Asset security and the insolvency connection: Time to harmonise?

Paul Omar discusses the further benefits of harmonisation of insolvency laws across Europe

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The role of asset security in the funding of business is essential where debt finance is one of the few options for businesses intending to expand.

While creditors would prefer, obviously, to have the sums lent repaid, the availability of a "Plan B" that palliates the risks of non-performance or insolvency, in theory also reducing the cost of access to credit, has long been attractive for lenders. For that reason, the mediaeval strictures of the *pari passu* principle have been avoided, almost from the outset, for creditors, consensual security being one of the avenues recognised at law for the mitigation of the doctrine, the other usually being preferences, the latter normally of statutory origin or creation.[1] The importance attached to security as a tool for the support of lending, especially for developing countries, is seen in its reflection in key international texts, such as the World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes.[2] In the World Bank's view, the creditor's ability to bargain for the transfer of security rights enabling enforcement over the debtor's property is the "simplest [and] most effective means" of ensuring the principle of prompt payment. It is certainly more effective, they say, than would be the prospect of insolvency proceedings with attendant procedural complexity and delays.[3]

The desire to enable direct enforcement by the creditor may explain the popularity at common law, historically, of institutions like receivership, granting direct access to the debtor's property (and later the entirety of their business), as a method for circumventing recourse to more formal (and usually collective) proceedings. It might also explain the concern, even within formal proceedings, with preserving the creditor's rights by segregating or exempting secured assets, as many systems in fact do, thus creating two pools of assets, which may be termed "general" and "encumbered", the latter being normally only available to the creditor in whose favour the security has been created. In an environment where liquidation is the norm, such separate pools cause few problems, although rules need to be made for what happens if assets in the "encumbered" pool are insufficient to meet the value of the security: will the creditor be able to claim against assets in the "general" pool and on what basis, i.e. is the secured status preserved? Different systems answer these problems in slightly different ways. Where rescue procedures are available, segregating assets may be inefficient and counter-productive in the case of a sale of the business as a going concern and many systems, but not all, favour a form of reintegration of the otherwise segregated assets, subject to continued respect for the creditor's priority.

Recognising this difference in treatment has meant, as the phenomenon of cross-border insolvencies has grown, dealing with the issue of what happens to security interests at international level. The European Insolvency Regulation ("EIR"), first adopted in 2000, chose to deal with the problem by a reference back to a relevant domestic law. In Article 5 (and Articles 6 and 7 on quasi-security), the rule was expressed as being that the law of the location of the assets over which an *in rem* right could be exercised should govern the outcome of the bargain.[4] Thus, while Article 4 identified the *lex concursus*, it was entirely possible that Article 5 invited the application of a different law. The EIR did not, however, delineate in precise terms the articulation between the provisions, particularly whether Article 4's governance of issues such as the composition of the estate, the opening and closure of proceedings and effect on third-party rights etc. had a potential bearing on the exercise of rights governed by a different law, never mind the thorny question of transactional avoidance. There is certainly potential for conflict, although the limited amount of case-law, including references to the European Court of Justice, suggests that the problem was largely side-stepped by pragmatic treatment of (and perhaps deference to) secured creditors, whose consent was usually needed for most rescue procedures to stand a chance of success. As such, the position in the Recast EIR, adopted in 2015, and its Articles 8-10, replicating the previous regime, is perfectly explicable by an unwillingness to undermine the position of secured creditors. There, the position stands for now.[5]

What are the options?

Going forward, however, what could be the options available? Classically, there seem to be two: a harmonisation of the concept (and types) of security and/or a

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harmonisation of the treatment of security in private international law. In relation to the first, although most Western European legal systems boast an inheritance from Roman law and its insistence on classifying security into real and personal, also incidentally determining whether the security constituted a real right to the property or simply a privileged claim, the gulf in modern days between the civil law and common-law perspectives seems too wide to bridge. In the way the latter has moved to the creation of an intermediate class of interests (based on equitable principles) and the availability of security over classes or collections of assets, the differences are palpable.[6] Furthermore, the prohibition of European Union competence in the matter of real property,[7] on which real security rests, could pose an obstacle to the holistic treatment of all forms of security for the purposes of any harmonisation. An alternative way of dealing with this difficulty might be to explore how the personal property security interest framework, a development originating in North America, could have application, given it has been adopted by some mixed legal systems, such as Jersey.[8] However, this might be a step too far for jurisdictions in which lending practices have revolved around the availability of certain models of security, while the transition to new models might be, arguably, costly in terms of altering not just contract clauses, but also behaviour and expectations.

In relation to the harmonisation of private international law rules, the argument might be made that the EIR framework, in both its versions, already constitutes an attempt at dealing with the issue by identifying the law that applies. In that light, it appears no different to the other instruments in the private international law arena adopted by the European Union, including the Rome I and Brussels I Regulations.[9] However, as noted above, the uncertain articulation between the *lex concursus* and the law applicable to security is a less than perfect situation and leaves unresolved a considerable number of issues that have yet to be fleshed out by the jurisprudence. In the context of the *Ius Commune* project, which has sought to identify common principles for the harmonisation of European private law, the question has also been asked as to whether private international law should be harmonised.[10] There, unfortunately, the question has remained, with no great positive answer forthcoming, apart from the discrete developments already mentioned. It seems unlikely that there will be a major initiative taken here without further work on harmonisation of the underlying private law concepts.

In any event, the debate over harmonisation and its desirability may be ceding ground to a different approach, that seen in the Financial Collateral Directive,[11] which seeks to immunise financial collateral from the consequences of the application of domestic insolvency law rules. As such, this approach, which is the norm for arrangements in favour of regulated lenders, may well come to influence the lending dynamic entirely, including influencing the terms of contracts for lending and the treatment of collateral in all other situations. This would incidentally remove the need for consideration for underlying harmonisation, given that such arrangements, whether involving financial collateral or not, would effectively lead to the segregation of such assets from insolvency. This still leaves the question of asset integration open, particularly where this may constitute the *sine qua non* for rescue and which would otherwise lead to tying indissolubly the fate of rescue to the views of the secured lender. Whether this is in all circumstances desirable remains an open question. ■

THE UNCERTAIN ARTICULATION BETWEEN THE LEX CONCURSUS AND THE LAW APPLICABLE TO SECURITY IS A LESS THAN PERFECT SITUATION

Footnotes:

1 This article is based on a conference paper delivered at the University of Santiago da Compostela, Spain on 15 April 2016.
2 See the 8 Principles in Part A of the text (2015 Revision).
3 Executive Summary, World Bank Principles, at 5.
4 For Article 6, the rule was slightly differently worded, being "the law applicable to the claim", since set-off is usually only available in the case of mutual claims (a species of choses in action).
5 There have been, however, two reviews by different consortia of Universities, both led by the Leeds Law School and funded by the European Commission, into (i) the issues surrounding Article 5 and its application and (ii) transactional avoidance. The outcome of the recommendations, as well as any timeframe for reforms, is not yet known.
6 Curiously, the Mauritian Civil Code manages to accommodate both classic civil law forms of security and, in Book III, Title XVIII, Chapter X, *sûretés flottantes* (floating security, i.e. the floating charge).
7 Article 345, TFEU (Old Article 295, EC Treaty).
8 In the Security Interests (Jersey) Law 2012.
9 Regulation (EC) 593/2008 and Regulation (EC) 44/2001 respectively.
10 A. Fiorini, "The Codification of Private International Law in Europe: Could the Community Learn from the Experience of Mixed Jurisdictions?" (2008) 12(1) *Electronic Journal of Comparative Law*.
11 Directive 2002/47/EC.