Kluwer Arbitration Blog

The Law Governing the Effects of Insolvency in Arbitration: Is UNCITRAL Getting it Wrong? – Part I

Manuel Penades (King's College London) · Tuesday, November 26th, 2024

Since 2019, Working Group ("WG") V of UNCITRAL has been working on the adoption of a choice of law instrument that regulates the law applicable to the international effects of insolvency proceedings. The project seeks to include a rule on the law governing the impact of insolvency in arbitration. Part I of this post examines the various regulatory models considered by WG V to govern this issue and argues that the recent change of direction in favour of an absolute rule in favour of the law of the State in which insolvency proceedings have been opened (the *lex fori concursus*) is misguided. Part II of the post explains the practical difficulties that would follow from the adoption of this model.

The Positive Contribution of Working Group V to the Insolvency and Arbitration Debate

To date, the efforts of WG V have been commendable for various reasons.

First, WG V has rightly acknowledged that generally arbitration law is insufficient (indeed, silent) in regulating the effects that foreign insolvencies have on arbitration agreements and proceedings seated abroad (*see* A/CN.9/1169, para. 64). This is an insolvency-specific issue, and the better approach is for insolvency law to regulate this, both substantively and at the level of conflict-of-laws.

Second, national laws vary widely on the effects that insolvency has on the possibility to commence and continue arbitration proceedings involving the insolvent party (*see* IBA Toolkit on Insolvency and Arbitration, Explanatory Report, para. 10). Rather than attempting to unify this diversity at a global level, WG V has opted for the more feasible and measured approach which seeks to agree on a choice-of-law rule that will identify the law that courts and tribunals will apply to determine the impact of insolvency in arbitration.

Third, WG V has also acknowledged that the law governing the impact of insolvency in arbitration does not intend to replace the overall regulatory framework applicable in international arbitration (*see* A/CN.9/1169, para. 64). Rather, the regulatory scope of that law is limited to the specific effects produced by the opening of insolvency proceedings. Unaffected facets of arbitration will continue to be regulated by the law applicable in ordinary circumstances.

Finally, WG V has recognised that the starting point should be that the law governing the effects of

insolvency is the same for arbitration and court proceedings (*see* A/CN.9/1169, para. 67). Such consistent approach is explained by the fact that, despite not being governed by the same instruments internationally, arbitration and litigation ultimately raise similar questions concerning the possibility to conduct proceedings outside of the collective insolvency process.

The Model So Far: The *Lex Fori Concursus* and the Exception for Pending Proceedings

Up until the 63rd session, 11-15 December 2023, WG V had worked with a model which, essentially, provides that the *lex fori concursus* will govern the possibility to conduct arbitration proceedings concerning the insolvency estate (even abroad). This rule, however, was subject to an exception in favour of the law governing the arbitral proceedings (*lex arbitri*, which frequently is the law of the seat—*lex loci arbitri*) when the arbitration proceedings are already pending at the time insolvency commences.

As mentioned elsewhere [here and here], there are various reasons why this model offered a satisfactory compromise between the competing insolvency and arbitration policies. It provided for the general rule in favour of the *lex fori concursus*; but it also acknowledged the fact that when individual proceedings are afoot, it is appropriate to respect that the law governing the already existing procedural relationship (the *lex loci arbitri*) determines the effects of the foreign insolvency.

This recognition facilitates the acceptance of the choice-of-law rules used by arbitral tribunals and national courts acting in arbitration-related litigation (as opposed to courts acting in an insolvency capacity). These rules are primarily the New York Convention ("NYC") and national arbitration laws. Still, the model inserts insolvency considerations into the arbitration sphere. This is because, while it respects the continued application of the *lex loci arbitri*, it requests arbitrators and courts to apply the insolvency-specific effects provided by the *lex loci arbitri* to respond to the irruption of a foreign insolvency process.

In addition, and importantly, the described choice-of-law model remains outcome-neutral; i.e., it does not mean that the pending arbitration proceedings will necessarily continue. That will be for each national law to decide. In fact, if the foreign insolvency was recognised by the courts of the seat of the arbitration, article 20 of the UNCITRAL Model Law on Cross-border Insolvency ("UMLCBI"), as part of the *lex loci arbitri*, would automatically stay the pending proceedings in favour of the insolvency forum.

Incidentally, the model of rule and exception favoured by WG V up until their session in May 2024 replicates the solution that has been tested and worked satisfactorily for over two decades in the European Union, which provides for the same distinction between new and pending proceedings in articles 7.2(e) and 18 of the EU Insolvency Regulation.

The New Model: The Absolute Application of the *Lex Fori Concursus*

This model, however, seems to have been abandoned by WG V.

In the 64th session, 13-17 May 2024, WG V has proposed to delete the exception in favour of the

lex loci arbitri for pending arbitration proceedings. Under the new model, the *lex fori concursus* will govern all the effects of insolvency in arbitration agreements and proceedings, regardless of their status at the time of the commencement of insolvency. Para. 67 of Document A/CN.9/1169, issued by WG V after the 64th session, briefly justifies the decision on three grounds. As explained below, these reasons do not withstand scrutiny.

The Feeble Justification of the New Model

The Coherence of the New Model

The first justification is that the new model is "considered coherent with the other items on the *lex fori concursus* list and the goal to prevent interference of irrelevant laws in the administration of insolvency proceedings."

While insolvency models based on the principle of universalism have traditionally recognised the primary application of the *lex fori concursus*, every advanced regime on cross-border insolvency (including WG V's own proposal) recognises the need to foresee choice-of-law exceptions to allow for the application of laws other than the *lex fori concursus* to regulate discrete issues that are not core to the insolvency process. In this case, that would be the possibility to continue with ongoing claims involving the insolvent party outside of the *forum concursus*.

Importantly, an exception in favour of the *lex loci arbitri* for pending arbitrations would be compatible with the application of the *lex fori concursus* to any substantive effects on the contract subject to the dispute resolution process. This would be a merits issue, separate from the jurisdictional and procedural matters governed by the *lex loci arbitri*.

Equally, the *lex fori concursus* would also govern how any resulting award is integrated into the insolvency process in terms of admissibility, ranking, and patrimonial distribution. This is why the exception is not an "interference of irrelevant laws in the administration of insolvency proceedings," as wrongly suggested in Document A/CN.9/1169. Much the contrary, the exception is necessary to acknowledge and respect the existence of a live procedural relationship already established between the insolvent party, third parties, and arbitrators before the opening of the insolvency. While it can be understood that the *lex fori concursus* might want to have a say on the commencement of new individual proceedings after the opening of insolvency (even if the arbitration agreement was concluded pre-insolvency and *in bonis*), the imposition of the *lex fori concursus* over a pending proceeding is excessive and unnecessary for the "administration of insolvency proceedings." If, under the law of the arbitration, the proceedings are allowed to continue, the credit subject to them can be registered in the insolvency as contingent until the case comes to an end (*see* IBA Toolkit on Insolvency and Arbitration, Explanatory Report, paras. 126-28).

The Impact of Pending Proceedings

The second reason in Document A/CN.9/1169 for the general choice of the *lex fori concursus* is

that “the impact that ongoing proceedings would have for the insolvency estate in terms of claims, liabilities, assets and costs, and because that impact would be assessed and managed by the insolvency representative and the insolvency court, justified that the *lex fori concursus* would be the governing law.”

Again, this justification is misplaced. Should the individual proceedings continue, the foreign arbitral tribunal or national court shall adapt the representation of the insolvent party in light of the prescriptions of the *lex fori concursus*, which (as personal law) will govern the procedural capacity and *locus standi* of the insolvent party and the insolvency representative. Current arbitration practice and article 12 UMLCBI already accept this. Equally, as explained above, the application of the law of the place of arbitration will not necessarily mean that the individual proceedings will continue. What is more, and this is important, even if arbitration was allowed to continue (for instance, because the State where the seat is located has not adopted article 20 UMLCBI, or because the stay was lifted by the courts of the seat), this would not necessarily lead to the enforcement of any award that could be issued against the insolvent party. Three reasons support this:

1. In many jurisdictions, the continuation of the arbitration is subject to the requirement that the relief available in arbitration is merely declaratory and not condemnatory (*see*, *e.g.*, the IBA Reports for France, para. 108, and Germany, para. 17). The same has been accepted by arbitral awards (*e.g.*, ICC cases 11876 (2002) [seat London, French insolvency law], 7563 (1993) [seat Paris, French insolvency law], 7337 (1996) [seat Germany, Swedish insolvency law] and 7205 (1993) [seat Paris, French insolvency law]). Therefore, the award might be a valid title to join the queue of creditors in the insolvency, but it lacks teeth to bite assets of the insolvent estate outside of the collective proceedings and thus it does not threaten the *par conditio creditorum*.
2. Equally, if the *lex loci arbitri* does not provide for this limitation on arbitral relief, the courts of the seat that decide on the possibility of lifting the stay under article 20 UMLCBI can rule that any such lift is “subject to a condition that no enforcement action, whether in this jurisdiction or otherwise, be taken […] in respect of any award it obtain[ed] from the arbitration,” just as the High Court of Singapore decided recently in *Re Sapura Fabrication Sdn Bhd* [2024] SGHC 241 (18 September 2024).
3. Finally, even if the arbitration results in a condemnatory award, recent studies confirm that in the “overwhelming majority of jurisdictions, […] even where the arbitration itself is not stayed, the enforcement of any resulting arbitration award typically must be pursued through the single, collective bankruptcy process” (*see* IBA Toolkit on Insolvency and Arbitration, Explanatory Report, para. 124). By way of example, a recent French decision has refused the enforcement of an ICC award against a company subject to insolvency proceedings in Italy on the grounds that an individual enforcement action would infringe the principle of equality of creditors and contravene the prohibition of individual executions under the foreign insolvency law (*see* Cour d’appel de Paris, 3 October 2024, n° 22-15049).

It cannot be denied that the conduct of individual proceedings might be a source of expenses for the insolvency estate, but this is not unavoidable. Those proceedings may be amended pursuant to expedited or fast-track procedures to accelerate the dispute resolution process, while maintaining the forum selected by the parties prior to insolvency. In addition, the discontinuation of those proceedings when they are already pending and potentially advanced to commence a proof of debt process within the insolvency forum might duplicate costs and be a source of inefficiencies.

The Trends in the Arbitration Market

Finally, Document A/CN.9/1169 explains that the new model "was considered also appropriate and timely in the light of current trends in the arbitration market and attempts of more States to attract international arbitration cases by providing a framework favourable to arbitration, which might be at the cost of insolvency law considerations. It was submitted that a rule deferring to the *lex loci arbitri* might exacerbate those concerns."

This statement is misguided. The most relevant global development on the interface between insolvency and arbitration in the last decade has been the IBA Toolkit on Insolvency and Arbitration. The IBA Toolkit consciously adopts a measured and neutral approach, precisely to gain acceptance by insolvency and arbitration communities and avoid criticisms based on hostility towards either area. It is not fanatic in either direction. While it is true that some jurisdictions seek to attract arbitration business through arbitration-friendly legislations, Document A/CN.9/1169 fails to identify any instance where the so-called "current trends in the arbitration market and attempts" have led to an unjustified misplacement of legitimate insolvency considerations under the original model.

More importantly, UNCITRAL's publication also wrongly presupposes that resorting to the law of the place of the individual proceedings (e.g., *lex loci arbitri*) would be hostile to insolvency. The truth is that the choice of law regime under the original model was outcome neutral. Each State remains free to decide what the impact of insolvency should be, including the possibility of an automatic stay pursuant to article 20 UMLCBI.

Conclusion

The absolute imposition of the *lex fori concursus* for all individual proceedings, pending or not, involving the insolvent party is testament of the same unilateral and biased approach Document A/CN.9/1169 seeks to avoid. In addition, as explained in Part II of this post, it will be a source of the practical difficulties. A model based on the general application of the *lex fori concursus* alongside an exception for pending proceedings offers a measured and much more balanced compromise.

This entry was posted on Tuesday, November 26th, 2024 at 8:30 am and is filed under Arbitration, Insolvency, Lex Arbitri, Lex Fori, New York Convention, New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, UNCITRAL, UNCITRAL Model Law
You can follow any responses to this entry through the Comments (RSS) feed. You can leave a response, or trackback from your own site.