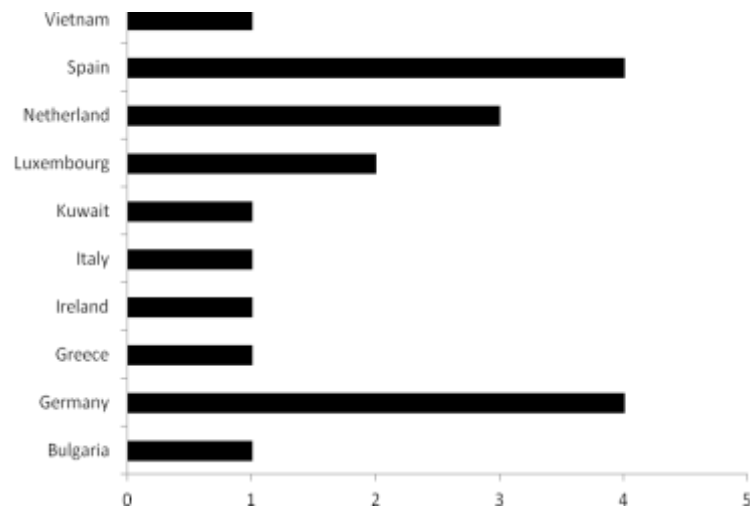


Figure 3 The number of schemes of arrangement according to countries

Source: author's own elaboration based on bailii.org

It results from above that most debtors claimed for scheme of arrangement from Germany and Spain. The reason for the application of German companies for the scheme of arrangement could be strict insolvency law and the substantial protection of creditors in German insolvency law. Therefore, it is not possible to solve default of company in a flexible way and sometimes it is impossible to get enough votes of creditors according to legislation. The problem of the Spanish law is that it enables only a few ways of solving the default of corporation.

The change of the insolvency status for the scheme of arrangement is very easy, because it is enough to change the governing law of financial documents. English judges developed one more condition: that company shall provide expert evidence that the relevant foreign jurisdiction will recognize the scheme of arrangement. This possibility of changing the insolvency status could also lead to the creation of speculative loans.

A potential problem of the scheme of arrangement is the recognition in the European Union Member states. Because it is based on contractual basis, English judges have concluded that it could be recognized according to Brussels regulation 2001. This was also confirmed by judge Newey in *Seat Pagine Gialle* [2012]. This issue is not clear because the German court refused to recognize the scheme of arrangement in the case of *Equitable life (OLG Celle 8 U 46/09)*. On the other hand, the German courts recognize the scheme of arrangement of *Rodenstock GmbH* [2011] or *Primacom* [2012].

The uncertain issue of recognition is reason of its potential regulation at the European level.

4.3. Proposal of EU Insolvency Regulation and regulation of the scheme of arrangement

COM 744, 2012 has proposed the scope of EU Insolvency Regulation extend to include hybrid and pre-insolvency proceedings as well as debt discharge proceedings and other insolvency proceedings for natural persons who currently do not fit the definition. It should notably extend to proceedings which provide for the restructuring of a debtor at a pre-insolvency stage, proceedings which leave the existing management in place and proceedings providing for a debt discharge of consumers and self-employed persons (COM 743, 2012).

According to COM 744, 2012 the European Union Member states should notify the hybrid proceedings which should be included under the new definition of the scope of the EU Insolvency Regulation. So the European Union Member states might refrain from this notification and might maintain the status quo and the current possibilities or tools in their national legislation will remain unchanged. In my point of view, this type of regulation is not convenient because in this way, the above-mentioned problems are not solved. For the European Union Members states there is no reason why they should limit their insolvency tools.

In my point of view, this sort of proposed regulation is not sufficient because it does not guarantee legal certainty to creditors and debtors. When the European Union Member states notify the proceeding under regulation it will be clear that the only possible connection to its jurisdiction is COMI. On the other hand, in case the European Union Member states retain their status quo, the situation will be unclear.

I think that the EU Insolvency Regulation should regulate all insolvency proceedings as hybrid as classical or only classical insolvency proceeding. If the European insolvency proceeding will regulate only classical insolvency proceeding, there should be a proposition regarding the directive or the regulation which will create a common framework for hybrid proceeding.

5. CONCLUSION

Based on the careful review of the EU Insolvency Regulation, the review of 743/2012 and the review of English judgments such as Vita Group [2010], COM Gallery Capital [2010], La Seda de Barcelona SA [2010], Tele Columbus GmbH [2010], Wind Hellas [2010], Metrovacesa SA [2011], Rodenstock GmbH [2011], Cortefiel SA [2012], Eircom [2012], Estro Group [2012], Global Investment House [2012], NEF Telecom B.V. [2012], PrimaCom [2012], Seat Pagine [2012], Vivacom [2012], Deutsche Annigton Immobilien [2013], Icopal as and others [2013], Magyar Telecom [2013], Orizonia [2013], Vietnam Shipbuilding Industry Groups [2013] it was concluded that it is quite easy to change insolvency status. The popular way of changing insolvency status is the claim for scheme of arrangement. The English court requires sufficient connection to England usually based on governing law of financial documents or COMI. Also, courts require the recognition of the scheme of arrangement in the foreign company's home jurisdiction. The English judgments also provide further confirmation of the practical usefulness and flexibility of schemes as a delivery mechanism for cross-border restructuring. In my point of view, debtors and creditors should have the right to choose their jurisdiction and change their insolvency status. On the one hand, the forum shopping

migration is criticized for its lack of certainty; on the other hand it offers the solution to debtor to take advantage of the insolvency law of another European Union Member state and the possibility of rehabilitation of failed business. Debtors may exercise the freedom of establishment to benefit from the host country's insolvency. Furthermore, the paper confirms the hypothesis that the regulation of pre-insolvency proceeding is needed. First, all insolvency proceeding is included into the EU Insolvency Regulation and second, a new legislative framework is created under the form of regulation or directive. In my point of view, the current proposal COM 743/2012 is not sufficient, because it depends on the European Union Member states whether they include the hybrid proceeding within scope of regulation or exclude it. Thus, it will be unclear for the proceedings which remain excluded from EU Insolvency Regulation. Mentioned the legal uncertainty surrounding cross-border aspect of pre-insolvency might still remain. The paper does not approach the economic impact of the proposed regulation on the EU and the member states, but this may constitute a suggestion for future research.

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