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IMPACT OF BREXIT ON APPLICABLE LAW IN CROSS-BORDER INSOLVENCIES

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Legal Briefings

From 31 December 2020, the European Regulation on Insolvency Proceedings (the "**EIR**") ceased to apply in the UK. As a result:

- The EIR provides the rules for when the law of the place in which the insolvency proceedings have been opened can be supplanted by another law, but only that of a member state.
- The UK is no longer a member state and English law will no longer be applied under these rules.
- This will have a significant impact on English and EU businesses, particularly for creditors of debtors in EU states where the debts arise under English law agreements.

This briefing follows on from our **note** regarding the consequences for both insolvency proceedings in the EU requiring co-operation from the English courts and English insolvency and restructuring proceedings requiring co-operation in the EU jurisdictions.

DEFAULT RULE

Under the EIR, the law applicable to an insolvency proceeding in an EU state is the national law of that state. The national law therefore governs the opening of the proceedings, their conduct and their closure.

The EIR lists, non-exhaustively, certain matters which fall to be determined by the relevant national law. These include questions regarding the assets which form part of the insolvency estate and the powers of the debtor and the insolvency officeholder. They also include the effect of the insolvency proceedings on:

- the debtor's contracts;
- proceedings against the debtor commenced by individual creditors;
- the treatment of post-insolvency claims; and
- the avoidance of pre-insolvency transactions.

This general rule is subject to specific exceptions, where the EIR provides that the national law must give way to the law of another EU state. We examine certain of these exceptions and the changes in their operation below.

PRE-INSOLVENCY TRANSACTIONS

Under the EIR, the national law of the place in which insolvency proceedings have been opened will apply to avoidance claims in respect of pre-insolvency transactions which were entered into to the detriment of all creditors. As a result, the national law will determine whether pre-insolvency transactions are void, voidable or unenforceable.

However, under the EIR, it is open to the beneficiary of the transaction to argue that (1) the relevant transaction is subject to the law of another EU member state and (2) the law of that other state does not allow for the transaction to be challenged. In relation to the second limb, the European courts have held that it is unnecessary to show that there are no means in the law of the other state to challenge a transaction of the type in question. All that needs to be shown is that, under the law of the other state, any challenge would fail (e.g. because a defence was available to the beneficiary of the transaction).

Transaction avoidance regimes vary considerably by jurisdiction. In England, the regime tends to favour creditors and counterparties of the debtor. For example, the lookback period for claims relating to preferences and transactions at an undervalue entered into by the debtor with an unconnected party is relatively short and the matters which must be proved in order to set aside a transaction create a relatively high hurdle.

In other jurisdictions, regimes are more debtor-friendly. The conditions to be satisfied for a transaction avoidance claim may be much less stringent, with longer look back periods, no requirement to demonstrate any particular motive or desire on the part of the debtor to benefit a particular creditor or counterparty and/or no need to demonstrate that the transaction meant that the debtor was unable to pay its debts. While beneficial for the debtor, these rules create uncertainty for creditors and counterparties – in some cases, money which they have received from the debtor in the ordinary course of business is at risk of being clawed back.

The EIR provided a safe harbour in certain circumstances. As an example, the financial indebtedness of many companies in the EU is governed by English law. Take an Italian company that has entered into English law finance documents. The Italian company makes principal and interest payments until it becomes insolvent, entering insolvency proceedings in Italy. The default rule under the EIR is that Italian law would govern whether the principal and interest payments can be unwound on the grounds that they constitute a transaction entered into to the detriment of all creditors. The relevant Italian laws may be sufficiently broad that they can, in certain cases, capture ordinary course of business payments towards financial indebtedness. Financial creditors would therefore be exposed to the risk of payments they had received being clawed back by the Italian debtor. However, the financial creditors could argue that the payments were subject to English law and that, under English law, the payment could not be clawed back because an analogous English law claim would not succeed. If that argument was successful, the transaction could not be avoided under Italian law.

Now, though, the safe harbour for English law transactions has been lost or diluted. The EIR provides for the disapplication of the law of the insolvency proceedings only where the relevant transaction is subject to the law of another EU state. The UK is no longer a member state. In our example above, the financial creditors could no longer rely on the EIR to argue that payments could not be challenged as a matter of English law. The ability of the financial creditors to rely on the application of English law would now depend on the national law of Italy, not the EIR.

DETERMINATION OF ENGLISH COURTS ON MATTERS OF EUROPEAN INSOLVENCIES

The EIR did not just provide circumstances in which English law might be applied by the courts of another European state in which insolvency proceedings had been opened. It also provided certainty as to the application of English law to insolvency proceedings opened in England, whether the debtor was incorporated in England or not.

Though aspects of the EIR relating to jurisdiction have been transposed into English law, with amendments, the governing law aspects have not. For English insolvency proceedings, therefore, new questions may arise as to whether English law mandates the application of a foreign law to a particular question arising in the insolvency where the EIR would previously have mandated the application of English law.

RIGHTS *IN REM*

Under the EIR, the opening of insolvency proceedings does not affect the property rights of creditors or third parties where the assets of a debtor are situated within another EU state. This includes property rights permitting the disposal of those assets, such as via a mortgage. However, since the UK is no longer an EU state, rights in relation to assets found in England may no longer receive the same protection because it will be a question of national law of the insolvency proceedings whether to apply English law to determine the extent and effect of property rights over these assets.

Picking up our example again, imagine that the Italian company's business involves property development in London. It has granted security over its real estate in favour of the financial creditors. When the debtor enters Italian insolvency proceedings, the Italian court is no longer required by the EIR to apply English law to determine the effect of the opening of the Italian insolvency proceeding on the financial creditors' property law rights over London real estate. Will the Italian insolvency court apply English law to determine the extent of the financial creditors' proprietary rights (e.g. on the correct interpretation of the security document) and the impact of insolvency on those proprietary rights? That is now a question for Italian national law, not the EIR. If the Italian court applies solely Italian law and renders a judgment which purports to undermine the financial creditors' proprietary rights, will an English court recognise the Italian judgment or its purported effect on English law rights in respect of English land? That appears unlikely. What if the Italian court issues a judgment which purports to prevent the financial creditors' security being enforced but they enforce anyway, relying on their English law rights and taking the view that these cannot be affected by the Italian court? Could such a financial creditor be subject to sanction in Italy regarding compliance with the Italian court order? The uncertainty surrounding the answers to these questions could lead to additional costs for the financial creditors and delay enforcement.

OTHER EXCEPTIONS

Reservation of title – The opening of insolvency proceedings in an EU state does not affect seller's rights based on a reservation of title where the asset is situated within another EU state. English sellers will no longer benefit from this protection. Now, the insolvency court in the EU state may not apply English law in determining whether the opening of insolvency proceedings affects the seller's reservation of title rights in relation to assets situated in England.

Contracts related to immoveable property – The effects of the opening of insolvency proceedings on a contract conferring the right to acquire or use immoveable property (e.g. real estate) is governed solely by the law of the EU state in which the property is situated, although in certain circumstances the court in which insolvency proceedings had been opened could vary the contract. Acquirers or users of immoveable property situated may now be exposed to a greater degree of uncertainty that English law will be applied to English situated immoveable property by an insolvency court in an EU state. As with rights *in rem*, the uncertainty may make little difference in practice if the counterparty is able to pursue its English law rights in the English courts.

Miscellaneous – There are similar special rules for contracts of employment, payment systems, financial markets and publicly registered property (e.g. patents and ships). The ability of an EU insolvency law to govern the effect of the insolvency proceeding on English law contracts of employment, in particular, has potentially far-reaching effects.

PENDING PROCEEDINGS

Under the EIR, the effect of the commencement of insolvency proceedings on a pending lawsuit or arbitral proceeding shall be governed by the law of the EU state in which the lawsuit is pending or the tribunal has its seat, not the national law of the state in which the insolvency proceedings have been opened. This differs from proceedings which have not yet been commenced, where the law of the insolvency proceedings would continue to apply by default.

Therefore, prior to the end of the transition period and returning to our example above, if insolvency proceedings were commenced in Italy in relation to the debtor but the financial creditors had already commenced litigation in England, English law would apply to the question of whether to stay the English proceedings. If the English court determined as a matter of English law that the English litigation should continue, then there was little that the debtor could do about it. The result may, however, still be felt later in the proceedings – if the financial creditors succeeded in obtaining judgment in England, they may well be unable to recover under it other than by participating in the Italian insolvency process.

However, after the end of the transition period, the position is less clear. The Italian insolvency practitioner could seek recognition of the insolvency proceedings under the UNCITRAL Model Law (which the UK has adopted) which, if granted, would lead to the same stay of proceedings as if the Italian debtor had been wound up in England. What if the insolvency practitioner chooses not to seek recognition? Will the financial creditors be at risk of breaching Italian law, with consequences in Italy, if they continue proceedings in England notwithstanding that Italian law provides for a moratorium?

WHAT PRACTICAL DIFFERENCE WILL THESE CHANGES MAKE?

It is too early to say and much will depend on the attitude of courts in individual EU states.

However, it is already clear that these changes will lead to a greater degree of uncertainty for creditors or counterparties seeking to benefit from the specific protections which were previously afforded to English law rights or rights in respect of assets situated in England, particularly when those protections were relied on in the courts of other EU states. The probability of inconsistent judgments or decisions in different courts is also increased.

Ultimately, these changes may encourage forum shopping. English law creditors who have some degree of control over the place in which insolvency proceedings are opened may well favour an EU state whose national law will protect those English law rights.

If you have any questions, or would like to discuss how these changes are likely to affect you, please phone or email our key contacts below.

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If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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