

# Global Markets Carry International Recovery Challenges

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**B**usinesses have always had to ascertain the financial viability of customers to whom they were providing services or products in their own jurisdictions. In considering a decision to extend credit, businesses researched and determined the remedies and alternatives available in the event a customer defaulted.

This evaluation process has expanded dramatically as globalization has emerged. Doing business with customers in a number of jurisdictions greatly enhances the potential for increased sales and profitability, but has also resulted in increased risk if an international customer becomes insolvent or refuses to pay.

The ability to determine and assess the legal risks in a number of foreign jurisdictions in the past was difficult or unascertainable. For a number of years no readily available resolution was feasible because businesses would have to investigate the processes for recovering funds in a number of diverse jurisdictions, all at additional expense and with the possibility of little or no recovery. Substantial progress has been made in addressing these issues in the last 20 years. This article identifies

problems that can result in international recovery efforts and recommends how to address those issues.

## The Importance of COMI

The difficulty in addressing international cross-border issues is for a business to determine the scope and extent of the legal issues that must be addressed and to understand those issues well enough to make an economic determination as to what course of action, if any, should be taken.

As a hypothetical scenario for this article, a U.S. business provides products to a customer who operates in France, Germany, Italy, Mexico, and the United Kingdom. The business extends credit, does not have a security interest, and has shipped goods on open account to the customer in each of the jurisdictions in which it operates. The outstanding balance due to the U.S. business is \$500,000, which represents products shipped to each of the customer's five locations.

The initial issue to be addressed is the development of a game plan to recover the outstanding balance due from the customer. The insolvency laws in each of the jurisdictions involved must

be considered, but more importantly a determination must be made as to where the centre of main interest (COMI) of the customer is located.

The concept of COMI was first introduced in the development of the Insolvency Regulations by the European Union. The United Nations Commission on Trade Law (UNCITRAL) recognized COMI as an essential element in the development of The Model Law on Cross-Border Insolvency. The Insolvency Regulations promulgated by the EU control insolvency proceedings between its member states, while the Model Law has been adopted by more than 20 nations, including Australia, Canada, Colombia, Japan, Mexico, the United Kingdom, and the United States.

A determination of COMI is necessary when a debtor is operating in multiple jurisdictions and becomes insolvent. Both the European Insolvency Regulation and the Model Law, while not providing a definition of COMI, set forth a rebuttable presumption that the COMI of a debtor operating in multiple jurisdictions is the location in which the company was incorporated

continued on page 6

and maintains its registered office. The presumption can be overturned if evidence establishes that the principal operations of the debtor are conducted in a jurisdiction other than the place of incorporation.

The COMI of the debtor is important because once the location is determined, the insolvency laws of that jurisdiction control the insolvency proceeding in that jurisdiction, which is designated as the main proceeding for purposes of liquidation and distribution to creditors. All other jurisdictions in which the debtor conducts operations are ancillary or secondary. The COMI of the debtor can greatly alter the ability of creditors to recover balances due to them based on the laws of the jurisdiction.

A review of potential results based on where the customer's COMI is determined to be in the hypothetical scenario follows.

**Germany.** German law provides for the legal concept of retention of title (ROT). Under German ROT law, when a product is sold by a business to a debtor, title of the product remains with the seller until the product is paid for in full. If Germany was the COMI of the debtor in the hypothetical scenario, then a German insolvency court would apply ROT to all of the unsold products of the debtor, and the seller would maintain a lien for the balance due until it was fully paid. ROT is recognized by both civil and insolvency proceedings in Germany.

Under the insolvency regulations of the EU, if an EU country opens an insolvency proceeding and determines that Germany is the COMI of the debtor, then all other EU countries are bound by that law and ruling. The operations in France, Italy, and United Kingdom in the hypothetical scenario would be ancillary.

**Mexico.** If Mexico were the COMI of the debtor, then a very different result could occur. Mexico has constitutional laws that protect employees and funds due to them. In fact, the Mexican Constitution provides for basic protections for workers that cannot be superseded by other laws, such as Mexican insolvency laws. In addition, if workers' obligations are not being paid, then the officers and directors of the business are subject to criminal charges for the company's failure to pay its workers. The obligation not only applies to current wages, but

also to any retirement benefits or any obligations related to their employment.

Unlike Germany, under Mexican law a business that provides goods and materials to a debtor on an open account is an unsecured creditor. As a result of their constitutional priority, workers with unpaid obligations have priority over unsecured creditors. While other countries would not be required to recognize Mexican law regarding the treatment of wage claims, if the primary assets, including accounts receivable, were being collected in Mexico, Mexican law would apply to the distribution of those assets. As a result, unsecured creditors might receive little or nothing after payments to priority wage claimants and secured creditors.

**France.** If France were the COMI of the debtor, then a result different from either Germany or Mexico could occur. A French court would first focus on the continuation of the operations of the company; second, on what is in the best interest of the debtor's workers; and last, on what is in the best interest of creditors. Under French insolvency law, the ultimate sale or liquidation of a company does not occur by a plan or ballot, but when a French judge makes the determination based on those priorities.

So if a request to purchase the debtor's obligations that provides for payment to the workers and a continuation of the business but little or no payments to the creditors is filed with a French court, there is a strong probability that the request will be granted. Further complicating the process, French insolvency proceedings normally take 10 to 12 years.

**Italy.** A result similar to France would occur in Italy, except that preferential or fraudulent conveyance actions can be maintained in Italy based on actions that occurred seven or eight years prior to insolvency. That generates substantial litigation against companies that receive payments over whether or not those payments were preferential or fraudulent.

**United Kingdom.** Many of the U.K.'s insolvency procedures resemble those in the U.S. The U.K. favors and allows restructuring of a debtor's financial obligations and, in contrast to Mexico, has a preference for wages due and owing for 90 days prior to the filing of the insolvency proceeding. Thus, a debtor whose COMI is in the U.K. and that can

continue operations by restructuring its debt would be in a jurisdiction that favors creditors and would not require liquidation in all matters. If the business is concerned with continued operations of the debtor to generate future business, then a jurisdiction such as the U.K. could be favorable to the business.

## Opening of Insolvency Proceedings

The determination of COMI often occurs with the opening of an insolvency proceeding or shortly thereafter. Insolvency proceedings are opened at different times, depending on the jurisdiction involved. In the United States, the insolvency proceeding is generally opened the same day a case is filed. In Europe and other jurisdictions, the filing by the debtor of an insolvency proceeding does not trigger the opening of the proceeding. In many jurisdictions, the courts first must carefully review and analyze all of the filings by the debtor to determine if the opening of an insolvency proceeding is proper. This process often takes months.

During that time, in many jurisdictions outside the United States, as a general rule, no notification to unsecured creditors is given that the debtor has, in fact, filed insolvency proceedings. This can result in additional unpaid obligations when a business advances products or services to a debtor, not knowing that the debtor already has filed an insolvency proceeding.

A classic example is the *Parmalat* case, which involved billions of dollars of trade debt. Parmalat operated in Italy and was the "Enron" of Europe. Parmalat was a special administrative proceeding in Italy, where an insolvency liquidator was appointed under the control of the Italian government.

However, Bank of America had provided substantial funding to Parmalat through an Irish entity called EuroFoods. The bank filed an involuntary proceeding against EuroFoods in Ireland and requested an emergency hearing to have an insolvency representative appointed. During the initial hearing, an insolvency representative was appointed in Ireland with a determination that the COMI of EuroFoods was in Ireland.

The insolvency representative in Italy intervened and challenged those rulings. During the same time period,

the Italian insolvency representative placed EuroFoods into insolvency in Italy, and the Italian court determined that Italy was the COMI of EuroFoods. The European Court of Justice has jurisdiction to decide commercial disputes between EU member countries and accepted and reviewed the issues in regard to EuroFoods.

The European Court of Justice determined that because EuroFoods was opened first in Ireland, that determination was controlling. Italy was bound by that determination, and Irish law, rather than Italian law, applied. The preference and fraudulent conveyance law is much shorter in Ireland than in Italy, so Bank of America received a substantial benefit by the European Court of Justice decision.

Thus, if creditors have an interest in the determination of COMI, those issues must be addressed promptly, and creditor participation must be prevalent in the initial COMI determination or adverse results can occur.

As a further consideration, many countries do not have restructuring laws like the United States does and, therefore, the only option available to debtors and creditors in those countries is liquidation. Secured creditors often would prefer a jurisdiction in which liquidation occurs, as long as their liens and priorities are recognized so they can be paid.

Under the hypothetical scenario, France would not be a jurisdiction in which a secured creditor would prefer to have an insolvency proceeding pending. For businesses that rely on ongoing business to recover losses, the filing of an insolvency proceeding in a jurisdiction that allows restructuring would be of substantial importance to the unsecured creditor.

Litigation over COMI can be extensive and costly, and the ultimate outcome is often unpredictable. In the United States and other jurisdictions, the general experience is that COMI is generally well-recognized and, therefore, more than 90 percent of business insolvency proceedings do not involve a COMI dispute. In the event of a dispute in the EU, one of the main factors in determining COMI is the location that is recognizable by third parties as to where the debtor was conducting its primary business operations.

Substantial work has been undertaken at UNCITRAL to clarify issues to be considered in addressing COMI and to provide instructive clarification as to the legislative intent, background, and explanation regarding how the Model Law should be interpreted. UNCITRAL has developed a substantial revision to the Guide to Enactment, the explanatory guide to the Model Law, which includes recommendations regarding the primary factors to be used in determining the COMI of a debtor.

Those factors include determination of the location in which the debtor is conducting its principal business, as ascertainable by third parties, the same standard used by the EU in its insolvency regulations determining COMI. A second factor to be considered is where the principal operations and management of the debtor are being conducted. The revised Guide to Enactment provides that courts can look at other factors as set forth in case law, but the two primary factors should be considered as a basis for any COMI determination.

The EU is in the process of updating its insolvency regulations and has also proposed many substantial changes to address COMI and the determination of a debtor's COMI. These changes have established procedures that are more definitive and predictable for creditors in dealing with a debtor in international cross-border trade.

### Resolving Cross-Border Trade Matters

Having defined some of the problems in addressing international recovery issues, a look at potential ways in which resolutions can be effectuated is in order.

Prior to an initial business transaction, a company should obtain basic background information on a potential customer that operates internationally. One aspect is determining where the business is located and incorporated and obtaining supporting documentation for that finding. An additional aspect is to determine where the COMI of the debtor is by determining the location of the primary administration of the debtor, as ascertainable by third parties.

Due diligence may be required in regard to these issues, such as reviewing the debtor's website, looking at its billing and collection functions, and reviewing a number of other factors to determine the primary location in which the debtor's operations take

place. Obtaining this information at the outset allows a business to determine if it wants to engage in business with this entity and what issues it may confront if the customer becomes insolvent, depending on the location of the COMI.

As the business relationship continues, the same determination should be made annually to ascertain whether the COMI of the debtor has changed. Under both the European Union Regulations and the Model Law, the COMI of the debtor is to be determined upon the opening of the insolvency proceedings. Thus, if a debtor has changed locations, the COMI can change as part of that process, which could substantially modify the resulting treatment of the business if insolvency occurs.

### Role of a Gatekeeper

Over the past several years, a function known as a gatekeeper has emerged. A gatekeeper should be an individual who is experienced and has been engaged in cross-border insolvency proceedings for some time and who, in addition, has reliable contacts in numerous jurisdictions.

In cross-border insolvency proceedings, a gatekeeper enlists knowledgeable counsel from the different jurisdictions involved to determine the effect of each jurisdiction's insolvency law on the potential recovery by the business. The gatekeeper also establishes and coordinates specific directions as to the scope of work to be performed by professionals retained in different jurisdictions and establishes budgets for review and approval by the business.

In addition, the gatekeeper can assist in coordinating activities so that actions taken in one country are not detrimental in another country, which would either extinguish or substantially reduce recovery by the creditor if the COMI actually is determined to be in another jurisdiction. As an overall coordinator, the gatekeeper can be efficient, effective, and informative so that the business can make appropriate determinations and weigh its risk to determine what actions, if any, it wants to undertake to attempt to recover outstanding debt obligations.

The gatekeeper generally conducts on a three-phase process. Phase one is the initial review in coordination with the business of what jurisdictions are involved and what initial issues need to be reviewed. Phase two involves coordination with foreign counsel

to determine the likely results with regard to the debtor under each of the insolvency regimes in which insolvency proceedings could occur. Phase three is the development of a plan and course of action based on the results from phases one and two if the business elects to proceed.

If the insolvency proceedings involve fraud and the transfer of assets to other jurisdictions, the key is to obtain the services of knowledgeable and experienced experts in the field. Otherwise, the costs stemming from the selection of an individual with little or no experience in the process can be substantial. The International Chamber of Commerce FraudNet is an organization of experts involved in fraud and asset recovery. Various industries' trade associations also may prove to be excellent sources for information regarding financially troubled customers.

Unsecured creditors can band together to hire a gatekeeper to act collectively on their behalf to reduce the overall costs of the proceedings. Conflict rules must be carefully addressed, however, because individual creditors may have different exposure to preference



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or fraudulent issues that need to be addressed as part of the engagement.

### Realistic Evaluation

International trade generates additional considerations that must be addressed when a customer becomes insolvent or ceases paying its bills and obligations. A clear understanding of the issues and the respective laws of the jurisdictions involved must be developed, and then a plan for effectuating recovery must be executed. Often, a gatekeeper

who is efficient, knowledgeable, and cost-effective can help.

In each international recovery action, the business must make an economic determination after being properly informed as to what is reasonably feasible, given all of the facts and circumstances. Such a process can enhance recovery, but more importantly can provide a realistic evaluation for the business to determine what course of action, if any, it wants to pursue. ■