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The Law Applicable To The Effects Of Insolvency In Arbitration: UNCITRAL's Work In Progress

Manuel Penades (King's College London) · Wednesday, December 13th, 2023

For the last couple of years [Working Group V at UNCITRAL](#) has been working on a project dedicated to the [applicable law in insolvency proceedings](#). The law governing the effects of insolvency in arbitration has become one of the most contentious topics in the negotiations.

The [draft provisions](#) subject to discussion in the 63rd session, 11-15 December 2023, basically propose that “the *lex fori concursus* shall govern all aspects of the commencement, conduct, administration and closure of insolvency proceedings and their effects, including: ... (d) Protection and preservation of the insolvency estate, including application of a stay of proceedings, and, if it applies, its scope and duration, modification and termination”. That is, the law of State in which insolvency proceedings have opened will govern the possibility to commence arbitration proceedings concerning the insolvency estate (even abroad). This rule is subject to an exception for arbitration proceedings already pending at the time insolvency commences. The impact of insolvency in these ongoing proceedings “shall be governed by the *lex arbitri*”. The Note prepared by the Secretariat for the session explains the state of the debate and identifies outstanding issues.

This post examines various areas of the draft provisions and suggests areas of improvement.

The draft provisions could be incompatible with article 20 UNCITRAL Model Law on Cross Border Insolvencies (UMLCBI)

Article 20 UMLCBI regulates the effects of recognition of a foreign main proceeding. The first and most well-known effect is the imposition of a stay on the “(a) Commencement or continuation of individual actions or individual proceedings concerning the debtor’s assets, rights, obligations or liabilities”.

This stay applies to litigation as well as arbitration and goes beyond the mere choice of law rules currently under negotiation. (UMLCBI with Guide to Enactment and Interpretation, par. 180) Article 20 UMLCBI provides an automatic and mandatory effect and therefore it is a rule of substantive protection aimed at providing breathing space to the insolvent party.

By imposing a rule of substantive protection, article 20 UMLCBI includes an implied choice of law rule in favour of the law of the recognising State. That is, article 20 UMLCBI does not import

the effects of the law governing the foreign insolvency proceedings. It imposes its own relief, which might be more stringent than the *lex fori concursus*. (UMLCBI with Guide to Enactment and Interpretation, par. 178) In addition, the stay in article 20.1 UMLCBI does not distinguish between new and pending individual actions. The silent choice of law rule in article 20 UMLCBI would clash with the new general rule in favour of the *lex fori concursus*.

The Note of the Secretariat (paras. 10 and 11) acknowledges this incompatibility. To solve it, it proposes to rely on the rules on coordination between insolvency proceedings under the UMLCBI and the discretionary relief that courts might be able to provide under national law.

The reliance on vague coordination provisions as avenue to give effect to the choice of law rules in the draft provisions is too uncertain. In addition, in some legal systems courts might not be able to use such generic provisions to depart from the stay mandated by article 20.1 UMLCBI. (UMLCBI with Guide to Enactment and Interpretation, par. 184)

For that reason, the preferred approach would be to include an express exception to article 20.1 UMLCBI in article 20.2 UMLCBI. The proposed text should be:

2. The scope, and the modification or termination, of the stay and suspension referred to in paragraph 1 of this article are subject to:

(a) the application of the *lex fori concursus* pursuant to the choice of law rules on the effects of foreign insolvencies on individual actions or individual proceedings concerning the debtor's assets, rights, obligations or liabilities.

(b) the consideration that the *lex fori concursus*, despite not being applicable pursuant to the choice of law rules mentioned in (a) above, does not mandate a stay.

Letter (a) of the proposed exception would cover cases where the draft provisions refer to the *lex fori concursus*. Letter (b) is aimed at scenarios where the *lex fori concursus*, despite not being applicable, allows the existence and continuation of individual actions outside of the insolvency proceedings. In these cases, it will not make sense for the recognising State to impose a stay of individual actions assuming that the insolvency forum will decide them when, in fact, such forum allows those autonomous actions and might not contain rules to accept jurisdiction.

These exceptions would not apply to displace a stay when the stay is part of public policy in the recognising State. In those instances, article 6 UMLCBI would allow that State to disregard the exception and apply the mandatory stay.

In addition to article 20 UMLCBI, Article 21.1 UMLCBI widens the potential reach of a stay by providing that:

Upon recognition of a foreign proceeding, whether main or nonmain, where

necessary to protect the assets of the debtor or the interests of the creditors, the court may, at the request of the foreign representative, grant any appropriate relief, including:

(a) stay the commencement or continuation of individual actions or individual proceedings concerning the debtor's assets, rights, obligations or liabilities, to the extent they have not been stayed under paragraph 1 (a) of article 20;

The clash between the draft provisions and the scenario in article 21.1.a UMLCBI would only arise regarding new arbitration proceedings, when the courts of the seat imposed a stay under article 21.1.a UMLCBI on a discretionary basis whereas the *lex fori concursus* allowed arbitration. This would be a rare occurrence, and it could only take place “where necessary to protect the assets of the debtor or the interests of the creditors” and “at the request of the foreign representative”, which are the prerequisites to trigger article 21.1 UMLCBI. Given the discretionary nature of the relief under article 21 UMLCBI and the fact that it can only be actioned to protect insolvency interests, it will not be necessary to amend the text of article 21.1 UMLCBI to make it compatible with the draft provisions. (UMLCBI with Guide to Enactment and Interpretation, par. 176)

Arbitration agreements should not be treated as contracts for insolvency purposes

In parallel to the general rule on stays, the draft provisions also state that the *lex fori concursus* governs the “(h) Treatment of contracts, including automatic termination and acceleration clauses (ipso facto clauses)”. The draft commentary states that this includes “(vi) the treatment of arbitration agreements”.¹⁾ This rule is not subject to an exception concerning arbitration agreements which have given rise to pending arbitration proceedings.

The characterisation of arbitration agreements as contracts might be an acceptable classification in general circumstances (e.g., formation and interpretation of arbitration agreements or damages for their breach). However, the use of this classification for insolvency purposes, in parallel with the mentioned exception for pending proceedings, would be very problematic.

Insolvency rules that impact arbitration are very varied (see [IBA Toolkit on Insolvency and Arbitration, Explanatory Report](#), Question 1) and might simply state that individual actions are prohibited or that the insolvency estate is prevented from taking part in arbitration proceedings. If those proceedings were pending, the choice of law rules in UNCITRAL's draft provisions would direct to the *lex arbitri*. However, the same insolvency rules could be easily seen as rules which render the arbitration agreement invalid or, at least, ineffective. Therefore, it would be very unclear whether such insolvency rules would apply under letter (h) of the draft provisions or they should not because they would fall under the exception for pending arbitrations.

The coexistence of the two choice of law rules would become a constant source of debate and uncertainty. The preferred approach is that the reference to “arbitration agreements” is deleted from the draft commentary on letter (h) of the draft provisions, so the effects of insolvency on arbitration are determined solely by the rules on stay. This characterisation problem became evident in *Elektrim v Vivendi* [2009] EWCA Civ 677, [31] and that is the reason why article 18 of the [EU Insolvency Regulation](#) provides that “the effects of insolvency proceedings on a ... pending

arbitral proceedings ... shall be governed *solely* by the law of the Member State in which ... the arbitral tribunal has its seat”. Ultimately, the effects that insolvency law might impose on arbitration agreements are jurisdictional in nature; that is, they concern the ability to commence or continue arbitration proceedings affecting the insolvency estate. For that reason, the choice of law rules on stay (widely understood) should be the relevant rules to determine the effects of insolvency on arbitration agreements.

The exception should direct to the *lex loci arbitri*

The exception to the general rule subjects pending arbitrations to the *lex arbitri*. The *lex arbitri* is the legal system that governs the arbitration procedure. Usually, this *lex arbitri* is the same as law of the seat (*lex loci arbitri*), but this is not necessarily the case. Parties can choose a different law to govern the procedure (see article V(1)(e) NYC) as long as they respect the mandatory laws of the seat. The draft commentary by UNCITRAL to the draft provisions does not acknowledge this distinction.

The exception should not direct to the *lex arbitri* because the effects of insolvency on arbitration are not only procedural. As mentioned above, they are primarily jurisdictional. That is, they impact the very possibility of having arbitration proceedings running in parallel to the insolvency proceedings. For that reason, it is the law of the seat (*lex loci arbitri*) and not the law of the procedure (*lex arbitri*) that should govern these effects. This is the reason why article 18 EU Insolvency Regulation refers to “law of the Member State ... in which the arbitral tribunal has its seat” instead of the *lex arbitri*.

The exception to the general rule should be amended as follows:

The effects of insolvency proceedings on [any limits of the scope of application of this exception, as may be agreed upon by the Working Group] of ongoing arbitral proceedings concerning the insolvency estate that is administered in that insolvency proceeding shall be governed by the law of the State in which the arbitration proceeding has its seat.

The territorial reach of the exception

There is no need to indicate that the exception only applies to arbitral proceedings taking place outside the State where the insolvency proceedings have commenced because that is, in fact, the only relevant scenario in which this issue will arise. When the seat of the arbitration is located in the jurisdiction where insolvency proceedings have opened, the general choice of law rule and the exception will direct toward the same law (the *lex fori concursus*) and therefore there will not be a conflict of laws. It might be possible to include in the commentary that the only scenario in which the exception is relevant is where the seat of the arbitration is outside of the *forum concursus*.

The exception for pending proceedings should apply to arbitration as well as litigation

Insolvency proceedings can impact individual proceedings concerning the insolvent estate in arbitration as well as litigation. In fact, the stay in article 20 UMLCBI applies to litigation as well as arbitration. (UMLCBI with Guide to Enactment and Interpretation, par. 180) There is no justification to subject arbitration to an exception that does not apply to litigation. Both dispute resolution procedures should be subject to the same jurisdictional treatment in the context of insolvency. Arbitration agreements and choice of court agreements produce similar jurisdictional effects (prorogation and derogation) and most insolvency laws approach the effects on both (and on litigation more generally) together. The exception to pending proceedings in the draft provisions should apply to arbitration as well as litigation.

The text of the exception should read as follows:

The effects of insolvency proceedings on *[any limits of the scope of application of this exception, as may be agreed upon by the Working Group]* of ongoing court proceedings and arbitral proceedings concerning the insolvency estate that is administered in that insolvency proceeding shall be governed by the law of the State in which the court proceedings are pending or the law of the State in which the arbitration proceedings have their seat.

The draft provisions should be applicable in arbitration and by arbitrators

While the draft provisions refer to arbitration, their application in arbitration and by arbitrators might be a source of contention. Under some conceptions of arbitration, arbitrators are loosely connected to the law of the seat and might not be bound by its conflict of laws rules (see [IBA Toolkit, Explanatory Report](#), Question 33). Therefore, even when a stay is mandated by the law applicable under the choice of law rules in the draft provisions, arbitrators might allow the arbitration to proceed and issue an award concerning the insolvency estate. Given that the mere breach of choice of law rules by arbitrators might not be *per se* a ground to set aside the award or to refuse its recognition and enforcement (see [IBA Toolkit, Explanatory Report](#), Question 34), the arbitrators' deviation from UNCITRAL's choice of law rules might go unsanctioned.

To reduce this risk, the draft provisions, or at least for the commentary/enactment guidelines, should express clearly that the choice of law rules on the effects of insolvency in arbitration are applicable also *in arbitration and by arbitrators*. That is, they are not just aimed at courts, but are part of the *lex loci arbitri*. Many of the rules in the *lex loci arbitri* are non-mandatory and parties can dispose of them by agreement (usually by selecting arbitration rules). Others, however, are mandatory and must be respected by arbitrators seated in that jurisdiction. The choice of law rules in UNCITRAL's draft provisions would be part of this latter group (mandatory rules of the *lex loci arbitri*). Even jurisdictions that are traditionally very favourable to arbitration have declared that some of their rules are of mandatory application by arbitrators seating within their jurisdiction (see [section 4 English Arbitration Act 1996](#)) and that some of the choice of law rules at the seat are equally applicable in arbitration and by arbitrators (see the decision by the Swiss Federal Court in [4A_50/2012, 16 October 2012, para. 3.3.2](#), concerning the application in arbitration of the Swiss choice of law rules governing personal capacity).

An express rule mandating the application of UNCITRAL's draft provisions in arbitration and by arbitrators would produce two significant benefits:

- It would eliminate the uncertainty frequently present in arbitration proceedings on how to determine the effects of insolvency in arbitration. Often, parties and tribunals debate about the possibility to resort to insolvency-specific rules in the law of the seat by way of analogy. Sometimes these are choice of law rules (like UNCITRAL's draft provisions or the EU Insolvency Regulation). Other times, those rules have a direct substantive effect (such as rules of the seat providing for a stay) and parties intend to justify their application based on their alleged mandatory nature. In a significant number of cases, the debate is not only about insolvency-specific rules and it shifts toward the impact that insolvency has on arbitration-specific categories. That is, is the arbitration agreement still valid and operative? Is the subject matter still arbitrable? Does the insolvent party retain capacity to arbitrate and to appear in the proceedings? Each of these arbitration categories has its own applicable law regime, which multiplies the choice of law variables and allows parties to adapt their arguments strategically. Overall, practice demonstrates that these debates are extensive and very costly despite the lack of resources inherent to insolvency. Making the choice of law rules in UNCITRAL's draft provisions directly applicable to arbitration would significantly simplify the debate, as the effects would be determined by the law applicable under those choice of law rules.
- The use of arbitration-specific categories by arbitrators means that awards sometimes clash with the approach taken by national courts on the same issue, as courts will apply the insolvency-specific choice of law rules on the effects of insolvency in arbitration. Sometimes this leads to the annulment or ineffectiveness of awards that would not have been issued if the arbitrators had followed the same decisional logic as the national courts responsible for the annulment and / or enforcement of the award. This is a source of unnecessary expense and uncertainty, which would be eliminated if arbitrators and courts determined the effects of insolvency in arbitration under the same choice of law rules.

An additional measure to facilitate the application of UNCITRAL's draft provisions in arbitration and by arbitrators would be to include a recommendation in the commentary/enacting guidelines that the party interested to invoke the effects of the foreign insolvency in the arbitration should request the recognition of such insolvency by the courts of the seat. This would mean that, as a matter of law (and not only of fact), the foreign insolvency would be a legally relevant effect in the eyes of the law of the seat. While this should not be a prerequisite for the application of the UNCITRAL's draft provisions by arbitrators, it would reinforce their decision to apply those provisions. It would also mean that the choice of law rules concerning the effects of the foreign insolvency on the arbitration would be taken into consideration in any arbitration-related litigation before the courts of the seat, including setting aside proceedings.

Note: Manuel Penades is the academic chair of IBA Toolkit on Insolvency and Arbitration


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References

- ?¹ [A-CN.9-WG.V-WP.190](#) – Applicable law in insolvency proceedings, Default Rule, Draft commentary, par. 21.

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