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European Court provides insights into defences available to defeat insolvency challenges

In the recent case of ***Lutz [2015] EU ECJ C-557/13***, the European Court of Justice (ECJ) provided useful guidance on when a creditor or third party's legitimate expectations in respect of commercial transactions are protected, in the event such transactions are later challenged by an insolvency officeholder. In particular, the case considers the extent to which such parties can rely on the defence that the "detrimental" transaction could not be unwound by the law governing that transaction.

Why is this case important?

This is the first ECJ judgment on Article 13 of the European Regulation on Insolvency Proceedings (the Regulation). Article 13 is one of the key exceptions to the rule that the law governing the insolvency process also determines the ability of the insolvency officeholder to challenge acts considered detrimental to creditors. It provides that where there is a different governing law in relation to a particular "act" (a term which covers commercial transactions), and that governing law does not provide any means of challenge, then the act cannot be set aside. One of the purposes of this exception is to protect creditors and third parties who have entered into a transaction with a debtor and have chosen a particular law to govern that transaction, so they can expect that law to apply notwithstanding the commencement of insolvency proceedings in another jurisdiction. (For an overview of the key provisions of the Regulation see the box at the end of the briefing.)

The case follows a similar decision made in the European Free Trade Association Court (EFTA Court) ***LBI hf v Merrill Lynch International Ltd (Case E-28/13)***. In the context of the EFTA Court decision, the almost identical provision contained in the Winding Up Directive for Banks was considered. (For more information on the implications of that case, see our briefing note "**European Court gives guidance on the winding up directive for banks**".)

What does Article 13 say?

Article 13 provides that the law of the Member State where the insolvency proceedings were opened does not apply where the beneficiary of an act detrimental to all the creditors provides proof that:

1. the act is subject to the law of another Member State; and
2. that law does not allow any means of challenging that act in the relevant case.

Key issues

- First European Court decision to consider the defences available under Article 13 of the European Regulation on Insolvency Proceedings
- Wide interpretation to protect the legitimate interests of creditors and third parties who have entered into transactions prior to the insolvency
- Defences under the governing law of the transaction include both procedural and substantive

The Lutz case

The importance of this case is perhaps reflected by the number of non-parties who submitted observations to the court including, the European Commission, the German, Greek, Spanish, and Portuguese governments, in addition

to Mr Lutz and the liquidator. The German liquidator of the debtor, ECZ Autohandel GmbH (ECZ), sought to set aside a payment made from ECZ's bank accounts in Austria which had arisen as a result of an enforceable payment order in Mr Lutz's favour awarded before the insolvency proceedings had been opened. The payment from the accounts however were made after the German court had commenced insolvency proceedings in respect of ECZ.

Questions for the European court

The key questions before the European Court were:

1. Is Article 13 wide enough to enable the beneficiary of the act to rely on limitation periods or other time-bars available under the law which governs the dispute?
2. Are the relevant procedural requirements for asserting a claim for the purpose of Article 13 also to be determined according to the law governing the transaction or by the law governing the insolvency proceedings?

Nature of the defence and procedural requirements

In relation to the questions set out above, the ECJ decided that both the procedural and substantive provisions of the law governing the act complained of (i.e. not the law of the insolvency proceedings) would be available to provide a defence to a challenge brought by the insolvency officeholder in the context of the insolvency proceedings. In this particular case Mr Lutz relied upon a limitation defence that was available to him as a matter of Austrian law, namely that the application to challenge the payment had not been made within the appropriate time limit. The European Commission argued that if procedural aspects were excluded from Article 13 it would result in an arbitrary approach, because it would be driven by how individual Member States categorised whether something was procedural or substantive. It was noted that the wording of Article 13 draws no distinction between the type of defences available under that provision. Likewise, in relation to question 2, the ECJ held for similar reasons that the law governing the detrimental act also determined the procedural requirements needed to assert the defence in Article 13.

So what?

The case follows a similar approach to the EFTA Court decision in relation to the defences available under Article 30 in WUDB (equivalent to Article 13) which comprise both substantive and procedural aspects.

The judgment provides welcome confirmation on this key aspect of cross-border insolvency law, which may in practice allow parties who find themselves subject to challenges initiated by insolvency officeholders with a defence to defeat the claim. While the judgment may not come as much of a surprise, like the EFTA court decision it will be seen as providing some useful clarity on this issue - especially when it comes to structuring transactions and providing legal opinions on contracts that are subject to different laws (in particular where acts are governed by a law different to the law of the insolvency proceedings).

Even though the Lutz case is relatively limited in its analysis of the nature of defences, it is useful to have the confirmation and like the EFTA Court decision this case means that jurisdictional variances in the treatment of claw back claims should become less of an issue in practice, as it shifts the focus to the governing law of the act in question which can usually be predicted at the time of the transaction being structured, rather than the law of the place where insolvency proceedings are opened, which at the outset of a transaction is inherently less certain.

The European Regulation on Insolvency Proceedings

Overview

The Regulation does not provide uniform substantive legal provisions for members of the EU. It codifies how a Member State should determine whether it has jurisdiction to open insolvency proceedings, whilst also imposing a uniform approach to the governing law applicable to those proceedings. The Regulation also provides for the automatic recognition of insolvency proceedings throughout the EU. Once these factors have been determined, the procedural rules of the Member State in which proceedings are opened will generally apply.

Scope

The Regulation applies to all collective insolvency proceedings relating to corporate entities and individuals within the EU. The scope of its application is confined to parties with their centre of main interests within a Member State of the EU. It does not apply to banks, credit institutions, insurance companies, investment undertakings which hold funds or securities for third parties, or collective investment schemes, which benefit from different EU legislative instruments.

Jurisdiction

The primary jurisdiction for insolvency proceedings, as provided by the Regulation, is the court of the Member State where the debtor's centre of main interests (COMI) is located. In the case of a company or other legal person, in the absence of proof to the contrary, there is a rebuttable presumption that the COMI is in the Member State where the registered office of the company or other legal person is located.

The Regulation allows for the courts in countries to open "territorial" insolvency proceedings or, after the commencement of main proceedings, "secondary" proceedings, in the event that such debtor possesses an establishment in the territory of such other Member State. The applicable law of such territorial or secondary insolvency proceedings will be the law of that other Member State.

Governing law (Article 4 of the Regulation)

The Regulation imposes a unified code for the governing law. The general rule is that the law applicable to the insolvency proceedings and its effects shall be that of the Member State within the territory in which such proceedings are opened. This includes the rules relating to the voidness, voidability or unenforceability of legal acts detrimental to all creditors (Article 4(2)(m)).

Exceptions to the governing law (Articles 5 to 15 of the Regulation)

The Regulation recognises that there will be cases where strict adherence to the general rule on governing law will interfere with the rules under which transactions are carried out in other Member States, and therefore the general rule is subject to a number of exceptions and carve-outs.

These exceptions include '*rights in rem'* including, amongst other things, rights of security (Article 5) rights of set-off permitted by the law applicable to the insolvent debtor's claim (Article 6), rights under a reservation of title clause, contracts relating to immovable property, rules of payment systems and financial markets and contracts of employment.

Article 13

This is the exception relied upon in the Lutz case. It states that Article 4(2)(m) i.e. the law governing the insolvency, shall not apply where the person who benefited from an act detrimental to all creditors provides proof that the said act is subject to the law of a different Member State, and that law does not allow any means of challenging the act.

Future Amendments to the Regulation

Amendments broadening the scope of the Regulation are due to come into effect around 2017. Some of the key changes include clarifying the meaning of COMI, extending recognition to pre-insolvency proceedings and introducing co ordination proceeding for group companies. In addition, some practical improvements to the Regulation are being introduced such as the use of electronic EU wide insolvency registers and the standardisation of insolvency claim forms.

Authors

Adrian Cohen
Partner

T: +44 20 7006 1627
E: adrian.cohen
@cliffordchance.com

Philip Hertz
Partner

T: +44 20 7006 1666
E:philip.hertz
@cliffordchance.com

John MacLennan
Partner

T: +44 20 7006 1642
E: john.maclennan
@cliffordchance.com

David Steinberg
Partner

T: +44 20 7006 1621
E:david.steinberg
@cliffordchance.com

David Towers
Partner

T: +44 20 7006 8036
E: david.towers
@cliffordchance.com

Iain White
Partner

T: +44 20 7006 2825
E: iain.white
@cliffordchance.com