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Insolvency: Bankruptcy blunder



The EC's Insolvency Regulation requires judges to decide where a company's main interests lie and, as a result, under which jurisdiction's laws proceedings should be conducted — but this has led to inconsistent results, writes *Chris Mallon*

In years to come, we may well look back on the introduction in May 2002 of the European Commission (EC) Insolvency Regulation as one of the great legislative blunders of all time. The concept is fine; an insolvency regime that will provide a set of rules for the uniform application of insolvency laws across the European Union (EU). The fundamental problem, however, is that it requires judges to go against centuries of deference to corporate form over corporate substance. The EC regulation now requires judges to decide where a company's 'centre of main interests' (COMI) is situated and to apply the laws of that jurisdiction in an insolvency, rather than simply looking to the laws of the country of incorporation. In a perfect world, the EC regulation would work fine. In a world where high-minded directors, lawyers, judges and creditors would sacrifice any vestige of self-interest and defer to the courts and insolvency laws of another jurisdiction without question, the EC regulation would be a great success. Four years of application of the EC regulation have not borne out that ideal.



The EC regulation has, therefore, brought about a fundamental change in the ground rules for determining the applicable insolvency forum in any particular case. Those changes have resulted in uncertainty and the effect might ultimately be to change the way in which companies transact business. This is because it is likely to impact all aspects of tax planning and financing of group companies as lenders start to understand and price in the risks associated with these developments.

Under the old rules, financiers and other creditors could expect that if a company failed it would be subject to the insolvency rules applying in the country in which the company was incorporated. Not so now. The new rules enable a foreign court to look behind the facade of incorporation and decide for itself in which jurisdiction an insolvency should take place. Identifying an entity's COMI is a moveable feast. Almost identical criteria are now also to be used by courts in this country when considering the extent to which insolvency office-holders outside the EU should be recognised in the UK as a result of the implementation of the UNCITRAL model law provisions on cross-border insolvency. The same uncertainty is mirrored in those jurisdictions worldwide which have also enacted the model law.

The uncertainty and potential for dispute and delay inherent in the new rules was readily apparent in the recent high-profile case of Eurofood

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IFSC. Creditors there precipitated a race to the courts by placing Eurofood into provisional liquidation in Ireland (the country of incorporation) which resulted in its shareholder (Parmalat) placing the company into extraordinary administration in Italy. Confusion as to the interpretation of the EC regulation resulted in a referral by the Irish Supreme Court to the European Court of Justices (ECJ).

The observations of the ECJ in Eurofood have, however, provided only limited general guidance as to the approach to identifying where and how main proceedings can commence and how to identify COMI. Until the ECJ decision, most of the decided cases (mainly from the English High Court) had supported the idea that the COMI of a company could and should be equated with where the head office function for that company was located. This had the consequence (unintended by the drafters of the EC regulation) of allowing groups of companies (wherever incorporated) to be subjected to the insolvency regime applicable to that head office. The ECJ did hold that the presumption that COMI corresponds to the place of the registered office can be rebutted in the case of a 'letter-box company', where no business is conducted in the country of incorporation, but gave little further specific guidance to indicate other circumstances in which the registered office presumption might be rebutted. In particular, the ECJ made no observations specifically addressing the head-office functions approach which had been endorsed in the prior decision of the Advocate Generale in Eurofood.

Another important example of the uncertainty inherent in the introduction of both the EC regulation and the UNCITRAL model law is the recent decision the US Bankruptcy Court of the Southern District of New York in SPhinX. In that case, the court was faced with an application by joint liquidators of certain Cayman Islands-registered hedge funds appointed by the Cayman court ('the SPhinX Funds') for recognition as foreign representatives under Chapter 15 of the US Bankruptcy Code. The joint liquidators argued that the centre of main interests of the SPhinX Funds was in Cayman, so that those proceedings should be recognised as main proceedings. (Chapter 15 of the US Bankruptcy Code implements the UNCITRAL model law on cross-border insolvency into Federal Bankruptcy Law.) The recognition application was opposed by interested third parties, and hence was scrutinised carefully by the court. This was also the first time that there had been a contested hearing on a chapter 15 application for recognition.

For those lamenting the lack of a specific provision for dealing with groups of companies in the UNCITRAL text, as well as in the EC regulation, the decision in SPhinX will be welcomed as implicit support was provided for a head-office functions test. The US Bankruptcy Court in SPhinX quoted with approval from the House Report and which noted that 'the presumption that the place of registered office is also the centre of main interests' is included for speed and convenience of proof where there is no serious controversy.'

Judge Drain identified a number of factors which, singly or combined, were likely in most cases to be relevant in determining COMI and the listed factors included the following: the location of the debtors' headquarters; the location of those who manage the company; the location of the debtor's primary assets and the location of the debtor's primary assets. These factors were to be applied flexibly. Importantly, Judge Drain also stated that had the Cayman court made a finding as to the COMI of the SPhinX Funds, he would not have been bound by that finding.

The result of the hearing was that the judge recognised the Cayman Islands liquidators as foreign representatives in non-main proceedings, despite the fact that they had been appointed by the court in the country of incorporation of the companies involved. In arriving at this decision he



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identified key objective factors which pointed to the SPhinX Funds' COMI as being outside the Cayman Islands. These included the fact that no investment business was conducted in the Cayman Islands (and indeed had such business been transacted there, the companies would have lost their specially exempted status which brought favourable tax benefits). The only transactions taking place on the islands were those required for regulatory or compliance purposes. There were no employees, managers or directors in the Cayman Islands and no board meetings took place there. Most of the companies' creditors were outside the Cayman Islands and almost all of their assets were in the US. The judge was also influenced, if further persuasion were necessary, by the fact that the application for recognition as a foreign main proceeding was clearly tactical. Had the application been granted this would have brought into effect an automatic stay on litigation proceedings in the US. It was clear that the whole purpose of the application in SPhinX was to frustrate a settlement of substantial litigation by obtaining the stay of a pending appeal concerning the settlement. This strategy tainted the request for recognition and gave the appearance of improper forum shopping.

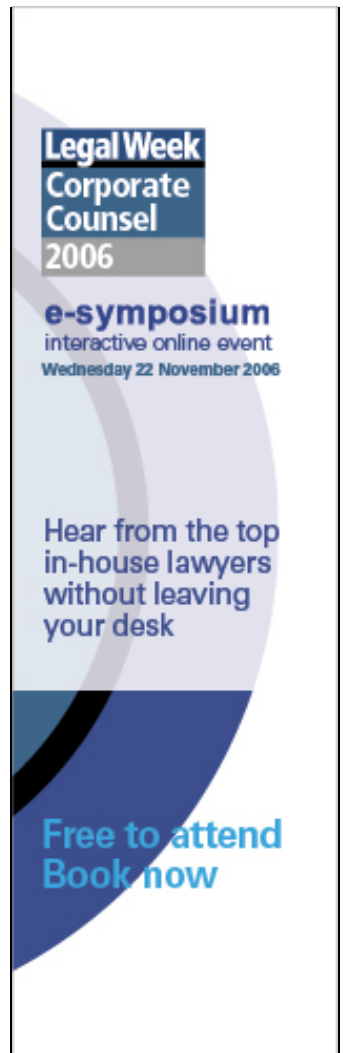
The judge's approach to determining COMI was notable for its pragmatism and its emphasis on achieving the best commercial outcome for stake-holders. He commented that it was reasonable to assume that the debtor and its creditors can, absent an improper purpose, best determine how to maximise the efficiency of a liquidation or reorganisation and ultimately the value of the debtor. The downside with this flexibility of approach is that it makes credit-risk assessment for financiers and other creditors very difficult, given the lack of certainty in its application. The approach in SPhinX, although correct, is likely to provide a green light to sophisticated debtors and creditors to forum shop with ever increasing regularity.

We shall have to wait and see if my pessimism as to the impact of the EC regulation and the model law are borne out. I am not confident that it will not be.

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