6(18)

EEC DRAFT CONVENTION ON BANKRUPTCY

Explanatory Note on Section 6 - Preferential & Secured Creditors

1. The following notes cover our understanding of the meaning and effect of Articles 40-46 inclusive of the draft convention. The issues involved are some of the most important and far reaching and the general approach and concepts, at least for the original Six Member States, vary considerably from those obtaining within the United Kingdom.

2. These Articles refer to general and special preferences and also to secured rights and possessory liens. Our understanding is that general rights of preference comprehend the following matters:-

Costs of liquidation
Funeral costs/Court costs
Liquidators' costs
Food for the last six months
School fees

in addition to the more important items of salaries and wages.

We understand that fiscal debts, social security debts and similar matters akin to taxes are also general preferences but as will be seen are treated separately from what our Continental colleagues call civil and commercial debts some of which I have listed above. The distinction may correspond roughly with that between private and public debts. General preferences attach to the whole estate of a debtor and must be satisfied before unsecured creditors are paid.

Special rights of preference are included in our concept of secured rights and whereas we in the UK draw a fairly clear distinction between preferential rights and secured rights our Continental colleagues tend to look upon all prior claims to assets

as "preference". Special preferences or secured rights attach to specific property and the creditor is entitled to be paid out of the proceeds of the sale of the sale of that property before any other creditor. If the proceeds are insufficient to discharge his claim then he is treated as an unsecured creditor for the balance. Differences do exist in the law of the original Six Member States both as regards the ranking of general preferences inter se and their ranking as against special preferences and it was not found possible to establish one common order of ranking into which the general and special preferences in the Community could be fitted. Because of the differing laws the experts adopted an accounting concept of sub-groups to counter-balance as far as possible inequality of treatment of creditors inside the Community and which will also permit further harmonisation as the Community develops. They found it was necessary to draw a distinction between general preferences in favour of the fiscal and State authorities and those relating to wages and the like (civil and commercial).

3. The original Six Member States commissioned an analysis of the law by Professor Sauveplanne of the University of Utrecht who suggested that:-

(a) for general preferences the law of the State in which the bankruptcy was opened should apply; and

(b) with regard to special preferences the applicable law (subject to a few exceptions) should be the lex situs.

The group of experts after examination considered that Professor Sauveplanne's proposals could not be implemented until such time as the laws of all the Member States, so far as preferences were concerned, were extensively harmonised. As such a harmonisation could not be achieved within a reasonable time scale the group decided that for the present preferences should be governed by the lex situs. This inroad into the unity of bankruptcy they counter-balanced by providing rules which enable general preferences other

than those concerned with indebtedness to the State, to have effect in all the States in which realisable property is situated.

4. To this end Article 40 provides that in civil and commercial matters creditors may claim those general preferences provided by the law of the State in which particular property is located. For example if the bankruptcy is opened in one State and there are assets and possibly employees' claims for wages in two other States then the employee creditors in all three States may claim that their wages be treated as preferential in each of the three States.

Article 41 determines which law is to apply for general preferences in civil and commercial matters and gives rules as to distribution and para 1 of that Article provides that the subject matter, extent and ranking of general preferences shall be determined by the law of the contracting State in which the assets were situated on the day when the bankruptcy was opened. Assets located in a non-Community State will be aggregated with those in the State in which the bankruptcy was opened.

The liquidator will, solely for purposes of account and subsequent distribution, have to establish sub-groups of assets and paras 2 and 3 of Article 41 give the rules for this purpose. The group of experts decided that as regards fiscal and social security and similar State debts the preferential rights attaching to such debts should be exercisable only in the contracting State in which the indebtedness arises. They are thus limited territorialy.

Article 43(1) provides that the applicable law for special preferences, secured rights and possessory liens shall be the law of the contracting State in which the property charged was situated (lex situs) at the date that the bankruptcy was opened.

Article 43(2) provides that secured rights over ships, aircraft and land vehicles shall be governed by the law of the State in which the property is registered.

Article 43(3) provides that the applicable law for possessory liens shall again be the lex situs.

Article 44 provides that the order of ranking between general and special preferences shall be determined by the law of the contracting State where the property is situated (lex situs).

Article 45 gives a rule for determining where certain movable property shall be deemed to be situated.

Article 46 provides rules where bankruptcy supersedes an earlier analogous proceeding.

5. It is clear from the foregoing that where a bankruptcy is opened in a contracting State in general the law of that State governs the distribution of assets in that State. The major exception being that in calculating a State's contribution to civil and commercial general preferences - the most important being claims for wages - they be included at the amount allowed in a particular State which gives the highest claim. So far as secured claims are concerned their rights are determined by the law of the State where the property is situated (lex situs) and this follows, I understand, the general principles of private international law. The solutions proposed are not simple and easy to apply because complications arise from the need to calculate the accounting position of various sub-groups.

When the proposals in Articles 40-46 were explained to us it appeared that so far as workers claims were concerned Article 41 (2) and (3) meant that the claims were to be effective in each Member State in proportion to the amount standing to the credit of each sub-group. This clearly gives a rule based on the ability of each of the sub-groups to pay the general preferences and ignores the amount of the obligation due by each sub-group and in certain instances it would see that this could produce an unfair result. Alternative methods of dealing with this problem are as follows:-

(1) as proposed in the draft convention in proportion to the balance on each sub-group estate; (see examples 1, 2and 3 post)

(2) in proportion to the liabilities of each sub-group estate according to the maximum allowed by the laws of that contracting State; (see examples 4, 5, 6, 7 and 8)

(3) by construing Article 41(3) strictly and making the proportion in accordance with the assets available by the law of the particular State to meet the obligation. This is similar to (2) above but has regard to the quantum of assets available (see examples 9 and 10).

(4) by taking into account both the availability of assets and the obligations. This could be done by making the proportion that given by the product of the two variables and this method gives due weight to both items assets and obligations (see examples 11, 12, 13, 14 and 15).

In all these methods if there is an insuffidency in any one sub-group then that shortfall is provided by the States able to contribute in the proportions applicable to each method.

6. The whole problem of preferences produces peculiar difficulties for the UK. In general the UK liquidators admit the claims of all wage-earners whether or not they come from States which are able to contribute assets. Fiscal or State debts could be higher, equal to or lower in ranking than other general preferences, some States have pre-preferential ranking for wages, others seem to have power to seize assets to meet fiscal debts. The limits as to time and amount allowed for wage earners' preferential claims vary widely from State to State and we have been conscious of possible unfairness where the law allows workers rights to be subrogated to, for instance, banks or State Agencies who provide money at a time of insolvency, particularly as often the wage earners are quite unaware that money is being advanced for that purpose. Finally for the UK we have the problem of floating charges, (a concept not widely understood or recognised on the Continent) where the security is postponed to the rights of preferential creditors.

7. To assist consideration of the different methods available for dealing with the sub-groups and their contributions, Mr Armstrong has prepared a series of calculations designed to show the different effects produced by each method and these calculations follow in this paper.

Insolvency Service
June 1974

1.

	A		B		C		TOTAL
Available Assets	7,000		1,000		2,000		10,000
Salaries	900	1,800		3,600		3,600	
1st distribution (7/10)		(1/10)	360	(1/5)	720	1,980	
Limited to 900							
Available Assets	---		640		1,280	1,620	1,920
		($\frac{1}{3}$)	540	($\frac{2}{3}$)	1,080	1,620	
			100		200	---	

In this example, it can be seen that the contribution from State A is 900 units, being the maximum which that State allows, whereas States B and C contribute 900 and 1,800, respectively, which is only half of their respective maximums allowed.

2. This position can be high-lighted by taking another example as follows:-

	A		B		C		TOTAL
Available Assets	7,000		7,000		7,000		21,000
Salaries	900	1,800		3,600		3,600	
1st Distribution ($\frac{1}{3}$)		($\frac{1}{3}$)	1,200	($\frac{1}{3}$)	1,200	3,300	
Limited to 900							
	-		5,800		5,800		11,600
2nd Distribution		($\frac{1}{2}$)	150	($\frac{1}{2}$)	150	300	
			5,650		5,650	---	

State A still contributes its maximum of 900; State B contributes 1,350 units, being 75% of its maximum, and State C contributes 1,350 units, being only 37.5% of its maximum, despite the fact that the available assets were equal in all three States.

3. The relative contributions are important because they affect the amount of assets remaining in a sub-group which could affect the extent to which fiscal debts are paid if they are of lower priority than salaries, as shown in the following example:-

	A	B	C	TOTAL
1st Salaries	900	1,800	3,600	
2nd Fiscal debts	6,000	6,000	6,000	
Available assets	6,500	6,500	6,500	19,500
Salaries 900		1,800	3,600	3,600
1st Distribution ($\frac{1}{3}$) Limited to	900	($\frac{1}{3}$) 1,200	($\frac{1}{3}$) 1,200	3,300
	5,600	5,300	5,300	300
2nd Distribution		($\frac{1}{2}$) 150	($\frac{1}{2}$) 150	300
		5,150	5,150	---
Fisc. on Account	5,600	5,150	5,150	

Because State A was obliged to contribute its maximum allowance of 900 units for salaries, its fiscal debts could not be paid in full, whereas had it merely contributed a proportion as in State B (75%) or State C (37.5%), there would have been more assets available for its fiscal debts, which presumably was the intention of its legislature.

4. In an effort to arrive at a more consistently equitable method of calculating the proportionate contributions for salaries, it may be necessary to define more precisely what is meant by "available assets". Irrespective of the total assets remaining in any sub-group at the particular stage, eg when the salary calculation has to be made, the available assets in any sub-group can never be more than those required to meet the maximum preferential claim allowed in that particular State.

5. If the calculation is based on this revised definition of "available assets", the previous examples can be re-worked as follows:-

	A	B	C	Total paid to salaries
Total Remaining Assets	7,000	1,000	2,000	
Available Assets being maximum salaries claim	900	1,800	3,600	
1st Distribution				
A $\frac{900}{6300} \times 3600$	514			514
B $\frac{1800}{6300} \times 3600$		1,028		
Limited to		1,000		1,000
C $\frac{3600}{6300} \times 3600$			2,056	
Limited to			2,000	2,000
	386			3,514
2nd Distribution	86			86
	300			3,600

OR

	A	B	C
Total Remaining Assets	7,000	1,000	2,000
Available Assets being Maximum salaries claim	900	1,800	3,600
1st Distribution limited to (1/7)	514	(2/7) 1,028	(4/7) 2,056
	386	- 28	- 56
2nd Distribution	86	28	56
	300		

In this re-worked example, State A contributes 600 units, being 66% of its maximum allowed; State B contributes 1,000 units, being 55% of its maximum and State C contributes 2,000, being 55% of its maximum, as compared with 100%; 50% and 50% respectively under the earlier method.

6. Re-working the second example gives the following result:-

		A		B		C	TOTAL
Total Remaining Assets		7,000		7,000		7,000	
Available Assets being amount of maximum salaries claim		900		1,800		3,600	6,300
1st Distribution	(1/7)	514	(2/7)	1,028	(4/7)	2,058	3,600
		386		772		1,542	2,700

State A contributes 57% of its maximum, State B 57% and State C 57% compared with 100%; 75% and 37.5%, respectively, under the earlier method.

7. Re-working the third example gives the following result:-

		A		B		C	TOTAL
1st Salaries		900		1,800		3,600	
2nd Fiscal debts		6,000		6,000		6,000	
Total Remaining Assets		6,500		6,500		6,500	19,500
Available Assets	900		1,800		3,600	6,300	
1st Distribution (1/7)	514	(2/7)	1,028	(4/7)	2,058	3,600	3,600
		386		772		1,542	
		5,986		5,472		4,442	15,900
Fiscal debts on account		5,986		5,472		4,442	15,900

Because State A only contributed 57% of its maximum allowable salary claim instead of 100% under the earlier method, it can now pay 5,986 units to its fiscal creditors instead of 5,600 units. Similarly, because State B contributed only 57% instead of 75% under the earlier method,

its fiscal creditors receive 5,472 units instead of only 5,150. State C, on the other hand, which allows the highest salary claim in priority to fiscal debts, in fact only pays its fiscal creditors 4,442 units instead of 5,150 units under the earlier method.

8. This result seems to be more in keeping with the intention of the legislature of the respective member States, namely that State C which allows its employees greater preferential rights should do so at the expense of its own fiscal debts if they are of next rank in priority, and not at the expense of the fiscal debts of the other member States.

9. The disadvantage of this method of calculation is shown in the first re-worked example where the amount of the calculated contribution exceeds the actual assets available and, therefore, requires calculations for second and perhaps subsequent distribution. As a practical way of avoiding this, and therefore simplifying the calculation, available assets can be defined as the maximum amount required to meet the particular preferential class of claims or the actual assets available in each subgroup whichever is the less.

10. The first example can be re-worked in this way as follows:-

	A	B	C	TOTAL
Total Remaining Assets	7,000	1,000	2,000	10,000
Salaries	900	1,800	3,600	
Available Assets	900	1,000	2,000	3,900
1st Distribution	(9/39) 831	(10/39) 923	(20/39) 1,846	3,600

This method which applies only where the available assets in any subgroup are less than the maximum allowable preferential claim suffers from the same disadvantage, although to a lesser extent, as the method at present laid down in the draft Convention, namely State A contributes 92% of its maximum allowable claim whereas States B and C contribute only 51%.

11. Another method of calculation can be used which will take into account both the total available assets in the sub-groups (as used in the method adopted in the draft Convention at present) and the maximum claim allowed by each State. It will be necessary firstly to multiply the amount of available assets in each sub-group by the maximum claim allowed in each particular State respectively. The contribution from each sub-group can then be calculated in proportion to these products.

12. The previous examples if worked out according to this method show the following results:

	A		B		C		Total
Available Assets		7,000		1,000		2,000	
Salaries	900		1,800		3,600		
Product	630,000		180,000		7,200,000		
	63		18		720		801
1st Distribution	(63/801)	283	(18/801)	81	(720/801)	3,236	
		6,717		919		- 1.236	
2nd Distribution (63/81) Limited to		617	Balance	619		1,236	
		6,000		300		---	

In this re-worked example the contributions from the three States as compared with their contributions under the earlier methods are:-

	1st Method		2nd Method		3rd Method		4th Method	
State A	900	100%	600	66%	831	92%	900	100%
" B	1,350	75%	1,000	55%	923	51%	700	39%
" C	1,350	37.5%	2,000	55%	1,846	51%	2,000	55%

13. Re-working the second example gives the following results:-

		A		B		C	Total
Available Assets		7,000		7,000		7,000	21,000
Salaries	900		1,800		3,600		
Product	6,300,000		12,600,000		25,200,000		
	63		126		252		
	1		2		4		
1st Distribution	(1/7)	514		1,028		2,058	3,600
		6,486		5,972		4,942	17,400

This gives exactly the same result as the second and third methods, because the available assets are the same in all three States.

14. To draw any conclusions between this method and the other methods an example must be taken where the available assets are different in the three States, although still sufficient to pay the calculated contribution in full, viz:-

		A		B		C		Total
Available Assets		1,000		2,000		6,000		9,000
Salaries	900		1,800		3,600			
Product	900,000		3,600,000		21,600,000			
	9		36		216			
	1		4		24		29	
1st Distribution	(1/29)	124	(4/29)	497	(24/29)	2,979		3,600
		876		1,503		3,021		5,400

In this example State A contributes 14% of its maximum allowed claim; State B contributes 28% and State C contributes 83%, reflecting the position that the maximum assets and maximum liability were in State C. This is a similar relative position as would have resulted from using the method at present in the draft Convention, but producing more extreme results.

15. It would appear under this method that except where the assets in all sub-groups are equal, the results are relatively similar to those achieved by the method in the present draft of the Convention, but are more extreme in that the contribution from the State where both the assets and obligations are smallest is very much reduced, whilst that from the State where both the assets and obligations are greatest is correspondingly increased.

6(1.9)

BANKRUPTCY CONVENTION

MEMO - 7. (26 Nov. 71)
Read with Memo 6
Memo 6A

Preferential debts - the attitude of the Commission and the authors of the Convention.

At the Conference, Dr. Hauschild on behalf of the Commission made the following contribution (Proceedings: pp. 250 to 251: M.H.'s translation)

"Another difficulty which the Committee (of Jurists) has not been able to surmount is that of the multiplicity of preferential and secured claims (privilèges et sûretés), all having different bases of assessments extents and preferential ranking.

In the Report of M. Noel and M. Lemontey the following passage appears on this subject (p.127) :-

'The Committee soon came to the conclusion that on this subject no solution based on conflict of laws is entirely satisfactory, and that the only real solution to the problem would consist in the unification of the rights of secured creditors, but the drafting of a uniform law of such a character, apart from the fact that it would go far beyond the Committee's terms of reference, would have entailed wholly unacceptable delays' (the passage is not at p. 127 of my copy of the Report, and I have not yet identified it in my copy: M.H.)

Faced with the necessity of finding a solution the Committee decided to subject the question of secured creditors and preferential rights to the law of the place where the assets were situated. Even if this solution is realistic because there is no means of improving on it for

the time being, it is neither simple nor practical, for it implies a decentralised distribution of the bankrupt's assets, such distribution to take place as a first phase in the national context and only in a second phase in the Community context.'

The imperfections of the draft on this point are self-evident. Its authors frankly admit this, while expressing the hope that a simpler solution may be found in a not too distant future. The only possible solution could lie in a diminution of the number of preferential rights, and the rendering of their basis, rank and scope more uniform.

One of the principal obstacles which presents itself to any initiative in this field is the existence of preferential rights for taxes. However, this obstacle is not unsurmountable, as has been demonstrated by the reforms now on foot in the Scandinavian countries. In Norway, for example, the law of 31st May 1963 has generally reduced the number of preferential debts. In particular they have abolished preferential rights for certain taxes. Under another head, the State preferences for taxes on capital, income and turnover are now restricted to the taxes accrue for the one year preceding the declaration of the bankrupt in place of the former period of three years.

In Norway, the reform of bankruptcy law seems to b tending in the direction of a total abolition of prefer rights for taxes. The arguments put forward in support such a measure are the following: Statistics demonstr that the existence of preferential rights for tax is great significance for the national revenue. Further

preferential rights do not significantly assist in the recovery of taxes by the Tax authorities. Finally, the losses sustained in bankruptcies are, under the current system, borne entirely by the creditors to the exclusion of the State, instead of being borne by society as a whole.

In Denmark, the laws No. 332 and 333 of 18th June 1969 have repealed a large number of preferential rights. Among these there have been abolished the preferential rights for taxes on income and on capital. Two events have facilitated this step. The first is the introduction from 1st January 1970 of the system of the deduction of taxes on wages and salaries at source by the employers. The second and more important factor is that during recent years the majority of those bankrupts who were not wage-earners, were no longer found to be substantially in arrear in respect of unpaid income tax. This explains the favourable attitude of thoseadministrations towards this reform. Other repeals of preferential rights in Denmark relate to the value-added tax, whose recovery has at the same time been facilitated.

The same is true in principle of import duties, for which since 1969 all preferential rights or securities have been abolished. The reduction or the elimination of certain of these duties has helped to render this measure feasible.

In Sweden, the elimination of preferential rights is also under study. But we do not at present know what solutions will be presented to that Government. The opposition to a total abolition of these preferential rights seems stronger in that country than in its neighbours. It is evident that the future studies by the Community institutions in this field will draw very much benefit from the experience of the Nordic countries."

PREFERENTIAL AND SECURED DEBTS

5.1. All insolvency codes, while founded on the general principle of rateable distribution of the insolvent's assets among his creditors, make to a greater or less extent two principal exceptions, with respect to secured debts and to preferential debts.

~~5.2.~~ In the case of secured debts, i.e. debts secured on the whole or part of the property of the bankrupt, these are in general not interfered with by the bankruptcy, so long as the creation of the security was not in itself a fraud upon or otherwise invalid as against the creditors; but there are exceptions to this general rule.

expand on exceptions

5.2. In the case of preferential debts, these are classified as such, and are made recoverable in priority to ordinary unsecured creditors, on grounds of public policy, in order either to benefit the public revenue or to fulfil other social objectives. Historically, the preferential debts system derives in the United Kingdom, firstly from the Crown's prerogative power to recover debts due to itself from its subjects for tax and other public obligations; by the executive power, later extended to municipal rates and taxes in one form or another, and secondly from a desire to ensure that the employees of a bankrupt employer are not left indigent by reason of the non-payment of arrears of wages unpaid when their employment ceased.

5.3. The preferential debts code, in its present-day form (which, with an important exception hereinafter

mentioned in para 5.6 below, is identical both for personal bankrupts and for companies in insolvent liquidation), as established by the Bankruptcy Acts and the Companies Acts of the U.K., is based upon two fundamental premises -

(1) that the Crown no longer possesses, in insolvency, any prerogative rights whatsoever, although it has certain privileges over other creditors;

(2) that all creditors on whom statutory rights of preference are conferred, including the Crown, rank pari passu with one another for priority payment out of the assets.

5.4. The Crown's privileges are (a) that in respect of taxes, although it is entitled to rank preferentially for only one year's tax (in respect of each category of tax), it may select for its preferential claim the "best year" out of the six years preceding the bankruptcy or the winding-up; (b) that if any assessment to tax made on the insolvent taxpayer, even if "arbitrary", (i.e. based on estimated assessments) has become final within the statutory tax code before the bankruptcy or winding-up, it cannot be challenged or re-opened by the trustee in bankruptcy or the liquidator as a matter of right, but only as a matter of administrative concession, differing in this respect from almost all other debts provable in insolvency; and (c) that it can enforce certain tax debts by means of committal to prison. (Debtors Act 1869, s.5)

5.5 The categories of debts to which preference is now accorded in the United Kingdom may be summarised as follows :

(1) taxes (maximum one year's arrears, but the "best year" can be selected);

(2) rates(not exceeding "last year's" arrears);

(3) P.A.Y.E., V.A.T., and analogous imposts (not exceeding "last year's" arrears);

(4) unpaid employees' wages (maximum of 4 months arrears of remuneration and holiday pay, not exceeding £200 in all per person);

(5) sundry other pecuniary obligations to public bodies which have power to levy charges for public purposes.

5.6. The difference between the personal bankruptcy code and the company liquidation code is that, under the latter code, persons who have advanced sums to the company out of which the employees have been paid remuneration, for which, if unpaid, the employees would have been entitled to preference, are themselves entitled to preference by an express statutory subrogation.* This statutory preference is not accorded by the Bankruptcy Acts, although isolated instances of "subrogation preferences" may occur.

5.7. As might be expected, the insolvency codes of the other States of the E.E.C. demonstrate many of the same characteristics as those of the U.K.; but certain

* C.A. 1948, s.319(4).

fundamental differences are to be noted, namely :

(1) in most States, preferential debts do not share the same rank of preference, but enjoy different rankings; there is also a greater variety of debts enjoying preferences than in the U.K.

(2) in some States, the State still possesses certain "prerogative rights" of recovering the debtor's obligations to it of a fiscal or quasi-fiscal nature, irrespective of the incidence of his bankruptcy or liquidation.

(3) in some States, preferential debts may constitute prior charges on the securities held by secured creditors. S.94.CA

(4) generally, State debts and "social obligations" are regarded as enjoying special privileges and protection on grounds of "public policy" ("ordre public"), or "social policy" ("ordre social") which confer ~~enjoy~~ on them a quasi-constitutional status.

5.8. It is the policy of the Convention not to inferfere with the basic internal bankruptcy laws of each State (see para. above); accordingly, the domestic preferential debts code of each State will in itself remain unchanged. The intended impact of the Convention's provisions is to be found in ~~three~~ four areas :

(1) all creditors entitled under the laws of their own State to preferential treatment shall be entitled (whether their State is "the State of the

Bankruptcy" or not) to enforce those preferential rights against the assets of the bankrupt situate within their own State: e.g. a preferential French creditor could enforce the preferential rights conferred on him by the French bankruptcy law against the assets in France, according to the ranking of his preference.

(2) all creditors are to be entitled to enforce, against any assets situate in a State other than their own, such preferential rights (if any) as are conferred on creditors of that class (other than creditors of a fiscal or quasi-fiscal character) by that State: e.g. an unpaid French employee could enforce such preferential rights as are conferred upon an unpaid German employee in Germany against the assets situate in Germany;

(3) all creditors are to be entitled to prove as creditors in the bankruptcy for such preferential rights of dividend or distribution as are conferred on creditors by the bankruptcy laws of the State of the bankruptcy.

(4) fiscal and quasi-fiscal debts are not to be permitted to enjoy such privileges of preferential recovery in any State other than in the State to which, or within which, those debts are owed. Any balance of those debts which the creditors to whom they are due have not succeeded in recovering

by the use of their prerogative rights of recovery in their own State will rank for proof in the bankruptcy, if in another State, but only as unsecured creditors (Article 42(1) and (2)).

5.9. The situation presented by paragraph 5.8(4), if carried into effect, will represent a fundamental change in that branch of private international law, which at present universally provides that the Courts of one State do not enforce the fiscal or quasi-fiscal obligations of a foreign state by process against the debtor or his property within their jurisdiction, whether directly by action or indirectly through a trustee in bankruptcy or a liquidator; in the case of the U.K., this rule applies even where the foreign State is a Dominion or other member of the British Commonwealth, and it also applies between ~~within~~ E.E.C. Member States. Under the Convention provision, sums due by a French debtor or a British debtor in respect of French income tax (or the balance after the exhaustion of French-located assets) could be proved for as an unsecured debt in their U.K. bankruptcies; similarly, sums due by a British debtor or a German debtor in respect of British income tax could be proved for as an unsecured debt in their German bankruptcies.

5.10. The views of readers are sought on the following questions: (1) whether the right of a State to prove for fiscal and quasi-fiscal debts "across frontiers" should

be allowed, and (2) whether the U.K. laws relating to the recovery of such debts should be extended so as to confer on the U.K. Government comparable procedures for "self-help" against U.K.-based assets of foreign-based debtors.

5.11. In this field, however, the fiscal and quasi-fiscal laws of the U.K. differ markedly from some other E.E.C. States. As already stated, the U.K. Government presently enjoys no prerogative rights of recovery of fiscal or quasi-fiscal debts in bankruptcy or insolvent winding-up. Accordingly, it will not, in the case of the bankruptcy in another State of a debtor indebted to it for fiscal or quasi-fiscal debts (who, by reason of the location of his centre of administration there, can only be made bankrupt there) be entitled to "self-help" out of the debtor's U.K.-based assets. The U.K. would seem, under the Convention on the Recognition of Bankruptcy / our present law, to be confined to proving as an unsecured creditor in that bankruptcy.

X

5.12. There is one exception to the proposition stated in the preceding paragraph, namely, where a company has granted a floating charge over its assets, registered (in England) under s.95, and (in Scotland) under s.106A et seq. of the Companies Act, 1948, (as amended by the Companies (Floating Charges) Scotland Act, 1961, or under the comparable Northern Irish Act. By virtue of the provisions of s.94 of the 1948 Act (for England) and of s.19 of the Companies (Floating Charges and Receivers) (Scotland) Act, 1972 (for

Scotland) and of the comparable Northern Irish Acts, where a receiver and manager is appointed under such a floating charge and the company is not in winding-up, the first monies recovered by him out of the assets bound by the charge (after defraying his charges, etc.) are to be applied in paying those debts which would be preferential in an insolvent winding-up. A similar prior charge over the assets is created in the case of an actual winding-up; but such a privilege could, under the present U.K. codes, only apply to a winding-up under the U.K. Companies Acts, and not to a foreign winding-up. No comparable prior charge exists in relation to the assets of personal bankrupts in the U.K.

floating charges not to be recognised within the E.E.C.

5.13. If there are to continue to exist, within the E.E.C., locally enforceable preferential debts which are to be enforceable against the locally-based assets of a bankrupt made bankrupt in another State, this will call for local administrations of the bankrupt's estate on an individual State basis, so that the local assets-pool can be identified and accounted for, and any balance remaining after local enforcement can be recovered by the trustee or liquidator. This concept and this procedure involves, of course, a species of "sub-liquidation" in each State where assets of the bankrupt are situated, and will require either a direct and fairly detailed multi-State administration by the trustee or liquidator appointed by the Courts of, or under the laws of, the State of the bankruptcy (whom we will call

"the central liquidator"), or the delegation of local sub-administrations to local "sub-liquidators", similarly appointed by the courts or under the laws of the State of the bankruptcy.

5.14. The Convention does not itself expressly legislate for the setting up of such sub-liquidations, or the appointment of sub-liquidators; In the Report, however, (at p.142 et seq) the term "sub-unit of assets" (French "sous-masse") has been coined to describe the localisation of the administration of assets so as to permit the local enforcement against, or the local distribution of, assets in the interests of local preferential creditors. In accordance with that concept, the provisions of Article 28 prescribing the powers of the (central) liquidator, and the appointment of more than one, possibly from among those qualified so to act in other States, would seem to contemplate the administrative procedure described in the preceding paragraph. It further appears from Article 41, and also from Article 42, that such sub-liquidations will be necessary, to deal both with the multi-State preferential claims permitted by the former Article, and with the local enforcement and recovery of fiscal and quasi-fiscal debts under the latter.

5.15. These questions (which raise questions of difficulty) are considered in more detail below, but as an initial step, readers are asked to express their views

as to the choice between the appointment of and administration by one central-liquidator solely or ~~of~~ a system of a central liquidator, assisted by sub-liquidators.

5.16. The advantages of the former would seem to be the possible reduction of administrative costs and remuneration, and of the latter the familiarity of a local sub-liquidator with the local law and practice in the recovery of assets, etc. The provisional view of the Committee is that the choice must vary with the scale and extent of the bankruptcy; in a complex, wide-ranging, administration, raising major points of local law in "foreign" States, the appointment of sub-liquidators would seem to be inescapable, whereas in a simple, though technically multi-State, bankruptcy, it would be unnecessary.

5.17. As has been indicated above (para. 5.8), it is the policy of the Convention that creditors entitled to preferential distribution, other than in respect of fiscal or quasi-fiscal debts, should be entitled to claim such preferential rights as are conferred on creditors of that preferential category in each of the States, subject only to the necessary precondition that there are some assets of the bankrupt located in that State. Before we examine the mechanism by which these rights are to be enforced, it should be pointed out that in the view of the Committee, the predominant creditor of this type will be the unpaid employee, to such extent that he is a preferential creditor either in respect of his arrears of wages, accrued holiday

Inconsistent with S.22(1)?

remuneration, or redundancy (or severance) pay. Under the U.K. insolvency codes, redundancy pay is a claim vested in the employee himself as against his employer; but should his employer become insolvent, he can recover from the appropriate department of state, which is then subrogated to the employee's rights in the employer's bankruptcy (Redundancy Payments Act, 1965, s.6), but not enjoying a preferential status. But it is understood that severance pay is a preferential debt in certain States either of the employee or of the State by subrogation, and that there may be a tendency for such rights to be extended, e.g. in Germany.

5.18. In the U.K., however, in the winding-up code, as already described (see para. 5.6. above) there already exists an extensive right of claim by subrogation in respect of advances made for the payments of wages (under s.319 (4) of the Companies Act, 1948). This right, although enacted in general terms, appears to be enjoyed almost exclusively by the bankers of companies, to whom credit for the payment of wages is extended, generally on a special "wages account", which conserves the maximum preferential employee's right to four months' pay, not exceeding £200, for which the bankers are entitled to claim preferentially in the winding-up. These sums may be of significant size, and with the possible exception of the Revenue, may constitute one of the largest individual debts, and the largest preferential debt.

5.19. It has been represented to the Committee that this subrogated right of preference is of great commercial importance, in that it ensures the continuance in operation of companies, by facilitating the protected advance of wages, the non-payment of which would result in the departure of the labour-force. It is, on the other hand, criticised by other classes of unsecured creditors as capable of creating a situation of "false credit", in that the company continues to trade (possibly for years) on borrowed money, which in a winding-up ranks preferentially ahead, e.g., of unpaid suppliers of goods, raw materials and services.

5.20. The significance of the system described in the foregoing paragraphs is that for practical purposes there are likely to be in a winding-up, ~~the~~ few unpaid employees, and certainly only for relatively trifling sums, for it is not thought likely that an employee would work for more than, say, two weeks without being paid. The "unpaid employee" problem must therefore for the purposes of the preferential debts code be confined in winding-up to the rights of the subrogated wages-lenders, although ~~he~~ the employee ~~has~~ retains his full rights in non-corporate trading entities.

5.21. The Report does not refer to the case of the subrogation of wages-lenders, nor does the Convention; the Convention, however, confers a considerable privilege on creditors for "debts arising from contracts of employment", in that Article 17(8) excludes disputes in relation thereto

more detailed information as to the real extent of the "unpaid employee" problem, both in other States and in the U.K., which it will endeavour to acquire; but the initial views of readers on the foregoing questions are nevertheless invited at this stage.

5.24. As has already been described above (para.), while the Convention is founded on the twin principles of unity and universality, exceptions have had to be made for certain classes of debts, namely fiscal and quasi-fiscal debts, social security debts and the debts arising out of contracts of employment just considered. By Article 17(8), disputes relating to debts generally are subjected to the exclusive jurisdiction of the courts of the State of the bankruptcy; but those excepted classes of debts are excluded from that universal jurisdiction, in relation to which Article 17(8) provides; "the courts or authorities normally having jurisdiction shall determine the existence and the amount of the debt and the extent of such preferential rights as it may enjoy." This exception to the universal jurisdiction appears to the Committee to give rise to a number of questions.

5.25. In a U.K. bankruptcy or winding-up, the trustee or liquidator has the general duty of determining, under the directions and by the adjudications of the Courts exercising bankruptcy or winding-up jurisdiction (of which courts he is deemed to be an officer), precisely those questions of the existence of amount and preferential states of debts. If, prior to the bankruptcy or winding-up

order, the debt has been established inter partes by the judgement of a court of competent jurisdiction; the trustee or liquidator will in general be bound by that judgement, (though not if it was a judgement by consent or one vitiated by collusion or fraud); as already mentioned (para 4. above), he also may be unable as a matter of right to disturb a finalised tax assessment. But in all other cases, i.e. of unadjudicated debts, he has the right to adjudicate, subject to appeal to his court; and that court has also, as a matter of fact and/or law, to determine whether and to what extent the debt, if and when established (as agreed or the subject of a judgement), enjoys preferential status: such preferences are in U.K. law strictly construed, and are not to be extended by implication or analogy, to the detriment of the general body of creditors.

5.26. The effect of Article 17(8) produces, in the case of the U.K., an anomalous situation; for once a bankruptcy or winding-up occurs, "the courts or authorities normally having jurisdiction to determine" the foregoing questions are the bankruptcy and winding-up courts; the only "authorities" which can be envisaged as referred to are the Inland Revenue or other quasi-judicial tribunals, but they can at the best determine the existence and amount of the debt, and not its preferential status, if any.

5.27. In order to comply with the policy of Article 17(8), the U.K. would therefore need to establish courts or authorities capable of determining, from the point of view of U.K. preferential creditors of the

Article 17(8) classes, and for the purpose of a "foreign" bankruptcy, the matters thereby left to their decision. The views of readers are invited on the form that such "courts or authorities" should take, and the nature and extent of the right of representation before them by or on behalf of the foreign trustee or liquidator.

5.28. It must, by parity of reasoning, follow that the existence, amount, and preferential status of those classes of debts, when owed by the debtor in or to other States, are to be conclusively determined by the appropriate courts or authorities in those states, for the purposes of the submission of proofs of debt (called, in Article 30, "claims") in respect of those debts in a U.K. bankruptcy or winding-up. Such "claims" are by Article 30(1) capable of being lodged by creditors informally in writing, stating the amount of the debt and whether or not it is preferential or secured. This informal mode of presentation of claims seems to be wholly inconsistent with the situation arising with an Article 17(8) debt. A further inconsistency is created by Article 30(2), whereunder creditors residing in a State other than the State of the bankruptcy may dispute other creditors' claims, again by informally writing. It is not indicated whether it is contemplated that creditors (as opposed to the trustee or liquidator) may be entitled to make themselves parties to the proceedings relating to disputed debts under Article 17(8).

5.28. The views of readers are invited as to the acceptability and practicability of these exclusions ~~from the~~

from the jurisdiction of the bankruptcy court and the conferment on other, foreign courts of the adjudication upon claims which may amount to very large amounts, and may rank preferentially, to the detriment of the general body of creditors.

5.29. Over and above the general question of the mode and place of adjudication of the excepted classes of debts referred to in Article 17(3), there is the special question of the rights of preferential creditors, having exhausted such local rights of recovery against assets as they may enjoy, to come into the "foreign" bankruptcy or winding-up, eg. in the U.K., to claim for the balance. This applies in particular to the case of fiscal and quasi-fiscal debts, which, though not enjoying the right of multi-state preferential recoveries, can prove as unsecured creditors for their unsatisfied balances. It has been suggested to the Committee that such debts, (which may likely be very large) should in some way be moderated, either by the "hotch-pot" rule, or by a doctrine of "election" between local recovery and proof in the "foreign" bankruptcy. The views of readers are invited.

5.30 The Committee appreciates that it could be argued, on behalf of the U.K., that if other States possess, in respect of obligations to the State, rights of "self-help" by way of recovery by executive action, (such as existed formerly in the U.K., until finally abolished by the Crown Proceedings Act 1947), the U.K. would itself be entitled to re-introduce such procedures, so as to protect the national exchequer from suffering unfair discrimination in foreign

bankruptcies. While no doubt the Inland Revenue (and perhaps many taxpayers also) would itself welcome such an accretion to its armoury, it must be borne in mind that, unless it was expressly restricted to the case of foreign bankruptcies, such a measure would be likely still further to prejudice the general body of creditors and to widely be regarded as retrogressive. The views of readers on this possible solution are invited.

5.31. Thus far, the Committee has sought to present the general pattern of the Convention's policy towards preferential debts in relation to its modus operandi rather than to its social justifications. It is however now necessary to examine the social basis for the proposed multi-State preferential claim, intended to be afforded to all preferential creditors other than for fiscal and quasi-fiscal debts.

5.32. As already explained, the present position under the U.K. insolvency codes is that all creditors, wherever situate or resident, are entitled to prove as creditors in any bankruptcy or winding-up, so long as their debts are not per se excluded by the codes from proof, such as on grounds of illegality, immorality or contravention of public policy. Even debts which are temporarily irrecoverable, such as those caught by the Exchange Control Act or the Trading with the Enemy Acts, are not excluded but only deferred or blocked.

5.33. Subject to a creditor establishing his rights to be admitted to proof, he can then claim such preferential

status as the U.K. codes confer on a debt of that class, e.g. an unpaid employee in a foreign country is entitled, in the U.K. bankruptcy or winding-up of his U.K.-based or U.K.-registered employer, to prove preferentially for his wages, and a person (wherever situate) would be entitled to prove by subrogation(in the winding-up) for moneys advanced to pay wages to such employee.

5.54. Four possible attitudes can be postulated for the U.K. to adopt under the Convention:

(1) to adhere to its existing law, namely that preferential creditors may claim in bankruptcy or in liquidation here; but if they recover any sum from the same debtor in a "foreign" state, they must bring it into account;

(2) to adhere to its existing law relating to proof of debts and distribution, but agree to a preferential creditor being entitled to elect whether to prove as such or to exercise his rights of recovery from assets situate in another state.

(3) to adhere to its existing law, but agree to a preferential creditor exercising his preferential rights not only to prove as such in the bankruptcy or winding-up (regardless as to which is the State of the bankruptcy) but also to recover as a preferential creditor against the assets of the debtor situate in any other state or States, to the extent (if at all) that their laws permit him to do so, subject to some formula limiting the totality of his receipts.

(4) to adhere to its existing law, but agree to provide a preferential creditor additionally to whatever other preferential rights are accorded to him by the law of his own State, only, subject to some formula limiting the totality of his receipts.

3.33. The Committee, while inviting readers' views on the generality of the problems presented above, would wish to indicate its own provisional view, which is mainly founded on proposition (3), in three parts:-

(1) a preferential creditor shall be entitled to the preference allowed to him by the law of his own State out of the assets available to him in that State as a member of that class of preferential creditors (i.e. that class may rank against such assets lower than other classes, such as fiscal debts);

(2) If (a) these assets are insufficient to satisfy his claim, or (b) the pecuniary limit on his claim as such preferential creditor in his own State is lower than the limit prescribed by the laws of the State of the bankruptcy, then he may claim preferentially in the bankruptcy for any shortfall under (a), so that his total recoveries will not exceed the maximum sum recoverable in the bankruptcy, or under (b) up to an amount equal to the limit imposed by the laws of the State of the bankruptcy.

5.36. The justification which has been presented to the Committee for the course they propose above is that every preferential creditor, and especially an employee-creditor, may may be entitled to feel that the assets of the debtor in <u>his</u> State should be charged firstly with payment of the preferential debts owed in that State (this is an aspect of what is known in the E.E.C. as "ordre social"), and only thereafter should the balance of those assets be available to "foreigners". But the Committee, though recognising the moral and constitutional force of that argument, while confined to a one-State relationship, do not feel in any way moved to accord such an exceptional preferential right to be enforceable in other States, i.e. other than the State of the creditor, except of course in the State of the bankruptcy and subject to its laws. The views of readers are invited.

5.37. It must of course be appreciated that the adoption of the course proposed would reduce the multi-State administration problem, and the consequential sub-liquidations, in volume, but not in the potential number of the sub-units, since in theory any debtor might have assets in every other State, against which that State's preferential creditors might be entitled to proceed. In any view, therefore, some system of sub-liquidations would seem to be inescapable.

5.38. [Here refer (a) to the analyses of foreign fiscal and non-fiscal preferences in Trevor Traylor's paper, and (b) to the illustrative paper demonstrating the operation of multi-State preferences]

5.39. The Committee is aware of the strong feelings among the business community against all, or at least most,

preferences, and against any extension thereof. It understands that similar undertakings are to be found in all other [illegible] Treaties, and that it is not impossible to foresee an eventual elimination, if not an abolition, of preferences, or alternatively, a harmonization of a kind between all EEC Treaties, which would considerably assist in the solution of many of the problems considered here.

MW
14.11.74.

Notes by Secretary - Preferential and Secured Creditors

Articles 40 to 46

Mr Muir Hunter deals with the subject in his Opinion dated 17th January 1973, starting at page 34; he has also translated appropriate extracts from "The Sauveplanne Memorandum", starting at page 45. The following memoranda supporting Mr Muir Hunter's Opinion are also relevant:-

5A : Enforceability of foreign revenue claims

6 : Preferential debts in bankruptcy (This memo also cites the present position in the U.K.)

6A : French tax preferences

7 : The attitude of the Commission and the authors of the Convention to preferential debts.

The Noel-Lemontey Report deals with the subject, starting at page 136.

As the Report points out, in multi-national bankruptcies (liquidations), the liquidator will have to record the realisation of assets in national sub-units, having as many sub-units in his books as there are States in which assets are situated. The Report refers to it as a matter of "book-keeping only" and so it may be, but the rules for dividing the assets seem extremely complicated, having to take into account that a debt can have a right of preference or security in several States for unequal amounts and differing in kind and rank.

The Convention differentiates between two kinds of general preference, dealing with them respectively in Articles 40 and 42.

Article 40 deals with the general rights of preference in civil and commercial matters, such as arising under contracts of employment, and it confers on foreign creditors, in respect of property situated in any contracting State, the same preference which the bankruptcy law of that State gives to its own national creditors for analogous debts. Supposing a company had assets in Germany, Holland and England, and German, Dutch and English employees in its respective branches in those Countries; its C/A was in Italy staffed by Italians. Then as I read it, all the employees, regardless of nationality or place of employment, would have general rights of preference ranking pari passus against:-

(i) the assets in Germany i.a.w. German bankruptcy laws of preference;
(ii) " " " Holland " Dutch " " "
(iii) " " " England " English ditto (s.319 C.A.1948)
(iv) " " " Italy " Italian ditto (up to a year's salary)

Article 41 endeavours to lay down the rules for division of assets in regard to the general preferential creditors cited in Art.40. It would seem from 41(1) that the lex situs of the property as at the date of the commencement of the bankruptcy is to govern the general preferences which encumber that property. Property situated in non-contracting States is to be included in the sub-unit relating to the State of the bankruptcy.

41(2) deals with a debt which is preferential, presumably for the same amount, in a number of contracting States and says that it must be satisfied from each of the sub-units of assets, not in equal parts, but in proportion to the sum remaining in each sub-unit. An example is calculated on page 143 of the Report.

41(3) considers a claim which is preferential for a different amount in each State, such as could arise with wages - three months being pref. in France, four months in the U.K., six months in Belgium and a year in Italy. There is a calculation on

page 144 of the Report.

41(4) refers to general rights of preference of differing rank, saying that they shall be satisfied in the order prescribed in the States concerned (i.e. the States in which the assets against which they are preferential are situated). The Report suggests that this is only likely to arise between claims for legal costs and claims by employees and some complicated calculations are given at page 145.

Article 42 deals with general rights of preference in regard to fiscal, social security and other 'public law' claims. Such claims will be preferential against the assets realised in the State of the claimant, but any shortfall will rank as unsecured pari passu with the general body of creditors against the balance of the estate. The Committee will recall that disputes relating to such debts remain within the jurisdiction of the claimant (Art.17(8)).

Article 43 deals with secured rights, special rights of preference and possessory liens, indicating that such rights will be governed by the law of the contracting State in which the property thus charged is situated as at the date when 'the debtor was declared bankrupt'. N.B. There is some inconsistency apparently, as Art.41 refers to 'the day when the bankruptcy proceedings were instituted'.

43(2) deals with charges on ships, boats, aircraft and motor-driven land vehicles, referring to the law of the Flag or the State in which the property is registered in any form (N.B. it does not say 'contracting State')

43(3) says that possessory liens shall be governed by the law of the place where t property is situated.

Article 44 states that priority as between general rights of preference on the one hand and secured rights and special rights on the other, shall be determined by the law of the contracting State in which the property is situated.

Article 45 says that for the purposes of articles 41 to 44 movable property which is required to be registered in any form shall be deemed to be situated in the State in which it is registered.

Article 46 deals with the question of the date for determining the place where th property is situated, in the case of one bankruptcy proceeding following upon another, and says that it shall be the date when the most recent proceedings were instituted.

Armstrong's paper

COMMENTARY ON THE PROPOSAL OF THE EEC ADVISORY COMMITTEE FOR DEALING WITH PREFERENTIAL CLAIMS FOR SALARIES

I The principles upon which the EEC Bankruptcy Convention deals with these claims are:-

(1) All workers within the EEC, wherever they might be employed, will receive the same preferential rights.

(2) These rights will be the most favourable rights accorded by the law of any contracting State where assets are situated, but the assets in any contracting State will not be used for the purpose of preferential wages, in excess of what the law of that State allows.

(3) Subject to the limit imposed in sub-paragraph (2), preferential wages to all workers will be paid out of contributions from the assets in all contracting States in proportion to the assets available in those States.

II According to English law, all workers wherever they might be employed, receive the same preferential rights in bankruptcy and company liquidation. The principle (I(1)) laid down in the Convention would appear to be in accordance with our own law.

III The Convention, in giving these equal rights to all workers however, has not limited them to the preferential rights accorded by the law of the bankruptcy, but has allowed the workers, wherever they might be employed within the EEC, to have the rights accorded by the lex situs of the assets. This means that workers in a State which gives them no preferential rights at all, may have such rights against assets in other States as the law of those States allow. This has the disadvantage that it reduces the residue ultimately available for unsecured creditors, but if the principle of equal treatment for workers is accepted, the application of the lex situs would appear to raise less problems than applying the law of the bankruptcy, particularly where the latter is less favourable.

IV If the principles laid down in sub-paragraph I(2) are accepted, the method of application given in sub-paragraph I(3) can be altered to arrive at the most equitable way of calculating contributions from the various groups of assets.

V The principles upon which the EEC Advisory Committee base their proposed method of dealing with preferential claims (presumably relating only to wages) are:-

(1) Workers will receive different preferential rights according to the law of the State in which they are employed - or more precisely the law of the State governing their contracts of service - provided assets are available in such Contracting States.

(2) If the assets in any such Contracting State are insufficient to pay the particular workers' preferential claims in full, according to the law of that State, those workers may receive the balance of their preferential claims from the assets in the State where the bankruptcy is opened, up to the limit of the workers' preferential rights given by the law of that latter State.

VI The advantage of this proposal is that the workers will receive only what they would expect to receive under their Contracts of Service, and the unsecured creditors will not suffer in any way.

VII The disadvantage of this method is that workers in the same bankruptcy, are treated differently, and this strikes at one of the basic principles of English insolvency law. Another, and perhaps more important disadvantage, is that the method could produce unfairness between various sets of workers. This is illustrated by the following three examples:-

(A) Suppose a bankruptcy is opened in State 'A' and there are assets and claims for wages, all with equal preferential rights, in three Contracting States. Let us assume there are 10 workers in State 'A' each with a preferential claim of 100 units; 50 workers in State 'B' each with a preferential claim of 100 units and 100 workers in State 'C' each with a preferential claim of 100 units.

		A		B		C
Assets		1000		1000		1,000
Wages	10 x 100	1000	50 x 100	5000	100 x 100	10,000
Residue		NIL		NIL		NIL

Workers in State 'A' receive full preferential rights i.e. 100 units each
Workers in State 'B' receive 20% preferential rights i.e. 20 units each
Workers in State 'C' receive 10% preferential rights i.e. 10 units each

Because there is no residue in State 'A', the workers in States 'B' and 'C' do not receive even the preferential rights given by the law of the bankruptcy.

(B) Suppose a bankruptcy is opened in State 'A' and there are assets and claims for wages but with different preferential rights, in three Contracting States. Let us assume that there are 10 workers in State 'A' each with a preferential claim of 100 units; 10 workers in State 'B' each with a preferential right of 200 units and 10 workers in State 'C' each with a preferential right of 300 units.

		A		B		C
Assets		5000		1000		3000
Wages	10 x 100	1000	10 x 200	2000	10 x 300	3000
Residue		4000		NIL		NIL

Because the Workers in State 'B' have already received from their own assets, a payment on account equal to the preference allowed by State 'A' where the bankruptcy was opened, they cannot claim the balance owing from the residue in that latter State.

Workers in State 'A' receive full preferential rights i.e. 100 units each
Workers in State 'B' receive 50% preferential rights i.e. 100 units each
Workers in State 'C' receive full preferential rights i.e. 300 units each

(C) Suppose a bankruptcy is opened in State 'A' and there are assets and claims for wages but with different preferential amounts, in three Contracting States. Let us assume there are 10 workers in State 'A' each with a preferential claim of 100 units; 50 workers in State 'B' each with a preferential claim of 200 units and 100 workers in State C each with a preferential claim of 300 units.

		A		B		C
Assets		10,000		1,000		100
Wages	10 x 100	1,000	50 x 200	10,000	100 x 300	30,000
Residue		9,000		NIL		NIL

Workers in State B have received only 10% i.e. 20 units each, and they are entitled therefore to a further 80 units each from the residue in 'A', which would require a total of 4000 units for the 50 workers. Similarly workers in State 'C' have received only 1 unit each, so they are entitled to 99 units each, requiring a further 9,900 units. The total units required therefore to be contributed by 'A' to give these workers the preferential rights accorded by the law of the bankruptcy is 13,900, but there are only 9000 units available.

How then is this sum to be apportioned?

If it is apportioned relative to the balances owing, it gives an unfair result as follows:-

$$\frac{4,000}{13,900} \times 9,000 \text{ to State 'B'} = 2590 \text{ units}$$

$$\frac{9,900}{13,900} \times 9,000 \text{ to State 'C'} = 6410 \text{ units}$$

Workers in State 'B' therefore receive a total of 3590 units, being 72 units each; whereas workers in State 'C' receive a total of 6510 units, being 65 units each, despite the fact that neither receives what he would have been entitled to under the law of the bankruptcy.

The result is that:-

Workers in State 'A' receive full preferential rights i.e. 100 units each
Workers in State 'B' receive 36% preferential rights i.e. 72 units each
Workers in State 'C' receive 22% preferential rights i.e. 65 units each

VIII The conclusion to be drawn from these three examples is that under the method proposed by the EEC Advisory Committee, workers in the State where the bankruptcy is opened will always receive the most favourable treatement, provided the assets in that State are available to meet their preferential claims in full, but workers in other States may receive less favourable treatment than, not only the laws of their own States allow, but even that allowed by the law of the bankruptcy.

Secondly where the laws of a Contracting State impose an upper monetary limit on the preferential rights of workers, this will give less favourable treatment in real money terms to workers in other States where wages and cost of living are relatively higher, and who might be limited to that amount because of lack of assets in their own States.

(Signed W Armstrong)
INS-S
10 July 1974

EEC DRAFT CONVENTION ON BANKRUPTCY

Explanatory Note on Section 6 - Preferential & Secured Creditors

1. The following notes cover our understanding of the meaning and effect of Articles 40-46 inclusive of the draft convention. The issues involved are some of the most important and far reaching and the general approach and concepts, at least for the original Six Member States, vary considerably from those obtaining within the United Kingdom.

2. These Articles refer to general and special preferences and als to secured rights and possessory liens. Our understanding is that general rights of preference comprehend the following matters:-

Costs of liquidation
Funeral costs/Court costs
Liquidators' costs
Food for the last six months
School fees

in addition to the more important items of salaries and wages.

We understand that fiscal debts, social security debts and similar matters akin to taxes are also general preferences but, as will be seen, are treated separately from what our Continental colleagues call civil and commercial debts some of which I have listed above. The distinction may correspond roughly with that between private and public debts. General preferences attach to th whole estate of a debtor and must be satisfied before unsecured creditors are paid.

Special rights of preference are included in our concept of secured rights, and whereas we in the UK draw a fairly clear distinction between preferential rights and secured rights, our Continental colleagues tend to look upon all prior claims to asse

as "preference". Special preferences or secured rights attach to specific property and the creditor is entitled to be paid out of the proceeds of the sale of the sale of that property before any other creditor. If the proceeds are insufficient to discharge his claim, then he is treated as an unsecured creditor for the balance. Differences do exist in the law of the original Six Member States, both as regards the ranking of general preferences inter se and their ranking as against special preferences, and it was not found possible to establish one common order of ranking into which the general and special preferences in the Community could be fitted. Because of the differing laws, the experts adopted an accounting concept of sub-groups to counter-balance as far as possible inequality of treatment of creditors inside the Community and which will also permit further harmonisation as the Community develops. They found it was necessary to draw a distinction between general preferences in favour of the fiscal and State authorities and those relating to wages and the like (civil and commercial).

3. The original Six Member States commissioned an analysis of the law by Professor Sauveplanne of the University of Utrecht who suggested that:-

(a) for general preferences, the law of the State in which the bankruptcy was opened should apply; and

(b) with regard to special preferences the applicable law (subject to a few exceptions) should be the lex situs.

The group of experts, after examination, considered that Professor Sauveplanne's proposals could not be implemented until such time as the laws of all the Member States, so far as preference were concerned, were extensively harmonised. As such a harmonisatio could not be achieved within a reasonable time scale, the group decided that for the present preferences should be governed by the lex situs. This inroad into the unity of bankruptcy they counter-balanced by providing rules which enable general preferences, other

than those concerned with indebtedness to the State, to have effect in all the States in which realisable property is situated.

4. To this end, Article 40 provides that in civil and commercial matters, creditors may claim those general preferences provided by the law of the State in which particular property is located. For example if the bankruptcy is opened in one State and there are assets and possibly employees' claims for wages in two other States, then the employee creditors in all three States may claim that their wages be treated as preferential in each of the three States.

Article 41 determines which law is to apply for general preferen in civil and commercial matters and gives rules as to distribution a para 1 of that Article provides that the subject matter, extent and ranking of general preferences shall be determined by the law of the contracting State in which the assets were situated on the day when the bankruptcy was opened. Assets located in a non-Community State will be aggregated with those in the State in which the bankruptcy was opened.

The liquidator will, solely for purposes of account and subsequent distribution, have to establish sub-groups of assets and paras 2 and 3 of Article 41 give the rules for this purpose. The group of experts decided that as regards fiscal and social security and similar State debts, the preferential rights attaching to such debts should be exercisable only in the contracting State in which the indebtedness arises. They are thus limited territorially.

Article 43(1) provides that the applicable law for special preferences, secured rights and possessory liens shall be the law of the contracting State in which the property charged was situated (le situs) at the date that the bankruptcy was opened.

Article 43(2) provides that secured rights over ships, aircraft and land vehicles shall be governed by the law of the State in which the property is registered.

Article 43(3) provides that the applicable law for possessory liens shall again be the lex situs.

Article 44 provides that the order of ranking between general and special preferences shall be determined by the law of the contracting State where the property is situated (lex situs).

Article 45 gives a rule for determining where certain movable property shall be deemed to be situated.

Article 46 provides rules where bankruptcy supersedes an earlier analogous proceeding.

5. It is clear from the foregoing that where a bankruptcy is opened in a contracting State, in general the law of that State governs the distribution of assets in that State. The major exception being that in calculating a State's contribution to civil and commercial general preferences - the most important being claims for wages - they be included at the amount allowed in a particular State which gives the highest claim. So far as secured claims are concerned their rights are determined by the law of the State where the property is situate (lex situs) and this follows, I understand, the general principles of private international law. The solutions proposed are not simple and easy to apply because complications arise from the need to calculate the accounting position of various sub-groups.

When the proposals in Articles 40-46 were explained to us, it appeared that so far as workers' claims were concerned Article 41 (2) and (3) meant that the claims were to be effective in each Member State in proportion to the amount standing to the credit of each sub group. This clearly gives a rule based on the ability of each of the sub-groups to pay the general preferences and ignores the amount of the obligation due by each sub-group and in certain instances it would seem that this could produce an unfair result. Alternative methods of dealing with this problem are as follows:-

(1) as proposed in the draft convention in proportion to the balance on each sub-group estate; (see examples 1, 2 and 3 post)

(2) in proportion to the liabilities of each sub-group estate according to the maximum allowed by the laws of that contracting State; (see examples 4, 5, 6, 7 and 8)

(3) by construing Article 41(3) strictly and making the proportion in accordance with the assets available by the law of the particular State to meet the obligation. This is similar to (2) above but has regard to the quantum of assets available (see examples 9 and 10).

(4) by taking into account both the availability of assets and the obligations. This could be done by making the proportion that given by the product of the two variables and this method gives due weight to both items assets and obligations (see examples 11, 12, 13, 14 and 15).

In all these methods if there is an insufficiency in any one sub-group then that shortfall is provided by the States able to contribute in the proportions applicable to each method.

6. The whole problem of preferences produces peculiar difficulties for the UK. In general the UK liquidators admit the claims of all wage-earners whether or not they come from States which are able to contribute assets. Fiscal or State debts could be higher, equal to, or lower in ranking than other general preferences, some States have pre-preferential ranking for wages, others seem to have power to sei assets to meet fiscal debts. The limits as to time and amount allow for wage earners' preferential claims vary widely from State to Stat and we have been conscious of possible unfairness where the law allo workers' rights to be assumed by, for instance, banks or State Agencies who provide money at a time of insolvency, particularly as often the wage earners are quite unaware that money is being advance for that purpose. Finally, for the UK we have the problem of floatin charges, (a concept not widely understood or recognised on the Continent) where the security is postponed to the rights of preferential creditors.

7. To assist consideration of the different methods available for dealing with the sub-groups and their contributions, Mr Armstrong has prepared a series of calculations designed to show the different effects produced by each method and these calculations follow in this paper.

1.

	A		B		C		TOTAL
Available Assets	7,000		1,000		2,000		10,000
Salaries	900	1,800		3,600		3,600	
1st distribution (7/10)		(1/10)	360	(1/5)	720	1,980	
£2520 Limited to	900						
Available Assets	---		640		1,280	1,620	1,920
		(⅓)	540	(⅔)	1,080	1,620	
			100		200	---	

360
7
2520

In this example, it can be seen that the contribution from State A is 900 units, being the maximum which that State allows, whereas States B and C contribute 900 and 1,800, respectively, which is only half of their respective maximums allowed.

2. This position can be high-lighted by taking another example as follows:-

	A		B		C		TOTAL
Available Assets	7,000		7,000		7,000		21,000
Salaries	900	1,800		3,600		3,600	
1st Distribution (⅓)		(⅓)	1,200	(⅓)	1,200	3,300	
Limited to	900						
	-		5,800		5,800		11,600
2nd Distribution		(½)	150	(½)	150	300	
			5,650		5,650	---	

State A still contributes its maximum of 900; State B contributes 1,350 units, being 75% of its maximum, and State C contributes 1,350 units, being only 37.5% of its maximum, despite the fact that the available assets were equal in all three States.

3. The relative contributions are important because they affect the amount of assets remaining in a sub-group which could affect the extent to which fiscal debts are paid if they are of lower priority than salaries, as shown in the following example:-

	A		B		C	TOTAL
1st Salaries	900		1,800		3,600	
2nd Fiscal debts	6,000		6,000		6,000	
Available assets	6,500		6,500		6,500	19,500
Salaries	900		1,800		3,600	3,600
1st Distribution ($\frac{1}{3}$)		($\frac{1}{3}$)	1,200	($\frac{1}{3}$)	1,200	3,300
Limited to	900					
	5,600		5,300		5,300	300
2nd Distribution		($\frac{1}{2}$)	150	($\frac{1}{2}$)	150	300
			5,150		5,150	---
Fisc. on Account	5,600		5,150		5,150	

Because State A was obliged to contribute its maximum allowance of 900 units for salaries, its fiscal debts could not be paid in full, whereas had it merely contributed a proportion as in State B (75%) or State C (37.5%), there would have been more assets available for its fiscal debts, which presumably was the intention of its legislature.

4. In an effort to arrive at a more consistently equitable method of calculating the proportionate contributions for salaries, it may be necessary to define more precisely what is meant by "available assets". Irrespective of the total assets remaining in any sub-group at the particular stage, eg when the salary calculation has to be made, the available assets in any sub-group can never be more than those required to meet the maximum preferential claim allowed in that particular State.

5. If the calculation is based on this revised definition of "available assets", the previous examples can be re-worked as follows:-

	A	B	C	Total paid to salaries
Total Remaining Assets	7,000	1,000	2,000	
Available Assets being maximum salaries claim	900	1,800	3,600	
1st Distribution				
A $\frac{900}{6300}$ x 3600	514			514
B $\frac{1800}{6300}$ x 3600		1,028		
Limited to		1,000		1,000
C $\frac{3600}{6300}$ x 3600			2,056	
Limited to			2,000	2,000
	386			3,514
2nd Distribution	86			86
	300			3,600

OR

	A		B		C
Total Remaining Assets	7,000		1,000		2,000
Available Assets being Maximum salaries claim	900	1,800		3,600	
1st Distribution limited to (1/7)	514	(2/7)	1,028	(4/7)	2,056
	386		- 28		- 56
2nd Distribution	86		28		56
	300				

In this re-worked example, State A contributes 600 units, being 66% of its maximum allowed; State B contributes 1,000 units, being 55% of its maximum and State C contributes 2,000, being 55% of its maximum, as compared with 100%; 50% and 50% respectively under the earlier method.

6. Re-working the second example gives the following result:-

		A		B		C	TOTAL
Total Remaining Assets		7,000		7,000		7,000	
Available Assets being amount of maximum salaries claim		900		1,800		3,600	6,300
1st Distribution	(1/7)	514	(2/7)	1,028	(4/7)	2,058	3,600
		386		772		1,542	2,700

State A contributes 57% of its maximum, State B 57% and State C 57% compared with 100%; 75% and 37.5%, respectively, under the earlier method.

7. Re-working the third example gives the following result:-

	A		B		C		TOTAL
1st Salaries	900		1,800		3,600		
2nd Fiscal debts	6,000		6,000		6,000		
Total Remaining Assets	6,500		6,500		6,500		19,500
Available Assets	900		1,800		3,600	6,300	
1st Distribution (1/7)	514	(2/7)	1,028	(4/7)	2,058	3,600	3,600
	386		772		1,542		
	5,986		5,472		4,442		15,900
Fiscal debts on account	5,986		5,472		4,442		15,900

Because State A only contributed 57% of its maximum allowable salary claim instead of 100% under the earlier method, it can now pay 5,986 units to its fiscal creditors instead of 5,600 units. Similarly, becaus State B contributed only 57% instead of 75% under the earlier method,

its fiscal creditors receive 5,472 units instead of only 5,150. State C on the other hand, which allows the highest salary claim in priority to fiscal debts, in fact only pays its fiscal creditors 4,442 units instead of 5,150 units under the earlier method.

8. This result seems to be more in keeping with the intention of the legislature of the respective member States, namely that State C which allows its employees greater preferential rights should do so at the expense of its own fiscal debts if they are of next rank in priority, and not at the expense of the fiscal debts of the other member States.

9. The disadvantage of this method of calculation is shown in the first re-worked example where the amount of the calculated contribution exceed the actual assets available and, therefore, requires calculations for second and perhaps subsequent distribution. As a practical way of avoiding this, and therefore simplifying the calculation, available assets ca be defined as the maximum amount required to meet the particular preferential class of claims or the actual assets available in each sub-group whichever is the less.

10. The first example can be re-worked in this way as follows:-

		A		B		C	TOTAL
Total Remaining Assets		7,000		1,000		2,000	10,000
Salaries		900		1,800		3,600	
Available Assets		900		1,000		2,000	3,900
1st Distribution	(9/39)	831	(10/39)	923	(20/39)	1,846	3,600

This method which applies only where the available assets in any sub-group are less than the maximum allowable preferential claim suffers from the same disadvantage, although to a lesser extent, as the method at present laid down in the draft Convention, namely State A contributes 92% of its maximum allowable claim whereas States B and C contribute only 51%.

EEC DRAFT CONVENTION ON BANKRUPTCY

Preferential & Secured Creditors

The following computation replaces that shown in the first part of paragraph 12 of the Annex to the paper on Preferential and Secured Creditors:-

	A		B		C		TOT
Available Assets		7,000		1,000		2,000	
Salaries (max pref claim allowed)	900		1,800		3,600		
Product	6,300,000		1,800,000		7,200,000		
	63		18		72		1
1st Distribution (63/153)			(18/153)	424	(72/153)	1,629	
Limited to:		900					
		6,100		576		371	
2nd Distribution		-	($\frac{1}{3}$)	215	Limit to:	371	
				361		-	
3rd Distribution		-		61		-	
		6,100		300		-	

11. Another method of calculation can be used which will take into account both the total available assets in the sub-groups (as used in the method adopted in the draft Convention at present) and the maximum claim allowed by each State. It will be necessary firstly to multiply the amount of available assets in each sub-group by the maximum claim allowed in each particular State respectively. The contribution from each sub-group can then be calculated in proportion to these products.

12. The previous examples if worked out according to this method show the following results:

	A		B		C		Total
Available Assets		7,000		1,000		2,000	
Salaries	900		1,800		3,600		
Product	630,000		180,000		7,200,000		
	63		18		720		801
1st Distribution	(63/801)	283	(18/801)	81	(720/801)	3,236	
		6,717		919		- 1.236	
2nd Distribution	(63/81) Limited to	617	Balance	619		1,236	
		6,000		300		---	

In this re-worked example the contributions from the three States as compared with their contributions under the earlier methods are:-

	1st Method		2nd Method		3rd Method		4th Method	
State A	900	100%	600	66%	831	92%	900	100%
" B	1,350	75%	1,000	55%	923	51%	700	39%
" C	1,350	37.5%	2,000	55%	1,846	51%	2,000	55%

13. Re-working the second example gives the following results:-

		A		B		C	Total
Available Assets		7,000		7,000		7,000	21,000
Salaries	900		1,800		3,600		
Product	6,300,000		12,600,000		25,200,000		
	63		126		252		
	1		2		4		
1st Distribution	(1/7)	514		1,028		2,058	3,600
		6,486		5,972		4,942	17,400

This gives exactly the same result as the second and third methods, because the available assets are the same in all three States.

14. To draw any conclusions between this method and the other methods an example must be taken where the available assets are different in the three States, although still sufficient to pay the calculated contribution in full, viz:-

		A		B		C	Total
Available Assets		1,000		2,000		6,000	9,000
Salaries	900		1,800		3,600		
Product	900,000		3,600,000		21,600,000		
	9		36		216		
	1		4		24	29	
1st Distribution	(1/29)	124	(4/29)	497	(24/29)	2,979	3,600
		876		1,503		3,021	5,400

In this example State A contributes 14% of its maximum allowed claim; State B contributes 28% and State C contributes 83%, reflecting the position that the maximum assets and maximum liability were in State C. This is a similar relative position as would have resulted from using the method at present in the draft Convention, but producing more extreme results.

15. It would appear under this method that except where the assets in all sub-groups are equal, the results are relatively similar to those achieved by the method in the present draft of the Convention, but are more extreme in that the contribution from the State where both the assets and obligations are smallest is very much reduced, whilst that from the State where both the assets and obligations are greatest is correspondingly increased.

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PREFERENTIAL AND SECURED CREDITORS

One of the major problems in a Convention based on unity and universality is that of determining the applicable law for dealing with secured and preferential creditors, since bankruptcy is a procedure of collective realisation of property and assets, and tends to satisfy creditors according to their rank. An added difficulty insofar as the UK is concerned is that the general approach and concepts of the original six Member States vary considerably from those obtaining within the United Kingdom.

Whereas we in the UK draw a fairly clear distinction between preferential rights and secured rights, the Continental States tend to regard all prior claims against assets as "Preferences", which are subdivided into "General Preferences" and "Special Preferences".

General preferences attach to the whole estate of a debtor and must be satisfied before unsecured creditors are paid. They are further subdivided into civil and commercial debts on the one hand and fiscal debts, social security debts and similar matters akin to taxes on the other; the distinction may be taken to correspond roughly with that between private and public debts and they are treated separately in the Convention.

It appears that civil and commercial general preferences include the costs of the liquidation, funeral costs, court costs, liquidators' costs, school fees, in addition to the more important items of wages and salaries.

Special preferences, which correspond to our secured rights, attach to specific property and the creditor is entitled to be paid out of the proceeds of the sale of that property before any other creditor. If the proceeds are insufficient to discharge his claim then he is treated as an unsecured creditor f the balance. Differences exist in the laws of the original six Member States both as regards the ranking of general preferences inter se and their ranking as against special preferences and it was not considered possible to establish one common order of ranking into which the general and special preferences in the Community could be fitted.

At the request of the EEC Commission, M. J. G. Sauveplanne, Professor at the State University of Utrecht made a study of the comparative law of the Member States and in October 1963 submitted the following recommendations

(a) general preferences should be governed by the law of the State in which the bankruptcy has been opened. An exception might be acceptable in the case of creditors who had transacted business with an establishment of the bankrupt in another Contracting State, to enable any preferential claims to be made against assets in that State, by application of its internal law.

(b) with regard to special preferences, the applicable law (subject to a few exceptions) should be the lex situs.

(c) special preferences against such as ships and aircraft should be governed by the law of the flag or the law of the registration, and a charge on an intangible asset should be governed by the law of the claim to which the charge relates.

(d) fiscal debts arising in the State in which the bankruptcy has been opened should be treated on the same footing as other general preferences. Fiscal debts arising in another Contracting State and having a prior charge under the law of that State should have a prior claim against any assets situated in that State.

The Panel of experts in Brussels decided that the 'Sauveplanne' proposals could not be implemented until such time as the related internal laws of the Member States were extensively harmonised, and that this could not be envisaged within a reasonable time scale. The Panel decided that, for the present, preferences should, in general, be governed by the lex situs. At the same time general preferences, other than those concerned with indebtedness to the State, should have effect in all States in which property was situated

To this end Article 40 provides that in civil and commercial matters creditors may claim those general preferences provided by the law of the State in which the property is situated. For example if the bankruptcy is opened in one State and there are also assets and employees' claims for wages in two other States, then all the employee creditors may claim preferentially against the assets in all three States, to the extent recognised by the national law of each State. In other words, the article confers on 'foreign' creditors in

respect of assets situate in each Contracting State, the same preference which is attached by the law of each of those States to analogous debts. It follows from this that all employees having wage claims will be entitled to the highest preferential claim allowed by the law of any of the States in which there are assets.

Article 41 determines the law which is to apply for general preferences in civil and commercial matters and gives rules as to distribution. Clause 1 provides that the subject matter, extent and ranking of general preferences shall be governed by the law of the State in which the assets were situated on the day when the bankruptcy was opened. Realisations from assets located in a non-Contracting State will be aggregated with those in the State of the bankruptcy.

For the purposes of account and subsequent distribution, the liquidator will have to establish sub-groups of assets and clauses 2 and 3 of Article 41 give rules for this purpose. It would seem from these rules that claims are to be effective in each Contracting State in proportion to the amount standing to the credit of each sub-group. This clearly gives a rule based on the ability of each of the sub-groups to pay, and ignores the amount of the obligation due by each sub-group and in certain instances this could produce an unfair result. The Department of Trade's Insolvency Service has evolved some alternative methods of dealing with the problem in an effort to counter any unfairness.

However, all these methods involve complicated calculations and at this stage the Committee is not satisfied that all of the principles adopted in the draft Convention are acceptable. These principles would appear to be

(1) All workers within the EEC, wherever they may be employed will receive the same preferential rights.

(2) These rights will be the most favourable rights accorded by the law of any Contracting State where assets are situated, but the assets in any Contracting State will not be used for the purpose of preferential wages, in excess of what the law of that State allows.

(3) Subject to the limit imposed by (2) above, preferential wages to all claimants will be paid out of contributions from the assets in all Contracting States, in proportion to the assets available in those States.

It has been represented to the Committee that the allocation of liability between States under Articles 40 and 41 was basically in order to have regard to the relative ranking of fiscal debts; it has been suggested that acceptance of any scheme such as that envisaged in the Convention might result in all Member States giving fiscal debts absolute priority on assets in 'own State', and of adopting the French system of direct right of recourse by revenue authorities against those assets. Such action would nullify the requirement for complicated apportionment schemes. Therefore the Committee is inclined to question the assumption made by the Panel of the original six Member States that harmonisation of existing national laws was not possible for the present (see paragraph above). Views are invited on this matter.

The preliminary view of the Committee is that the principle of looking to assets situated in one's own State for the preferential claim allowed by the law of that State is correct and acceptable; but they do not feel that the extension of this principle, whereby claims are pushed up to the highest available under the laws of affected States is either logical or desirable. Not only would it involve complicated methods of allocation but it would be detrimental to the general body of non-preferential creditors.

The principle of giving the highest preferential claim available in any State to all claimants seems difficult to justify in the present circumstances within the Community; there are different wage levels and fringe benefits, different approaches to redundancy payments, and one would expect that the preferences granted for such as wages and salaries were related to the circumstances of the employees in any given State.

In the Committee's view a worker, for example, has a moral and, at present, legal right to claim preferentially against assets situated in the State in which he is living and working; further, it feels that in the case of a multi-national liquidation he has a right to be considered a creditor of the totality. To this end the Committee's preliminary view is that in the absence of harmonisation of preferential law, a scheme based on the following two principles might be more widely acceptable than that in Article 40 and 41:-

(1) "A preferential creditor is entitled to the preference allowed to him by the law of his own State out of the assets available to him in that State."

(2) "If those assets are insufficient to meet that claim, or if the claim is less than would be allowed by the law of the State in which the bankruptcy has been opened, then he may claim for such balance in the State of the bankruptcy, but not so as to receive an amount greater than would be allowed to him by the preferential laws of the State of the bankruptcy."

The opinions of readers on these matters would be welcomed and to assist them, a summary of the existing preferential rules affecting such as wages and salaries, in Member States is set out here under.

Comparison of employees' preferences in Member States

Under German law salaries and equivalent claims have a high priority; claims relating to the year preceding the opening of the bankruptcy take precedence over taxation debts and are satisfied immediately after the costs of the bankruptcy. French law accords a priority charge in favour of the salaried employee; including paid holiday remuneration, it is the "fraction not subject to distraint" and is calculated for determined periods as a function of the category to which the interested party belongs. Such claims take precedence over all other claims including legal costs and taxation claims. On the other hand, other salary and equivalent claims rank lower and are limited to the period of six months preceding the bankruptcy, with the exception of domestic staff who may claim preferentially for the preceding and current year. Luxembourg law is similar to that of France.

In Holland workmen's claims for wages for the preceding and current year have priority over the whole of the debtor's estate. In Belgium there is a similar priority ranking, though certain movable assets may be subject to prior taxation charges. The claims of domestic staff are preferential for the preceding and current year, of salaried employees for six months and of workmen for one month; including holiday pay.

Under Italian law wage claims for domestic service enjoy priority for the preceding six months, followed by claims relating to professional services for one year, followed by claims of commercial agents for six months. All of these claims rank lower than other general and special preferences but above maintenance claims and those relating to taxation and social insurance contributions. It is understood that Denmark has abolished most, if not all, preferential rights; there is a similar proposal in Ireland.

In the U.K. preferential debts in bankruptcy are prescribed by S. 33 of the Bankruptcy Act 1914, and cover rates, taxes, wages and salaries of employees and national insurance contributions. S. 319 of the Companies Act, 1948 prescribes similar classes of preferential debts for insolvent liquidations, with the addition of a special right of subrogation conferred by S. 319(4). Where

compositions or schemes of arrangement are proposed under SS.16 or 21, BA1914 or S.206, CA 1948, it is obligatory that preferential debts should be provided for in full. All categories of preferential debts rank equally with one another and are paid out of the assets first realised by the trustee/ liquidator, after allowing for his own costs and expenses.

Fiscal debts, social security debts, etc.

Article 42 deals with general rights of preference in regard to fiscal, social security and other 'public law' claims. Such claims, as at present, will be preferential against assets situated in their 'own State' to the extent that the applicable national law allows, but any shortfall will rank as unsecured claims pari passus with the general body of unsecured creditors, against the balance of the estate.

No reason is given in the Report for this departure from current practice, and the preliminary view of the Committee is that, as now, fiscal and similar debts should be confined to settlement out of assets situated in the State in which the liability arose; alternatively, the balance ranking as unsecured against assets in other States, should be only in respect of arrears of tax, etc., normally payable, and fines and penalties should rank as deferred debts, to be paid after all other creditors have been paid in full.

In considering this matter, readers should note that by Article 17(8) disputes relating to such debts remain within the jurisdiction of the State to which the related fiscal/social security authorities belong. Further, that under Article 21(3) these authorities retain such rights of recovery as they at present enjoy under the laws of their own State.

Readers views on these matters are invited, particularly as to whether or not they consider the extension of unpaid fiscal, etc., claims to rank as unsecured creditors against assets in other States is acceptable. To assist readers a summary of comparative law in Member States follows.

Comparative law relating to taxation and National Insurance Preferences

These preferences exist in all legislations excepting that of Denmark, but they vary, both in the extent to which a claim may be preferential and in its ranking in relation to other preferences.

Under German law, only taxation claims arising during the course of the year preceding the opening of the bankruptcy proceedings are preferential, and they rank after wages and salary preferences. Under French law, certain taxation preferences are extinguished after two years and the claim enjoys no further priority. All taxation preferences rank after legal costs and wages and salary preferences, but they take precedence over all other charges.

In Holland and Luxembourg all taxation claims are preferential and rank before all other preferences except legal costs. In Italy, a distinction is made between indirect tax claims, which are special preferences of high priority, and direct taxation which is accorded a general preference of low priority, ranking after all other preferences with the exception of those relating to national insurance. Under Belgian law all taxation claims are preferential but rank behind all other preferences.

All claims in respect of arrears of social and national insurance contributions are preferential in the six original Member States. These claims rank equally with those for taxation in Holland and Luxembourg, and equally with wages and salaries in France and Germany. They rank after wages and salary preferences in Belgium, and as the final general preference, after taxation claims, in Italy.

In the U.K., one year's taxes are accorded preference, but the Crown has established the right to select as its preferential year in respect of each tax, "the best year", out of unpaid assessments for the past six years before the commencement of the bankruptcy or winding-up. This can involve a very large sum of money and may be regarded as prejudicial to the general body of creditors. However, against this is the fact that, with the exception of Germany, all taxation claims are preferential in the original Member States.

Local rates and arrears of national insurance contributions which have become due and payable in the 12 months preceding the opening of proceedings are preferential.

All the foregoing categories of preferential debts in the U.K. rank equally with one another being paid after the costs and expenses of the bankruptcy/winding-up.

It should be noted that the Crown is bound by the Bankruptcy Acts and the Companies Acts for insolvent administrations, and no longer enjoys any prerogative rights by way of "self-help" for the collection of debts due to it. Thus, the Crown does not possess anything comparable to the "droit éventuel de poursuite" referred to in Article 21(3), which appears to be a direct right of action against the debtor's property. Therefore, the Revenue authorities in this Country may be at a disadvantage with respect to the enforcement of preferential claims as compared with their counterparts in other Member States.

Secured rights, special preferences and possessory liens

Article 43(1) provides that the applicable law for secured rights and special preferences should be the law of the Contracting State in which the property charged was situated at the date when the bankruptcy was opened. Article 43(2) provides that secured rights over ships, aircraft and land vehicles should be governed by the law of the flag or of the State in which the property is registered. Article 43(3) provides that the applicable law for possessory liens should be the lex situs.

The Committee think the first clause of this Article might imply, that a receiver or receiver and manager appointed by a debenture holder could not continue to administer a debtor's estate following upon liquidation, but that he would simply have a preferential claim in the liquidator's administration, given to him by the crystallised floating charge. This may not be a correct assumption, however, because it is understood that under German law, special preferences are regarded as lien and mortgage rights and susceptible of legal retention; they therefore entitle the holder to remove related property from the bankruptcy proceedings for separate settlement, paying any surplus over to the liquidator.

To avoid ambiguity, the clause might be amended to permit methods of realisation allowed under the lex situs; readers' views are invited.

Readers are also invited to consider whether article 43(2) is acceptable in its present form or whether it should be qualified so as to be without prejudice to the operation of valid charges under the law of the situs, such as local arrestments and repairer's liens.

Article 44 provides that the order of ranking between general and special preferences should be determined by the law of the State in which the property is situated. The effect of this may be illustrated by S.94 of the Companies Act, 1948, whereby the special preference of a debenture holder gives way to the general preference of preferential creditors. The Committee see no objection to this article.

The Committee has found some difficulty in considering Artic. determines the place where certain movable property is situated. reference to Article 37(2) (an article setting out the effects of the bankruptcy on leases and hiring contracts) seems ambiguous : does it mean that Article 45 relates only to movable property which is the subject of contracts for lease or hire, or does the article relate to the type or class of movable property which is also dealt with by Article 37(2)? The Committee is inclined to the latter view, particularly since the Report indicates that Article 43 does not apply to all movable property which is required to be registered, in that it does not cover such as patents, trade marks or designs.

Finally, Article 46 provides rules whereby bankruptcy or liquidation supersedes an earlier analogous proceeding and the Committee see no objections to its terms.

Approved by Committee on 22/8/75
Subject to amendments as noted

5. Preferentials (2.1)

3.

Redo para 5.

PRELIMINARY DRAFT

6 August 1975

PREFERENTIAL AND SECURED CREDITORS

1. An essential principle of bankruptcy is equality of distribution. However, all insolvency codes, while founded on the general principle of rateable distribution of an insolvent's assets among his creditors, make to a greater or less extent ~~exceptions~~ exceptions in favour of secured creditors and preferential creditors.

~~2. For the purpose of distributing the assets of a bankrupt, creditors are divided into two classes, secured creditors and unsecured creditors. The unsecured creditors are, in turn, divided into those entitled to preferential treatment and those who are not. A secured creditor is one whose debt is secured by a mortgage, charge or lien. His preference operates following agreement between the parties concerned prior to bankruptcy, but the preference given to an unsecured creditor arises by operation of the law.~~

Delete.

3. In the United Kingdom, a fairly clear distinction is drawn between secured rights and preferential rights; but in Continental systems, all prior claims againt assets are referred to either as "special preferences" or as "general preferences".

a rough translation of "privilèges et hypothèques"

Secured creditors

4. Special preferences, which broadly speaking, correspond to secured rights in the United Kingdom, attach to specific property, and the creditor is generally entitled to be paid out of the realisation of that property before any other creditor. In the case of a shortfall, he ranks as an ordinary unsecured creditor for the balance. Secured rights are in general not interfered with by the bankruptcy, so long as the creation of the security was not in itself a fraud upon, or otherwise invalid as against the creditors. The scheme of the Convention seems to be generally satisfactory in that it preserves the rights of secured creditors under the law of the Member State in which the property charged was situated (Article 43(1)). Nor does it disturb the relative priority accorded to the security under that law in relation to other rights of preference (Article 44).

Proposed Amendments

Paragraph 5: Amend to read -

"There are, however, two matters which concern us in regard to the provisio of Article 43(1). Firstly, its possible effect in relation to floating charges. The present wording assumes that a special preference or secu right attaches to specific property. This is not necessarily true of floating charges, which may subsist over all, or any part of, a comp assets. There is a danger, therefore, that it would be character a foreign liquidator or court as conferring only a general pref possibly, or not conferring a preference of any kind. We con that the Convention should specifically assimilate floating preferences for the purposes of Article 43."

separate amendment

6. Sec... re a secured right attaches to properties sit... ore countries, provision should be made for the cla... isfied in proportional shares varying with the amount rea... on each property. Article 41(2) makes such a provision, but only in respect of general preferences.

7. An exception to the general principle of lex situs is made regarding certain moveable property, in particular, ships, boats, aircraft or motor-driven land vehicles. Article 43(2) provides that secured rights and "generally all other rights", secured upon such moveable property will be governed by the law of the flag or of the State in which the property is registered. We think these provisions may present difficulties, not only in respect of "Flags of convenience" and hence the application of the laws of non-member States, but also with regard to the relative priority of local arrestments. Difficulties might also arise, particularly for a liquidator, where motor vehicles are registered in two or more countries. We have not received the specialised advice which would enable us to reach satisfactory conclusions these matters and we recommend that the Department should engage further consultations.

In regard to possessory liens, we do not find the principle 43(3) objectionable, but there would appear to criticism which also applies to A... se "For the purpos... on of th...

Preferential creditors

9. General preferences are subdivided into civil and commercial debts on the one hand and fiscal debts, social security debts and similar public debts on the other. The two divisions are treated separately in the Convention.

10. Neither the Convention nor the N-L Report, defines "civil and commercial debts". We understand that the Protocol on Accession to the Judgments Convention, which is restricted to civil and commercial matters, ~~may include a definition and that Council's Working Group has provisionally agreed to a text.~~ while avoiding any definition, states We have taken this text as the basis for our consideration of civil and commercial debts, ~~namely~~ that "civil and commerical matters" do not include -

(1) revenue and customs matters, such as taxes, duties, levies and other charges of a like nature;

(2) administration matters, such as those involving relations between private individuals on the one hand and the State or another public entity, when not acting in the capacity of a private individual, on the other; and

(3) matters involving relations between States or public entities or authorities not acting in the same capacity as private individuals.

Preferential creditors in the United Kingdom

11. The categories of debts to which preference is accorded by the United Kingdom law may be summarised as follows:

(1) taxes (maximum one year's arrears, but the "best year" can be selected);

(2) rates (not exceeding "last year's" arrears);

(3) P.A.Y.E., V.A.T., and analogous imposts (not exceeding "last year's" arrears);

(4) unpaid employees' wages (maximum of 4 months' arrears of remuneration, not exceeding £200 in all per person) and holiday pay;

(5) sundry other pecuniary obligations to ~~public~~ bodies which have power to levy charges for public ~~purposes~~ and quasi-public purposes.

12. ~~These qualify as~~ preferential ~~debts and~~ claims are made recoverable in priority to ordinary unsecured ~~creditors~~ claims, on grounds of public policy, in order either to benefit the public revenue or to fulfil other social objectives. Historically, the preferential debts system derives in the United Kingdom firstly, so far as concerns England and Northern Ireland from the Crown's prerogative power, and so far as concerns Scotland, from power conferred on the Crown by statute, to recover debts due to itself from its subjects for tax and other public obligations, by means of the executive power, a power later extended by statute to municipal rates and taxes in one form or another; ~~secondly, the system derives from a desire to ensure that the employees of a bankrupt employer are not left unprovided for by reason of non-payment of arrears of wages outstanding when their employment ceased.~~ delete. However, the Crown no longer possesses, after a bankruptcy or winding-up has ~~former~~ extensive rights of direct recovery from its ~~action~~. In this respect the

Paragraph 12:

(i) Delete: 'secondly' to 'ceased', ~~lines 10 to 13~~.

(ii) Add: after 'Member States' at line 18:

"The most important objective which the U.K's rules relating to preferences seek to secure is the protection of the claims of a bankrupt's employees for arrears of wages and holiday pay. Similar rules are to be found in the laws of other Member States."

~~status, as~~

13. In the field of preferential debts, the ... to bankruptcy and winding-up in the United Kingdom are substantially identical in their provisions, save in one important respect, which is to be found in the latter provisions but not in the former, namely the subrogation of persons who have advanced monies to a Company for the payment of wages to its employees; such persons are subrogated in the winding-up of the company to the same preferential rights which the employees would have enjoyed if they had remained unpaid. ~~It has been submitted to us~~ advised that in practice, claims for unpaid wages ~~actually due to~~ as such the employees play a relatively small part, whereas the subrogation rights of the company's bankers can be substantial and frequently form the largest single preferential claim.

Amend to "may amount to a small part of the preferential claims"

14. It is the trustee or liquidator who has the ~~general~~ duty of determining, subject to the ~~directions and adjudications~~ general control of the courts exercising bankruptcy or winding-up jurisdiction, questions regarding the existence, the amount and the preferential status of debts. In cases where the debt has been established prior to the bankruptcy or winding-up order, by the judgment of a court of competent jurisdiction, the trustee or liquidator will in general be bound by that judgment, (though not necessarily if it was a judgment by consent, or one vitiated by collusion or fraud). Again, he may not be able, as a matter of right, to disturb a finalised tax assessment. But in all other cases, i.e. of unadjudicated debts, he has the right and duty in the first instance, to adjudicate upon them, subject to his decision being approved by the court. ~~Furthermore, that court has also the jurisdiction to determine in any disputed case, whether and to what extent the debt, if and when established, enjoys preferential status.~~

Omit

Continental general preferences

15. As might be expected, the insolvency codes of the other States of the EEC demonstrate many of the same characteristics as those of the United Kingdom; but certain fundamental differences between those States' codes and the corresponding United Kingdom provisions, are to be noted, namely:

(1) (a) In so far as the same category of debt ranks preferentially in the United Kingdom and other Member States, there are considerable variations regarding the amount to which preference is granted;

(b) In most of the States, preferential debts do not share the same equal rank of preference, ~~but enjoy different degrees of rankings;~~

(c) There is a greater variety of debts enjoying preference than in the United Kingdom.

(2) The concept of subrogation to the preferential rights of employee creditors, conferred by the United Kingdom winding-up provisions, does not exist in all Member States.

Think there is more

check up - should we include reference to difficulties in dealing with redundancy payments?

(3) In some States, preferential debts may constitute prior charges on the securities held by secured creditors, whereas the only ~~such~~ prior charge is enjoyed by preferential creditors in the United Kingdom ~~are confined to the case~~ is where a floating charge is realised by the appointment of a receiver and manager in England or in Northern Ireland, or a receiver in Scotland.

(4) In some States, general preferences relate exclusively to moveable property; in other States, certain general preferences (i.e. employees' wages) may be applied against fixed assets but only if the realisations from moveable assets prove insufficient. ~~It is only~~ In Germany and the Netherlands ~~that~~ general preferences may be levied against the whole of the debtor's estate, either moveable or immoveable.

(5) (a) A broad distinction is drawn in most of the States between civil and commercial debts on the one hand and "fiscal debts" and what may be called "quasi-fiscal debts" on the other. The latter often include debts to the social security administration which, with fiscal debts, are regarded as enjoying special privileges.

(b) Some States possess certain prerogative or executive powers for recovering fiscal or quasi-fiscal debts considerably exceeding any privileges enjoyed by the Crown in the United Kingdom. The Convention envisages that such direct rights of recovery will continue to be exercisable notwithstanding the opening of the bankruptcy proceedings.

General preferences under the Convention

16. The relevant provisions are mainly contained in Articles 40, 41 and 42, which may be summarised as follows:

(1) In civil and commercial matters, creditors may invoke

Paragraph 16(1): Add -

"This links general rights of preference with the laws of particular States and with the assets in those States, rather than with the law of the State of the bankruptcy and with the general pool of assets in the hands of the liquidator."

(5) Debts to which, in several Member States, general rights of preference of different ranking apply, are to be satisfied in the order prescribed in each of those States (Article 41(4)).

(6) In matters other than civil or commercial, including fiscal matters and social security matters, the public authorities, government departments and other public agencies of a Member State are, in every other Member State, to be unsecured creditors to the extent that they have not obtained full satisfaction in their own State (Article 42(1) and (2)).

17. It is not the intention of the Convention to disturb the internal provisions of each State in relation to preferential debts. Accordingly, on the footing that there will continue to exist, within the EEC or some of its Member States, and under the Convention, a system of locally-enforceable preferential debts, enforceable against the locally-based assets of a debtor made bankrupt in another State, the question arises as to how this system is to be administered by the liquidator in practice. It is plain that, in implementing the requirements of Articles 40 to 42, he will need to establish and maintain, in respect of each State wherein assets of the bankrupt were located at the opening of the bankruptcy, a notional "local assets-pool" (French "sous-masse") for the purpose of making appropriate distributions therefrom to those creditors who are established as having enforceable rights against it. But neither the Convention, nor the N-L Report, envisages or requires the setting-up of "sub-liquidations", or the appointment of "sub-liquidators". There is, ~~however~~ fortunately, power, under Article 28, to appoint more than one liquidator (one or more of whom may be qualified under the laws of a State other than the State of the bankruptcy), and for the liquidator or liquidators to employ agents to assist him, ~~also drawn from that class.~~

18. The Convention's system for dealing with preferential debts out of a series of local assets pools is ~~not, strictly speaking,~~ necessarily in conflict with the twin principles of unity and universality upon which the Convention as a whole is founded. The duty of the liquidator, ~~it seems,~~ is to administer those assets pools for the benefit of the preferential creditors interested therein, making the book-keeping entries requisite for giving effect to the principles in accordance with

contained in Articles 40 to 42. What is less certain is the extent to which a State's direct rights of recovery in relation to fiscal or quasi-fiscal debts impinges on those principles to the detriment of other categories of preferential creditors and ~~to~~ prevent the liquidator from ~~reducing~~ taking them into his official possession, even for the purpose of constituting them as part of the relevant local assets pool.

Fiscal debts

19. In ~~this Country~~ the United Kingdom the Crown no longer possesses, after a bankruptcy or winding-up has been opened, its former extensive rights of direct recovery from its debtors, by prerogative or other executive action. ~~Similar~~ These rights do exist, ~~however,~~ in some Member States, and Articles 21(3) and 42(1) envisage that such rights will continue to be exercisable, notwithstanding the opening of bankruptcy proceedings. Such rights are inconsistent with the basic philosophy of the Convention, but it seems unlikely that individual States will readily give up provisions designed to ensure the recovery of tax claims. Nor could a foreign liquidator expect to prevent a State obtaining payment of its claim out of assets located in its territory.

20. ~~We think that~~ The continued existence of prerogative rights of direct recovery by some, though not all, Member States, raises questions of a political nature on which we feel unable to express an opinion. However, we submit that serious consideration should be given to this problem. A system of "self-help" which gives government and public authorities an unfair advantage over other creditors, seems inconsistent with the Community's emphasis on the rights of individual persons and firms, and with the intention to foster trade across frontiers.

21. Revenue, customs and excise, social security and similar authorities will not be entitled to preferential rights in any State other than the State in which the debts are owed. ~~However,~~ Nevertheless Article 42 provides that such creditors may prove as ordinary unsecured creditors for the unsatisfied portion of their claims, even if the bankruptcy is administered in another Member State. This is completely a departure from contrary to existing rules of Private International Law, and would abrogate the rule in Government of India v Taylor (1955) A.C. 49 to the effect that, as a matter of public policy, ~~an English (or a Scottish)~~ a UK Court ~~will~~ should not enforce a foreign revenue claim, "foreign" being there construed as including a tax claim by a Commonwealth Government.

22. It is arguable that the existing rules were established in accordance with ~~the then currently accepted~~ notions of public policy and that such rules require modification in the light of membership of the EEC and that membership of such a Community necessarily involves the reciprocal recognition of the fiscal obligations owed to the public authorities of each Member State. In our view, such arguments might ~~hold substance~~ if there was some harmonisation of fiscal and quasi-fiscal preferences and of the rights of recovery of such debts. We are ~~firmly~~ of the opinion that, at the present level of harmonisation, it would be wrong to accept the extensions provided for in Article 42 and we recommend that the article should be rejected.

Civil and commercial preferences

23. In relation to debts other than fiscal and quasi-fiscal debts, Article 40 provides that a person entitled to a preferential claim in any Member State is entitled, in so far as he has not exhausted that claim in respect of the assets in his own State, to claim as a preferential creditor in other Member States so far as the assets in, and the laws of, those States permit. The rational basis or premise of this principle is the concept that the Member States constitute a conceptual unity for the purposes of bankruptcy. In consequence, creditors in any Member States will enjoy, so far as the assets in the Member States permit, the most favourable rights accorded to them by the laws of any of those States. This is clearly beneficial to the preferential creditors (including employees) as a class but ~~is equally detrimental~~ to unsecured creditors ~~who do not enjoy preferences~~.

24. We have received strong criticism that the ~~principles~~ rules governing distribution set out in Article 41 are confusing, complex and impractical. While we fully agree with this criticism, we think that it is the basic principles set out in Article 40 are at fault. We do not consider it appropriate that, when a company is ~~subject to~~ in liquidation, its creditors may be accorded preferences ~~which may adventitiously arise, or vary in scope and amount,~~ to a greater or lesser extent depending upon the existence or ~~non-existence~~ otherwise of assets in other Member States. We can see no logic in the assumption, implied by Article 40, that a worker in an employee in one country should be entitled to preferential claims available under the laws of another country, simply because there are assets in the latter country, with which he and his own job have no connection.

up to 8 weeks arrears of wages, holiday pay, etc, to employees whose employers have become insolvent. The Bill ~~gives~~ extends to the Fund ~~exactly the same priority as the employee now enjoys.~~ subrogatory rights. We understand that a similar, but more extensive scheme is under consideration in Germany.

35. We ~~think~~ consider that the provision or otherwise of subrogatory rights in respect of moneys advanced to pay wages is as much a social problem as it is a banking problem. On balance, we recommend that subrogatory rights should be recognised by all Member States, some others already do or exclusion of ?