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ARBITRATION AND INSOLVENCY PROCEEDINGS

In international arbitration, insolvency proceedings pertaining to the estate of a party can have diverging and unpredictable effects: Does the arbitration clause remain valid? Does insolvency result in a stay of pending arbitration? Do national insolvency proceedings acknowledge an arbitral award, in particular for verification purposes? No uniform answer is possible, as most recently demonstrated by the matter Elektrim vs Vivendi. The need for an international Convention going beyond the EC Regulation on Insolvency Proceedings is evident.

Key Words: *Arbitrability – Bankruptcy – EC Regulation on Insolvency Proceedings – Insolvency – Jurisdiction*

A scarcely strewn topic where arbitration and national law can get into conflict is the opening of insolvency proceedings. Some years ago it was seen as an outlandish and somewhat odd issue to deal with. In our days it has become more and more widespread, and it is worth to take a thorough look at it. The most pressing questions of law, regarding insolvency proceedings in connection with arbitration, evolve from the fact that arbitration mostly handles international matters so that different jurisdictions, procedural provisions, private international laws and insolvency regulations as well as arbitration laws are concerned.

Most legal systems differ between bankruptcy (forced liquidation) and reorganization of the debtor. While the reorganization imposes restrictions on the management but allows business to continue, bankruptcy in most cases goes along with the liquidation of the company and the appointment of a receiver, excluding management from representing the company. Insolvency proceedings are based on the principle of *par conditio creditorum*, the collective enforcement of creditors' claims and equal treatment (centralization). Therefore the bankruptcy proceedings are conducted by a state court to protect the legitimate expectations of the parties

involved and the certainty of transactions. Arbitration, on the other hand, excludes state courts and, moreover, follows a completely different legal principle: *Pacta sunt servanda* (decentralization). An arbitration clause constitutes an "agreement" and thus emphasizes the parties' autonomy in pursuing their rights. So it is quite natural that certain strains arise between the concept of arbitration and the principle of collective enforcement underlying insolvency laws.

Another aspect that has to be taken into consideration is the Sovereignty of State, which constitutes a substantial obstacle for centralization of insolvency proceedings and leads to the question of the law applicable and the validity of a choice of law by the parties. None of these questions can be answered in general because a uniform solution would require uniform laws, which do not exist. But the questions can be put in categories which result from the lack of such laws:

i) the lack of international treaties regarding the jurisdiction in insolvency proceedings and

ii) the lack of national legislation regarding the particularities of arbitration and insolvency.

i) Most countries exert their jurisdiction on companies that have assets within their territories. But only some national insolvency laws claim worldwide jurisdiction over the property of the debtor, like the United States or the United Kingdom do. However, in most cases corporations do not have assets in just one territory, but all over the world. Therefore each country has to consider that insolvency proceedings will also be opened in another. To create and participate in international conventions requires considerable time and coordination. On the other hand, extending national jurisdiction beyond territorial boundaries without international accords and reciprocity will eventually lead to lack of enforcement. Although there exists a strong necessity for adjusting and aligning insolvency systems by means of multi-national treaties, there are just a few, the most important within the EC being Council Regulation N° 1346/2000 on Insolvency Proceedings. The Regulation provides for rules and regulations on the law applicable to insolvency proceedings and their effects as well as to pending lawsuits, which, generally speaking, follow the law of the Member State that has opened the insolvency proceedings (*lex fori processus*).

ii) Another stumbling issue are the splintered national legislations. As mentioned, insolvency and arbitration are following two different principles: *par conditio creditorum* and *pacta sunt servanda*. It should be the task of the national legislator to evaluate this antagonism and to provide legal solutions which would take into account the particularities of both procedures, especially of arbitration. Considering its nature of a contract, the arbitration clause has no effect *erga omnes*, but binds the con-

tracting parties only. In contrast, the collective enforcement of creditors' claims requires summary proceedings and the highest possible degree of centralization, leaving only little room for individual agreements.

Naturally there are several approaches, which cannot be depicted individually. But a short statistical survey[1] evinces common concepts and similarities: One point of interest is whether the commencement of insolvency proceedings has an influence on the validity of antecedent arbitration agreements, which is not the case in 70% according to the survey. The next logical step is to ask, whether it is possible to enter into an arbitration agreement during insolvency proceedings. Here a distinction has to be made between liquidation and reorganization. Since liquidation imposes wider restrictions on the management, it is not remarkable that only 10% of national laws examined allow a debtor to enter into such an agreement, while an administrator appointed by court may do so in 60% of all countries. Reorganization, being the gentle way of insolvency proceedings, presents a higher rate of about 45% allowing a debtor to opt for arbitration, while the administrator's capacity remains at 60%. In the course of insolvency proceedings, a settlement of verification disputes by way of arbitration is impossible in 85%.

Another subject of prime importance is arbitrability. As a common fact, the admittance of a claim to verification proceedings renders redundant any other pending procedure. Verification serves as a modality of evaluating the nature and amount of unsettled liabilities and renders all uncontested claims enforceable.

We should now take into consideration certain aspects of personal arbitrability, meaning the effects of insolvency on persons involved. In most jurisdictions insolvency proceedings do not invalidate existing agreements and thus the arbitration clause, but leave it to the liquidator to terminate or contest certain contracts which are deemed detrimental for the creditors' interests. An exception is Poland: Article 142 Polish Bankruptcy and Reorganization law stipulates that any arbitration clause concluded by the debtor prior to the commencement of insolvency looses its legal effects and that any pending arbitral proceedings shall be discontinued. This rule was dealt with by England's High Court of Justice in the case *Elektrim* vs *Vivendi*[2]. In 2003, Vivendi, as creditor, initiated arbitration against Elektrim as the debtor, the place of arbitration being London. Elektrim was declared bankrupt in Warsaw in 2007, so the Tribunal had to decide which law shall govern the effects of the Polish bankruptcy order. Based on Article 4 in connection with Article 15 EC Regulation on Insolvency Proceedings, the award concluded that the law, which governs the effects of insolvency proceedings commenced in another Member

[1] Statistics from Alternative Dispute Resolution Manual, World Bank 2007.

[2] [2008] EWHC 2155.

State, is the law of the Member State where the lawsuit is pending, in the case at hand English law (*lex fori*). Lawsuits pending therefore are deemed an exception from the principle that insolvency proceedings and their effects shall be judged under the law of the Member State where insolvency was opened, as stated in Article 4 of the Regulation (*lex concursus*). Therefore the arbitration clause was declared valid and intact, which was confirmed by English High Court.

This decision is of particular interest because the Swiss Federal Supreme Court rendered a decision on the same issue with similar facts, but on the basis of an LCIA arbitration panel sitting in Switzerland (thus outside the EC), where the Tribunal denied jurisdiction. The Tribunal held, and was affirmed by Swiss Supreme Court, that in the absence of applicable EC law, the conflict had to be decided by the ordinary rules of Swiss Private International Law (PIL). Swiss law contains a positive provision on arbitrability during insolvency proceedings (Article 177 para 2 PIL) which, however, applies only to states and state companies. For private entities the general conflict-of-law rules apply (Article 154 and 155(c) PIL which lead to the law of the state of incorporation of the company, ie, Polish law. Therefore *Elektrim* was denied the legal capacity of being a party to arbitration proceedings in Switzerland.

As another illustrating example one can refer to the ICC matter *FEG Ltd* vs *The Republic of Equatorial Guinea*[3]. In the course of arbitral proceedings pending in Paris, Claimant was declared bankrupt in Equatorial Guinea with the local state court appointing a receiver, excluding management from representing the Claimant. The arbitral tribunal had to decide whether it should recognize the bankruptcy order and therefore the capacity of the receiver to represent the Claimant. In their award, regarding only preliminary issues such as the question of representation, the Arbitrators set out four requirements that have to be met: i) The acting court must have jurisdiction, ii) the insolvency order must have become final and binding, iii) the insolvency proceedings must have respected due process and iv) the recognition of insolvency order does not violate fundamental rules and principles of international public policy. As the tribunal concluded that due process had been violated, it disregarded the appointment of the receiver, giving Claimant's management full right of continued representation. This award can somehow be seen as a guideline whether and under what conditions one should make an exception from the principle that, by opening insolvency proceedings, the liquidator and the trustee respectively enter into contracts existing between the debtor and the creditor and therefore are bound to the arbitration clause. Although the Tribunal did not lift the national insolvency order, it appraised its effects under the rules and conditions of the law of the Member State where arbitral proceedings had been commenced.

[3] Case N°14576/CCO/JRF/GZ.

Another aspect of personal arbitrability also results from the difference between liquidation and reorganization: During the course of (forced) liquidation the debtor, in most jurisdictions, looses its capacity to conclude an arbitration agreement in respect of the administered estates. A unique provision, however, exists in Serbian law: The creditors may agree with the state judge on a special arbitral procedure which does not follow the terms and conditions of usual arbitration under Serbian law but is accommodated to the particular needs of insolvency proceedings.

On the other hand, reorganization in virtually all jurisdictions grants the debtor full capacity to conclude arbitration clauses, sometimes depending on the prior authorization by the administrator.

The next important topic is subject-matter (objective) arbitrability. The various effects, both procedural and substantive, that insolvency proceedings can exert on the legal relationship at stake can make it necessary to identify the relevant procedural laws that govern the opening, conduct and closure of the insolvency proceedings, as well as the relevant substantive laws that govern maturity, pending conditions, set-off, employment contracts, pending offers etc. Another point of interest is the rescission of legal transactions because of unequal treatment of creditors. Here, the US Supreme Court distinguished between "core matters" and "non-core matters". Core matters are defined as actions of creditors which seek to enforce claims in assets or rights of the insolvent estate. These normally represent the predominant part of a liquidation process and, in most jurisdictions, are handled by filing creditors' claims in course of verification. "Non-core matters", on the other hand, embrace actions of creditors which seek to determine the existence, validity, content or amount of a claim. They result from objections against claims in the verification process if they are coupled with, eg, fraud or error.

Both types of conflict can have effects on arbitration: International matters, which always bring up the question which law to apply on the effects of insolvency, are a more complex topic though. In respect of "Core matters", most private international laws as well as the EC Regulation on Insolvency Proceedings follow the principle of centralization by declaring the law of the opening state as applicable (*lex concursus*), whereas "Non-core matters" generally follow the law of state, where the case is pending (*lex fori*). If the opening state corresponds with the forum state, national insolvency laws usually will, in consideration of the distinctions outlined above, provide for appropriate centralization. The tendency is that arbitration aimed at enforcement of claims will be stayed at the opening of insolvency proceedings, at least until verification. New arbitration proceedings usually may not be initiated in respect of "Core matters", because these issues are reserved for verification (*vis attractiva cuncursus*). This extension of the jurisdiction of bankruptcy courts is

quite understandable: The principal reason of insolvency proceedings is collective enforcement of claims for the purpose of simplification, acceleration and equal treatment, which leaves no room for individual actions.

Whether "Non-core matters" may be settled by arbitration depends on the "survival" of the arbitration clause. Most insolvency laws (except Polish law) do not affect the validity of existing contracts but leave the rescission of adverse agreements to the liquidator. Arbitration agreements, however, cannot be deemed adverse as such, but they have to be evaluated in connection with the underlying material legal relationship. Another aspect that has equally to be taken into consideration is the discretion of bankruptcy courts, especially in the US (what can complicate things enormously).

Now that we have dealt with the theoretical background I would like to add a few practical comments and suggestions in respect of three stages of arbitral proceedings during which insolvency can occur: Before, during and after arbitration is initiated.

1) Problems and singularities of insolvency occurring *before* arbitral proceedings:

First of all one must distinguish between bankruptcy and reorganisation, because the differences between both types of insolvency have, as shown above, practical influence on the entire process. Another very practical aspect is the advance on costs. It can lead to a blocked situation if the Rules of Arbitration require an advance on costs in order to initiate arbitral proceedings. In this case the arbitrators should contact the liquidator and potentially fix separate advances to unblock the course of arbitral proceedings in case of a counter-claim or a jurisdictional dispute. Whether it is reasonable to file an arbitration request in order to use the later award as a title verification proceedings will very much depend on the individual circumstances.

To conclude an arbitration agreement during insolvency is possible in different variants: Between the debtor or administrator and the creditors in case of reorganization, between these parties in respect of estates which do not belong to the bankruptcy assets or, like in Serbia, even during bankruptcy proceedings just between the creditors, what, however, I was told to occur rarely. In the latter case arbitration could work as a compromise if court proceedings would be too complicated or time consuming.

2) Problems and singularities of insolvency occurring *during* pending arbitral proceedings:

Sometimes arbitral proceedings may function as a "cause" of insolvency. However, the exists no difference to national court proceedings: In

both cases proceedings are stayed until verification. There exist, however, differences between national laws how to stay the proceedings. The legal framework can be designed as a system of a mandatory stay (as in Serbia), a de-facto stay connected with the requirement to obtain the permission to continue the proceeding, or as a relative stay to the effect that no decision to perform but only a declaratory decision can be delivered.

Even if no stay is imposed on a pending proceeding, the administrator and the liquidator, respectively, has to be informed due to his capacity to represent the debtor during the entire insolvency proceeding and to avoid problems of unilateral enforcement.

3) Problems and singularities of insolvency occurring *after* termination of arbitral proceedings:

If the Debtor becomes insolvent after an enforceable award was delivered, the principle of collective enforcement and centralization can nevertheless apply: The award will serve as the basis for verification in the same way as the judgement of a state court. If property outside the effects of insolvency shall be seized, the award will equally constitute a sufficient title for enforcement, like a state court title. However, this has to be taken with care: In the case *Victrix* Steamship Co., S.A. vs *Salen Dry Cargo*[4]*, A.B.,* a Swedish debtor became insolvent in Sweden. Arbitral proceedings where conducted in London, without stay or verification, and the prevailing Claimant applied for enforcement in the USA. The application was dismissed. The US court recognized the Swedish bankruptcy order as an act of "comity" and therefore refused enforcement on the basis of public policy. Therefore, it can be deemed indispensable to notify an award in the verification procedure.

Finally one can only hope that there will be not too many situations where arbitration and insolvency coincide.

[4] US Court of Appeals, Second Circuit, 1987, 825 F.2d 709.