Kluwer Arbitration Blog

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

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

Building on Part I of this post, Part II explains the serious practical disfunctions that would derive from the adoption by Working Group V ("WG V") at UNCITRAL of the current proposal to subject all the effects of insolvency in arbitration to the law of the State in which insolvency proceedings have been opened (the *lex fori concursus*).

The Risk of Abuse

Practice shows that the ability of one party to an ongoing dispute resolution process to trigger insolvency proceedings in their home jurisdiction in order to claim that the *lex fori concursus* will unilaterally govern the possibility to continue with that process could easily become a source of abuse. Parties choose neutral *fora* to prevent the uncontrolled application of one party's laws to resolve their common disputes. The application of the law of that neutral forum to define the impact of insolvency on pending proceedings is a source of legal certainty and favours international transactions. Attempts by parties to torpedo their ongoing cases (particularly when they are not progressing favourably) by simply triggering insolvency protection in their home jurisdiction can backfire and generate scepticism from arbitrators and courts acting in an arbitration-capacity. This is particularly concerning given the application of the proposed choice-of-law regime to various types of insolvency proceedings that go beyond traditional liquidations and administrations, and which might be easily accessible, including reorganizations, simplified insolvency proceedings, and interim restructurings.

The Incompatibility with Article 20 UMLCBI

As pointed out in previous posts [here and here], Article 20 of the UNCITRAL Model Law on Cross-Border Insolvency("UMLCBI") includes an implied choice of law rule in favour of the law of the recognising State. That is, Article 20 MLCBI triggers an automatic stay in its own right and does not import the effects of the law governing the foreign insolvency proceedings. It imposes its own relief, which might be more or less stringent than the *lex fori concursus* (UMLCBI with Guide to Enactment and Interpretation, para. 178).

The new choice-of-law regime in favour of the *lex fori concursus* is directly incompatible with this

philosophy and it is very unclear that the rules on coordination will be sufficient to overcome this clash. For instance, if the *lex fori concursus* allows individual proceedings and Article 20 UMLCBI in the recognising State mandatorily provides for a stay, the incompatibility will only be resolved if the law of the recognising State allows for the lifting of the stay (which not every jurisdiction does). Or, if the *lex fori concursus* orders the stay in absolute terms and the recognising State provides for a stay under Article 20 UMLCBI but allows for the possibility of a lift, it is unclear which one should prevail.

Equally problematic will be the cases where the *lex fori concursus* and the recognising State regulate the possibility to lift the stay, but subject it to different criteria. Or even when Article 20 UMLCBI does not apply or has not been adopted by the State where proceedings are pending, the question will be whether the possibility to lift the stay will be a matter governed by the *lex fori concursus* (if characterised as a jurisdictional matter) or the *lex loci arbitri* (if classified as a procedural issue). A position that favoured the *lex loci arbitri* would produce a partition between the stay (governed by *lex fori concursus*) and the lifting of the stay (governed by the *lex loci arbitri*). *De facto* this would offer each recognising jurisdiction discretion to establish their own rules regarding the lifting of stays and hence potentially reintroduce the very conflicts that the new model proposed by WG V seeks to mitigate.

The Clash of Jurisdictions to Lift the Stay

Another related question would be the identification of the competent court to decide on the possibility to lift the stay. To an extent, it would appear that the *forum concursus* would be better placed to assess the insolvency considerations relevant to decide on the possible lift. However, this would clash frontally with the philosophy underlying Article 20 UMLCBI, which confers jurisdiction on the courts of the recognising State over these matters. Equally, it would be somehow paradoxical if the *forum concursus* could decide on the stay of proceedings located abroad, as it would directly impact on the jurisdiction of foreign courts and arbitral tribunals that would be already hearing the case (hence, violating the basic principle of *competence-competence*). It would also raise the concerns of extraterritoriality that led English courts to rule that the stay mandated by English insolvency law should not apply to foreign proceedings (see *Harms Offshore AHT 'Taurus' GmbH and Co KG v Bloom* [2009] EWCA Civ 632).

It is worth noting that Document A/CN.9/1169 fails to acknowledge in detail any of the very serious issues identified in the previous paragraphs, let alone resolve them. Importantly, none of these complexities would exist if the *lex loci arbitri* governed the impact of insolvency on pending proceedings, subject to the amendment to Article 20 UMLCBI suggested in previous posts [here and here].

The Difficult Compatibility with Article V NYC

The new model proposed by WG V would be compatible with Article II of the New York Convention ("NYC"), but it would be a source of significant tensions with Article V NYC.

Article II NYC

When a court has to decide on the enforcement of an arbitration agreement, Article II NYC applies. According to Article II NYC, the courts of the Contracting States shall refer parties to arbitration if the dispute concerns "a matter capable of settlement by arbitration" (Article II.1) and unless the arbitration agreement is "null and void, inoperative or incapable of being performed" (Article II.3). The NYC does not define these concepts or even prescribe a closed set of choice-of-law rules to identify the law applicable to give content to the referred terms. In cases of foreign insolvency, this silence concerning the relevant applicable law might allow courts to integrate relevant choice-of-law considerations pertaining to the cross-border insolvency sphere. That is, when examining the arbitrability of the dispute or the validity and effectiveness of the arbitration agreement the court might be able to use the law applicable under the cross-border insolvency regime (in the last proposal of WG V, the *lex fori concursus*) to define the effects of insolvency on arbitration, instead of the law ordinarily applicable to those matters under the general arbitration regime of that State.

Article V NYC

The situation is not equally accommodating at the post-award stage. Article V NYC contains a closed list of grounds that can be invoked to refuse the recognition and enforcement of a foreign arbitral award. This includes the loss of capacity of the insolvent party or the invalidity and ineffectiveness of the arbitration agreement (Article V.1.a), exceeding the scope of the arbitration agreement (Article V.1.c), the inarbitrability of the dispute (Article V.2.a), or the violation of public policy (Article V.2.b). Unlike Article II NYC, the grounds in Article V NYC contain prescribed choice-of-law rules. The capacity of the parties is defined by their personal law; the arbitration agreement is governed by the law chosen by the parties or, failing any indication thereon, by the law of the seat; and the arbitrability of the dispute and the relevant notions of public policy are prescribed by the law of the forum.

With the exception of capacity (as illustrated in *Vivendi v Elektrim*, Swiss Federal Tribunal, 4A_428/2008, 31 March 2009), none of these applicable laws will ordinarily point toward the *lex fori concursus*. Therefore, under the last proposal of WG V, a court that is presented with a request to recognise and enforce a foreign award that has not followed the *lex fori concursus* would face the dilemma whether to apply the *lex fori concursus* (as proposed by WG V) or to follow the different laws applicable under the grounds listed in Article V NYC, which in some States might be considered as hierarchically superior due to the fact that the NYC is an international treaty.

If none of the laws under Article V NYC prevented the continuation of the arbitration, the only option to impede the effectiveness of the foreign award would be to invoke a breach of public policy under Article V(2)(b) NYC. Sometimes, this will permit the refusal of the recognition as well as the enforcement of the award issued in violation of the *lex fori concursus*. Other times, however, the refusal will only concern the enforcement of the award, but not its recognition. That is, it is only the patrimonial diminution of the insolvent estate that is protected by the principle of *par conditio creditorum*. However, the mere invocation of an award for recognition purposes (even if it breached the *lex fori concursus*) might not violate public policy.

This is not a novel concept. In *Elektrim v Vivendi*, the Polish courts accepted the recognition of a LCIA award issued in England against a Polish insolvent party despite the prohibition to arbitrate

provided by Polish law. In an unpublished decision dated 16 November 2009, the Polish Court of Appeal found that the breach of that prohibition did not violate Polish public policy insofar the award creditor filed the award with the insolvency court to join the queue of creditors. Much more recently, the French Cour de Cassation has decided in Cass. Civ. 15 May 2024, no. 23-11.012 that the continuation of arbitration despite a stay mandated by the insolvency forum might not violate the public policy of the *lex fori concursus* if ultimately the award creditor submits the award before the insolvency court for recognition (as opposed to enforcement). A similar decision had been issued by the French Cour de Cassation in Cass. Civ. 12 November 2020, no. 19-18.849, accepting the recognition of a Swiss arbitration award in French insolvency proceedings despite the breach of the French rules on stay.

These cases exemplify that Document A/CN.9/1169, para. 65, is not entirely reflective of practice when it suggests that:

"(a) in some jurisdictions, the arbitral award resulting from the arbitral proceedings commenced or continued in disregard of the stay of proceedings imposed under the lex fori concursus *would be considered void; (b) in some places of arbitration, such an award would be annulled by the court under the domestic public policy; (c) in other jurisdictions, such an award might be set aside or not recognized and enforced by invoking the public policy or other exception under the New York Convention or other applicable framework; and (d) the arbitral tribunal's disregard of mandatory conflicts of law provisions imposed under insolvency law might lead to the same results*."

Contrary to these partial suggestions (which might be correct in some jurisdictions, but certainly not in others), the mentioned cases confirm that, while the enforcement of an award against an insolvent party is indeed highly improbable, the NYC will not be sufficient to guarantee the application of the *lex fori concursus* by arbitral tribunals or national courts acting in an arbitration context. That is, WG V would be proposing a choice-of-law rule that would be difficult to apply globally and whose breach would be incorrigible in many instances. The same might occur under equivalent regimes on the setting aside of awards, including Article 34 of the UNCITRAL Model Law on International Commercial Arbitration or Article IX of the 1961 European Convention on International Commercial Arbitration, which might impede the annulment of an award issued in breach of the stay mandated by a foreign *lex fori concursus*.

Importantly, the same incompatibility of regimes would exist between the last proposal of WG V in favour of the *lex fori concursus* and Article 9 of the 2005 Hague Convention on Choice of Court Agreements, which contains a closed list of grounds to refuse the enforcement of judgments derived from exclusive choice of court agreements similar to Article V NYC. This is relevant in light of the fact that WG V has recognised that the starting point should be that the law governing the effects of insolvency are the same for arbitration and for court proceedings (see A/CN.9/1169, para. 67).

Conclusion

To conclude, a choice-of-law rule that seeks to impose the *lex fori concursus* to determine the effects of insolvency in every arbitration and court proceeding involving the insolvent party regardless of their status at the time of the opening of the insolvency is seriously misguided. While apparently justified by legitimate universalist ideals, the motivations provided by WG V are flawed

and would give rise to serious practical problems. The application of the *lex fori concursus* to pending individual proceedings would permit abusive recourse to insolvency proceedings to boycott pending arbitrations and lawsuits; it would clash with the regime introduced by Article 20 UMLCBI; and it would be incompatible with some of the key provisions of the NYC (and equivalent rules of the 2005 Hague Convention).

In contrast with this clash, a choice-of-law rule that subjected the effects of insolvency on pending arbitrations to the *lex loci arbitri* (and the *lex fori* for pending litigation) would align the applicable laws under the insolvency and arbitration choice-of-law rules in the vast majority of cases. Meanwhile, it would still allow for a stay to operate under the *lex loci arbitri* (e.g., if mandated by Article 20 UMLCBI) and would prevent the enforcement of awards against insolvent parties under the public policy exception (Article V(2)(b) NYC) to protect the substantive facet of *par conditio creditorum*.

For these reasons, WG V is invited to return to the original choice-of-law rule which, subject to the amendments suggested in previous posts [here and here], recognised an exception in favour of the *lex loci arbitri* to govern the effects of insolvency in pending arbitration proceedings and the *lex fori* for pending litigation.

This entry was posted on Tuesday, November 26th, 2024 at 8:25 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.