MODIFIED UNIVERSALISM AND THIRD-STATES INSOLVENCY PROCEEDINGS*

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The article raises the problem of coordinating insolvency proceedings between the EU and third-states in the case of opening insolvency proceedings outside the Union. The author analyzed possible ways to resolve the problem.

Keywords: cross border insolvency, bankruptcy, procedural relationship, international civil procedure

Introduction

Regulation of insolvency proceedings will always be subject to criticism and improvement. Existing *Recast European Insolvency Regulation* (Regulation 2015/848, hereinafter Regulation, 'EIR') provides modified universalism that covers all the debtor's assets located on the territory of different states. This manifests the main characteristic of universalism - extraterritoriality. The problem, however, is that a debtor with a center of main interests ('COMI') or another home country in the European Union may also have assets outside the EU. Similarly, the center of main interests may be outside the EU, with a significant proportion of assets distributed in EU Member States. The challenge is to develop a regulatory model that ensures a fair and equitable distribution of the insolvent debtor's assets among creditors.

1. Methodological background of the article

Regulation of cross border insolvencies historically was complicated by struggle for sovereignty between states – recognition and coordination of foreign bankruptcies with national proceedings was seen as a decrease of internal and external sovereignty (Sgard 2010, 40–59). Therefore, the oldest approach for regulation of insolvency proceedings is territoriality.

The doctrine of territoriality constitutes extension local court's competence in order to grab local assets that belong to the debtor (Bebchuk & Guzman 1999, 777–778). Classic approach doesn't entail cording of parallel proceeding in several states. Territoriality is used to protect national creditors' interest and interest of state itself (if a state is a party of insolvency proceeding represented by competent authority, e.g. tax service). In the absence of coordination of different proceeding and lack of information about the debtor's assets creditors are forced to pursuit debtor's assets all over the world. Another problem of territoriality is double counting in two or more states.

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Absence of legal certainty and high transactional costs led to creation of controversial doctrine – universality. Unlike territoriality, the notion of universalism stands on the point of one proceeding and one court that has jurisdiction on all the debtor's assets wherever they are located. This approach was described as „*one law, one court*" (Tung 2001, 10). The basis of universality doctrine is extraterritoriality, i.e. other states where the debtor's assets are located shall recognize the main court's competence (1) to open insolvency proceeding, (2) to rule against property located in another state (Trautman, Westbrook & Emmanuel 1993, 575). Obviously, such idea is accomplishable due to the unwillingness of states to honor foreign court's orders.

Due to the abovementioned reasons classic approaches of these doctrines were improved. Thus, the doctrines of modified universality and modified territoriality were presented. Modified territorialism is founded on the notion of cooperation among courts that handle insolvency cases (Kilborn, Markell & Wessels 2009, 62). According to the notion proposed by *LoPucki,* cooperation may occur in the following cases:

1. Commencing insolvency proceedings in multiple jurisdictions at one time. For instance, creditors could opt for an insolvency procedure that is valid in all jurisdictions;
2. Uniform rules on the satisfaction of creditors' claims to avoid double satisfaction of the claims of the same creditors;
3. Joint sale of assets may result in a greater profit than selling them separately or when the value of the asset does not exceed the costs that would be incurred if sold separately;
4. Creditors whose claims are included in the register of another insolvency case may voluntarily finance the debtor's financial rehabilitation procedure;
5. Establishing a process to restore assets that were involved in disputed transactions to the bankrupt estate (recognizing court assets as invalid due to bankruptcy-related transactions).

Modified universality took from classic universality the notion of extraterritoriality, but unlike in the classic approach, modified universality entails opening secondary proceedings in other states. Great example here is the existing *Regulation*. While one court has a jurisdiction to open the main insolvency proceeding, foreign courts also have a right to open secondary proceedings.

2. Cross-border insolvency regulation in cases where the COMI is located within the borders of the EU

The resolution of cross-border insolvency issues is evidently both a legal and political affair. As such, the outcome of such cases relies considerably on the political standpoint of the involved states (Mucciarelli 2013, 175–200). The Regulation does not provide clear boundaries for its application. However, it is possible to determine them by means of a teleological interpretation. The Court of Justice of the European Union (hereinafter 'CJEU') has acknowledged the potential of employing this method of interpretation to this Regulation (judgement in case C-1/04 *Staubitz-Schreiber*). Thus, paragraph 88 of the preamble to the Regulation limits its applicability to within the borders of the European Union, excluding Denmark. As a result, foreign bankruptcies that occur outside the European Union cannot be governed by the Regulation.

This viewpoint is shared by scholars including *Pannen* (Pannen 2007, 46), *Virgos* and *Garcimartin* (Virgos & Garcimartin 2004, 14) and *Wessels,* who expressed some doubts (Wessels 2015, para. 10511). This perspective is understandable as it is based on recital 25 of the EIR, which clearly states that the Regulation solely applies when the debtor's primary center of interests is in the European Union. As a result, if the debtor's primary center of interests is situated outside the European Union, the Regulation is not applicable. The CJEU held that these legal relationships could be governed by the Regulation, based on its previous position that transactional disputes were covered by the Regulation (C-339/07 *Seagon*; C-382/12 *P MasterCard and Others v Commission*). Accordingly, the CJEU concluded that the courts of the Federal Republic of Germany, where the debtor had its residence during the dispute, rather than Switzerland, had jurisdiction to hear the case regarding the invalidation of the debtor's transaction.

The High Court of England and Wales expressed a similar opinion in the *BRAC Rent-A-Car International Inc* case ([2003] EWHC (Ch) 128.) Despite the debtor being registered in Delaware, the court determined that the English courts held jurisdiction to appoint an administrator for managing the debtor's assets. This decision was based on the existence of a center of main interests in the UK as well as the debtor's strong commercial ties to the UK. If the center of the debtor's main interests were located, for instance, in France instead of the UK, the English court would not have the entitlement to initiate insolvency proceedings based on a strong connection with the UK jurisdiction (*International Westminster Bank plc v Okeanos Maritime Corp* [1987] BCLC 450).

A court of a Member State in the European Union has jurisdiction over a debtor's insolvency if their center of main interests is in the EU. The debtor's place of residence, whether in or outside of the EU, is irrelevant (judgement in case C-328/12 *Schmid*). Regarding the enforcement of bankruptcy proceedings in a third state, the CJEU recommends employing bilateral agreements between a European Union member state and the third state where the debtor or their assets are located. Nonetheless, *Bork* argues that such a measure would not lead to the application of the Regulation to a bankruptcy case in a third state (Bork & Mangano 2016, 73).

3. Regulation of cross border insolvency in cases where the COMI is located outside of the EU

With economic relations developing and individual citizens gaining wealth, it is necessary to address a situation that differs from the one previously examined. For instance, an individual or entity may possess assets within the European Union but have their residence or primary interests elsewhere.

Since the EIR does not provide regulations for such cases, Member States of the European Union apply their national laws. For example, in the case of cross-border insolvency, *Hungary* applies its Statute on Private International Law (Act XXVIII of 2017 on Private International Law), as it has not implemented the UNCITRAL Model Law. Nevertheless, Hungary has not joined any international agreements that regulate cross-border insolvency. Recognition and enforcement of foreign judgements, including those in insolvency proceedings, may be possible based on the principle of comity.

In our view, this characteristic is also evident in the *Russian legal system*. Consequently, when examining requests for the recognition of foreign bankruptcies, Russian arbitration courts ground their judgements on the principle of international reciprocity (Judgement Moscow commercial court of 07.12.2018 case №A40-39791/2018; Judgement Saint-Peterburg commercial court of 28.05.2008 case №A56-22667/2007; Judgement Commercial of Sverdlovskaya region of 14.07.2019 case №A60-29115/2019). The aforementioned judgements by Russian arbitration courts can be regarded as an effort to fill the gap in legal regulation. It is difficult to disagree with *Yarkov*, who suggests that Russian judicial practice exceeds the progress of positive law (Yarkov 2023, 52–64).

This situation lacks legal certainty as the outcome of bankruptcy recognition determines the dependency of the debtor's national and foreign creditors. Additionally, it is feasible for a citizen of a third state, for instance, to possess assets in every European Union Member State. Pursuant to the existing regulation's reasoning, an appropriate measure would be starting insolvency proceedings in each Member State where the debtor has assets. Consequently, this regulation results in a move from modified universalism, as established in the Regulation, towards classical territorialism.

Cooperation between territorial insolvency authorities is possible. However, the likelihood of such cooperation is low for two reasons. Firstly, there is no statutory basis for such collaboration. Secondly, jurisdictions with better asset-liability ratios than others are more likely to decline cooperation. We believe that the current legal regulation of such relationships lacks balance among the interests of creditors situated in different jurisdictions and the debtor. The aim of cross-border insolvency regulation is to ensure the effectiveness of creditor protection, including the EIR or the uniform rules enforced in the Organization for the Harmonisation of Business Law in Africa (‘OHADA’) Member States (Adjelou 2013, 67–70; Eidenmueller 2009, 4–5). However, the current regulation, composed of bilateral agreements or international treaties, fails to meet efficiency requirements. Therefore, an analysis of potential models for regulating cross-border insolvency in the event of an economic center of interest outside the European Union is proposed.

4. Possible models of regulation

The existence of an unresolved problem often gives rise to suggestions as to how it might be resolved. The implementation of the *UNCITRAL Model Law* is the simplest solution to this problem and is undoubtedly the most obvious. Therefore, should the Model Law be enacted, the court in third state would be empowered to initiate the main proceeding, while in all EU Member States where the debtor's assets are situated, the courts could commence secondary proceedings.

However, we cannot consider this option as it is implausible that the UNCITRAL Model Law would not have been incorporated into the national laws of all countries long ago if it were possible. The same holds true for bilateral agreements, which would have been concluded if possible. Consequently, we propose introducing the following interaction models of insolvency proceedings.

5. Conclusion: Is the coordination of main proceedings a solution?

It seems inevitable that parallel proceedings will be initiated in the third states that are united in some supranational organization (e.g. *Commonwealth of Independent States* [CIS]/*Eurasian Economic Union* [EAEU], *BRICS* [intergovernmental organization comprising Brazil, Russia, India, China, South Africa, Iran, Egypt, Ethiopia, and the United Arab Emirates], Organization of Turkic States, *Latin American Integration Association*, *North American Free Trade Agreement* [NAFTA], *OHADA*, etc.) and the Member States of the EU. In the first paragraph we pointed out that the extension of universalism (pure or universal) to countries outside the European Union is impossible. However, the lack of possibility to use the first model of regulation, pushes us to use another model – modified territorialism (LoPucki 1999, 753).

Currently, there are significant variations in cross-border insolvency regulation throughout the post-Soviet states. However, a *draft CIS Model Law on Insolvency* is available which suggests that the competent court for insolvency proceedings be determined by the place of incorporation of the legal entity. Thus, let’s assume that in Russia, the main proceeding would be initiated against organization A because the organization was registered in Moscow. At the same time, a similar proceeding would be initiated in Hungary, as the center of its interests was located in Budapest. Consequently, there are two main proceedings against the same organization. However, the first proceeding would cover CIS countries, while the second proceeding would cover European Union Member States.

Such a problem could be solved by coordinating the main proceedings initiated in both the EU and the CIS. By providing commercial creditors with legal certainty, such a solution is able to ensure that the rights of vulnerable creditors such as the debtor's employees are protected. Finally, it may reduce the costs of proceedings. At the same time, such a solution is not without its shortcomings. For example, coordination of production requires a normative basis. In the absence of this basis, coordination of production is impossible.

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