The challenge of diverse priority rules in European insolvency laws

Paul Omar discusses how disparity in priorities and the lack of harmonised rules can lead to different outcomes depending on the jurisdiction

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Introduction

Every domestic insolvency framework has a system of priorities governing the ranking of claims and distribution of assets. Needless to say, not every legal system evidences exactly the same priorities, although there are some priorities that regularly feature on the list in a prominent position, particularly those afforded employees, secured creditors and state bodies in respect of unpaid tax and social security contributions. The reason for differences in the ranking of claims may be partly historical and partly cultural, in that the protection of certain claims through priorities is deemed necessary or desirable in that jurisdiction. Increasingly, and in Europe especially, priorities may be determined by supra-national rules given effect within domestic legislation. However, the disparity in priorities and the lack of harmonised rules open up the possibility that the same creditors will be treated differently in different jurisdictions. Historically, there have also been the added problems of whether foreign creditors could participate in domestic proceedings on an equal footing and whether certain types of claims could be rejected or left without recognition because of public policy rules. For example, in the common law, the rule expressed in *Government of India v Taylor*[1] for a long time prevented the admission of foreign revenue debts.

Multiple proceedings

In the European Union, the enactment of the European Insolvency Regulation has required consideration of the position of priority rules within the context of allocating jurisdiction for opening proceedings and determining the applicable law. The basic principle in Article 4(2)(g)-(i) is that the rules governing the admission of claims, what these may consist of and the special position of debts arising after the institution of insolvency proceedings, as well as proof and verification of all these claims are all matters for the substantive law of the jurisdiction where proceedings are opened. Similarly, the same substantive law also governs the distribution of proceeds when assets are realised, the ranking of claims as well as the rights of creditors who have obtained partial satisfaction after insolvency proceedings are opened through the use of quasi-security.[2] These of course will constitute matters most of interest to creditors

in proceedings but must also be sited in the context of Article 3, which qualifies instances in which proceedings may be opened and allows for the possibility of multiple proceedings subject to the threshold test of an 'establishment' existing in the case of secondary or territorial proceedings. Article 28 then applies the law of the secondary jurisdiction to those proceedings. Of course, the possibility of multiple proceedings each governed by a separate priority rule is a natural consequence of this position, but is understandable when viewed against Preamble Recital no. 11, which states that it would be impractical to introduce a single insolvency proceeding with universal scope.

Viewed against this background, it must be signalled that the *pari passu* principle and equal treatment of creditors is nonetheless stressed in the European Insolvency Regulation as enjoying pre-eminence. Article 32(1) states clearly that all creditors, wherever domiciled in the European Union, have the right to assert their individual claims in any of the insolvency proceedings that may be pending in relation to their debtor. Article 39 reinforces this position by permitting all creditors situated in member states the right to lodge their claims in writing in any proceedings taking place elsewhere. Because no creditors are expressly excluded, these provisions may be of particular benefit to tax authorities and social insurance institutions, which may thus extend their reach across national boundaries, an important departure thus from the practice in some jurisdictions with regard to the recognition of foreign revenue laws. Article 40(1) cements the principle by requiring the liquidator in any proceedings to inform known creditors resident elsewhere within the European Union, while the facility for publishing notice of the existence of proceedings under Article 21(1) will also inform creditors of the need to exercise their rights. In practice, despite these notice requirements, perhaps only diligent creditors will be able to take advantage of these provisions and there may well be a cost-element prohibiting smaller creditors from participating in more than one set of (local) proceedings. Nonetheless, the *pari passu* principle is an important one and its inclusion in the European Insolvency Regulation is amply justified in Preamble Recital no. 21.

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Equal treatment

The possibility of multiple claims, however, does not necessarily mean that the diligent are rewarded any more than other creditors. In order to ensure the equal treatment of creditors, there is an attempt to co-ordinate the overall distribution of proceeds by requiring creditors to account for dividends received in other proceedings. Under this arrangement, Article 20(2), also called the ‘imputation’ or ‘hotchpotch’ rule,[3] 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. Furthermore, the liquidator may also require under Article 20(1) a creditor to repay into a central fund any sum obtained as a result of enforcement measures in another country, subject to any rights *in rem* and clauses reserving title. The preservation of overall parity where multiple proceedings are opened is effected by Article 32(2), which permits liquidators to resubmit claims they have received in other proceedings, subject to the interests of other creditors being maintained. Creditors, in any event, retain the right to object to the admission of the claim, and the claimant itself is able to withdraw the application. The availability of funds from one set of proceedings for satisfaction of creditors elsewhere in also a possibility under the European Insolvency Regulation, where the transfer of surpluses from secondary proceedings for the benefit of creditors in main proceedings is provided for in Article 35, the converse apparently not being possible.

The problem, however, arises, where the diligent or astute creditor, taking advantage of the disparity in priority rules, seizes the opportunity to which they are entitled to submit their claim in another jurisdiction, where their claim would be given a higher priority and stand a better chance of being the subject of a distribution. With the type of ‘cross-priority’ provided through

the framework in the European Insolvency Regulation, the creditor could ‘promote’ themselves because the priority rule in that jurisdiction would apply to their ‘foreign’ claim just as it would to a ‘local’ claim. It is unlikely the converse would apply and a creditor choose to apply to a jurisdiction where their priority is ‘demoted’, unless substantial assets existed there that were likely to result in distributions further down the ‘food chain’. Even allowing for the imputation rule, it would be cost-effective for any creditor in the position of being able to ‘promote’ itself to do so where the likelihood of a distribution in its home jurisdiction is low. Paradoxically, this might confer an advantage on state creditors in those jurisdictions that have removed the preferential status accorded to these debts, for example Denmark, the United Kingdom and Spain (as to half of the debt), but it would also stand to benefit many other creditors. Under this system, the chances of the imputation rule applying to the distribution received in proceedings where the creditor is favoured is lessened, although not wholly avoided. The absence of a ‘consolidated proportion survey’, put forward in proposals at the early stages of the drafting of what eventually became the European Insolvency Regulation, which might have imposed a requirement for courts to ensure a tally of distributions in parallel proceedings is kept, adds to the possibility that the shrewd creditor might avoid an account altogether unless the liquidators in multiple proceedings make use of the co-operation and communications provisions in the text to keep a tally of overall distributions.

Judicial intervention

There is, however, a further problem. The possibility that disparate priority rules lead to the unequal treatment of creditors may well invite judicial intervention and the application of the Article 26 rule, which constitutes the public policy exception to the automatic recognition and enforcement provisions of the European Insolvency Regulation. In fact, in *Re: MG Rover España SA and others*,[5] the possibility that recognition of main proceedings would fall foul of Article 26, leading to the (inevitable) opening of separate secondary proceedings and the possible loss of synergy for co-ordinated rescue to take place, was accepted as good grounds to empower the administrators to

carry out a distribution (should they so choose) that took account of the special position of employees in the other jurisdictions involved. The same Article 26 has also been cited in the context of proceedings, albeit involving an Australian insurance company,[6] where Mr Justice Richards held (*obiter*) that, in his view, the European Insolvency Regulation does not oblige the liquidator in secondary proceedings to comply with the Article 35 requirement to transfer funds where the priority rules on distribution would be so different as to trigger a possible offence to a court's view of the *pari passu* principle.

Co-ordinated approach

In this light, the case for a co-ordinated approach to priority seems very strong. Given the advances that have been made in the context of resolving jurisdictional problems in insolvency, this appears a logical next step to take. However, when the history of contention behind efforts to achieve procedural harmonisation is viewed, an instrument harmonising substantive rules in insolvency like these has seemed thus far only a remote (and unattainable) possibility. Nonetheless, current moves are afoot to consider whether, in light of the experience with the European Insolvency Regulation and the competition it has indirectly created between legal systems, there are substantive issues that could usefully be harmonised. A recent report by INSOL Europe, presented to the European Parliament's Committee on Legal Affairs, has made the case that the diversity of priority rules may encourage forum-shopping and 'bankruptcy tourism', thus impeding successful re-organisations.[7] Although stopping short of advocating harmonisation, perhaps because of the public policy behind the formulation of many priority regimes, the report does at least urge serious consideration to the issue. It remains to be seen whether the recommendations will be taken up.

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Footnotes

1. [1955] AC 491.
2. The same principle is reflected in Article 9(f)-(h), Directive 2001/17/EC of 19 March 2001 (OJ 2001 L110/28) and Article 10(f)-(h), Directive 2001/24/EC of 4 April 2001 (OJ 2001 L125/15).
3. The same principle is reflected in Article 32, UNCITRAL Model Law on Cross-Border Insolvency 1997.
4. For a discussion of 'cross-priority', see Professor Jay Westbrook, 'Universal Priorities' (1998) 33 Texas International Law Journal 27.
5. Decision of Norris J (11 May 2005), Chancery Division, High Court (Birmingham District Registry), reported by E. Springford in (2005) 21 Insolvency Law and Practice 91.
6. *Re: HIH Casualty and General Insurance Limited and Others* [2005] EWHC 2125 (Ch).
7. Harmonisation of Insolvency Law at EU Level (April 2010), 14-15.