Singapore Journal of Legal Studies
[2002] 271 - 301

ENGLISH FIXED AND FLOATING CHARGES IN GERMAN INSOLVENCY PROCEEDINGS: UNSOLVED PROBLEMS UNDER THE NEW EUROPEAN REGULATION ON INSOLVENCY PROCEEDINGS

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The article deals with English fixed and floating charges and their recognition under the new European Insolvency Regulation on Insolvency Proceedings 2002. With the EU-Regulation on Insolvency Proceedings coming into force on 31 May 2002 one has to be aware of even more diversified international cross-border insolvency rules. Its aim is to secure the simplification of formalities governing the reciprocal recognition and enforcement of judgments of courts and tribunals in insolvency proceedings, which have an intra-Community dimension. The Regulation is, therefore, only applicable for insolvency proceedings where the centre of the debtor's main interest, *ie* in the absence of proof to the contrary the place of the registered office, was situated within the European Union (intra-Community insolvencies). The EU-Regulation does not solve the problems of English security rights in other European jurisdictions. The article analyses to what extent English security rights are enforceable in Germany. English security rights are in various aspects not in compliance with the German public policy rule which has to be applied according to Article 26 of the EU-Regulation. Despite the fact English security rights can qualify as a right *in rem* under Article 5 of the EU-Regulation the public policy rule prevents their enforceability in German insolvency proceedings. As a result, English security rights, as they exist today, cannot secure English creditor interest effectively as regards assets situated in Germany.

I. INTRODUCTION

The huge increase in international trade in modern times and the development of a global market place have inevitably led to an increase in the number, size and complexity of cross-border insolvencies. Novel problems have arisen since the creation of multi-national trading corporations which, in many cases, have little or no economic connection with any particular place of incorporation. The more the boundaries in international trade disappear and "globalisation" becomes reality, the greater is the need to modernise the insolvency laws of countries to keep abreast of the times and provide efficient solutions from an economic standpoint.

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Legal problems in cross-border insolvencies emerge in particular when there are assets of a multi-national company in more than one country belonging to more than one legal entity. Different national insolvency laws have different creditor priorities and in most cases incompatible rules in terms of antecedent transactions such as transactions at an undervalue, voidable preferences and gratuitous alienations which are prejudicial to creditors. The key questions arising are: which country can claim the international jurisdiction for the proceedings? Which substantive insolvency law has to be applied and how the different legal systems should interact?

In order to co-ordinate these complex issues some judges and authors had been in favour of an International Convention on Insolvency Proceedings.[1] For instance, the Vice-Chancellor Sir Donald Nicholls stated: "There is a crying need for an international insolvency convention".[2] The problem was more graphically described by Judge Brosman sitting in the United States Bankruptcy Court for the Southern District of New York when dealing with the Maxwell Communications Corporation's international insolvency:

> Lurking in all transnational bankruptcies is the potential for chaos if the court involved ignores the importance of comity. As anyone who has made even a brief excursion into this area of insolvency practice will report, there is little to guide practitioners or the judiciary in dealing with the unique problems posed by such bankruptcies. Yet it is critical to harmonise the proceedings in the different courts lest decrees at war with one another result.[3]

Today not only a Draft Model Legislative Provisions on Cross-Border Insolvency (UNCITRAL)[4] exists, but there are also some international

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1 See, for example, P Smart, *Cross-Border Insolvency*, 2nd ed (London: Butterworths, 1998) at 2.

2 *Re Paramount Airways Ltd* [1992] BCLC 710; *Re Paramount Airways Ltd (in adminstration)* [1993] Ch 223 at 239. See also Browne-Wilkinson V-C in *Re Bank of Credit and Commerce International* SA [1992] BCLC 570 at 577.

3 *Re Brierley* [1992] 145 BR 151 (Bankr SDNY).

4 Draft Model Legislative Provisions on Cross-Border Insolvency, adopted on 30 May 1997 by the United Nations Commission on International Trade Law (UNCITRAL) (United Nations General Assembly Official Record, 12-30 May 1997; 52nd Session; Supplement No 17 (A/52/17)). For the contents of the draft see IF Fletcher, "Bridges To The Future – Building Tomorrow's Solutions For International Insolvency Problems" (2000) CFILR 161; M Prior, "The UNCITRAL Model Law on cross-border insolvency" (1998) 14 ILP 215; IF Fletcher, *Insolvency in Private International Law* (Oxford: Clarendon Press, 1999) chapter 8 at 323-63. The text is printed in *Insolvency in Private International Law* (this note) Appendix IV at 323-441.

treaties in force dealing with the aforementioned problems. However, they are all limited to small groups of countries.[5]

Finally, in May 2000, the Council of the European Union revived the former failed European Union Convention on Insolvency Proceedings by way of Regulation. The new Council Regulation on insolvency proceedings (hereinafter referred to as "the Regulation")[6] will now, pursuant to Article 47 of the Regulation, come into force on 31 May 2002.

Before the enactment of the Regulation the European Union had failed to enact the European Union Convention on Insolvency Proceedings, despite the fact that 14 Member States had ratified the Convention pursuant to Article 49(2) until 23 May 1996. It is still a bit of a myth, why the United Kingdom had denied the ratification of the Convention[7]. Officially, The United Kingdom Government chose to embark upon a policy of non-cooperation with its European partners, as a gesture of dissatisfaction over the "beef crisis".[8] A more durable impediment might exist in the form of the centuries-old controversy between the United Kingdom and Spain regarding sovereignty over the territory of Gibraltar.[9] However, whatever politically tangential reasons had been decisive at that stage, it is undoubtedly the case that the EU Council with the enactment of the Regulation has taken over. It appears that the EU finally lost its patience because there has not been any attempt in the past four years to revive the Convention, although this was certainly possible, despite the lapse of the deadline.[10] Although it took almost a decade to enact eventually a law for the European Union, there has ever been a unanimous consent in favour of an International Insolvency Convention. Therefore it is not a surprise that the Council mainly simply transformed the identical wording of the former European Union Convention on Insolvency Proceedings into the Regulation.

Consequently, this leads to the key questions of what the merits of the Regulation are in comparison to the current national cross-border insolvency laws. This essay focuses on the cross-border insolvency law of the United Kingdom and Germany from a European perspective. It will be

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5 In this respect the Convention Regarding Bankruptcy (The Nordic Bankruptcy Convention) (Copenhagen, 7 November 1933; No 3574 (1935)) is a successful example. For its contents see M Bogdan, "The Nordic Bankruptcy Convention" in JS Ziegel (ed) *Current Developments in International and Comparative Corporate Insolvency Law* (Oxford: Clarendon Press, 1994) Chapter 31; IF Fletcher, *Insolvency in Private International Law* (Oxford: Clarendon Press, 1999) at 237-245. The text is printed in *Insolvency in Private International Law* (this note) Appendix VI at 449-53.

6 Council Regulation (EC) on insolvency proceedings No 1346/2000 of 29 May 2000 (2000) OJ L160/1.

7 For the text see IF Fletcher, *supra note* 4, Appendix II 387-408. The European Convention on Certain International Aspects of Bankruptcy (Istanbul Convention) (Istanbul, 5 June 1990; ETS No 136 (1990)), the ancestor of the International European Convention on Insolvency Proceedings, has also never entered into force.

8 P Smart, *Cross-Border Insolvency*, *supra* note 1, at 9.

9 IF Fletcher, *supra* note 4 at 298-300.

10 P Smart, *supra* note 1 at 10.

analysed to what extent the Regulation will have substantive effects for the participants, as the principle aim of the Regulation is to secure the simplification of formalities.[11] In doing so, the contents of the new Regulation on Insolvency Proceedings is explained first (II). Secondly, important questions of interpretation of the Regulation are discussed (III). Thirdly, a comparison between the Regulation and the current law of the UK and Germany emphasizes important consequences of the Regulation (IV). Finally, the essay analyses unsolved conflict of laws problems as regards English security rights such as the fixed charge and the floating charge. It is particularly dealt with, the question as whether or not English security rights can be recognized in Germany according to the new Regulation (V).

II. Contents Of The Regulation On Insolvency Proceedings

A. *Principles and Scope of the Regulation*

The European Regulation on Insolvency Proceedings will come into force on 31 May 2002.[12] Its aim is to secure the simplification of formalities governing the reciprocal recognition and enforcement of judgments of courts and tribunals in insolvency proceedings, which have an intra-Community dimension. Unlike all other European Conventions or statutes the Regulations combines international civil procedure rules and conflict of laws rules in one Act. As regards jurisdiction, recognition and enforcement of judgments the Regulation fills a gap left by the Brussels Convention on the recognition and enforcement of judgments in civil proceedings.[13] The conflict of laws rules, filling the gap within the Rome Convention, have the effect of harmonising, to a limited extent and in cases where the Regulation applies, the rules and procedures applicable in insolvency proceedings in Member States. It does not assimilate the grounds on which insolvency proceedings may be opened in the Member States or seek to change or harmonise comprehensively national insolvency rules and procedures.

The Regulation will apply to collective insolvency proceedings which involve the partial or total divestment of a debtor and the appointment of a liquidator (Article 1).[14] "Divestment" is a term of art which denotes any

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[11] The latter is supported by the fact that the Regulation, although making provision in relation to the jurisdiction to open (and the subsequent recognition of) insolvency proceedings, will take a conservative approach to the governing law of the proceedings. Any proceedings, whether main or secondary, are to be governed by the law of the state in which the proceedings are being conducted, see Council Reg 1346/2000, Art 4. In other words, English proceedings will continue to be governed by the Insolvency Act 1986, German proceedings by the new Insolvency Act (*Insolvenzordnung, InsO*) that came into effect on 1 January 1999.

[12] Council Reg 1346/2000, Art 47.

[13] A Strub, "Das Europäische Konkursübereinkommen" (1996) EuZW 71.

[14] *Ibid* at 72.

restrictions on the debtor or its management in the administration of its business and in the right to dispose of assets. "Partial divestment" denotes systems where the debtor remains essentially in possession but requires the consent or co-signature of a liquidator for certain transactions (typical of most European composition proceedings).[15] "Liquidator" is widely defined as any person or body whose function is to administer or liquidate assets of which the debtor has been divested,[16] to include (in the case of the UK) an administrator but not an administrative receiver appointed under a floating charge.[17] An Annex to the Regulation lists, by Member State, the national proceedings covered by the Regulation. The Regulation applies only when the centre of the debtor's main interest is within a Member State of the EU. Therefore, it cannot be emphasized enough that the different national laws, as described above, will still play an important role. As we shall see below,[18] the scope of the Regulation is even more reduced, as regards to corporate groups which are commonly organised through subsidiaries which means insolvency proceedings have to be commenced against each entity. Moreover, the Regulation does not apply according to Article 1(2) to credit institutions, insurance companies and certain investment undertakings in order to avoid risks to the financial system, insurance and (collective) investment undertakings and credit institutions.[19] It is believed that the authorities of the state of origin of the entity in question provisionally control the above sufficiently. Additionally, special rules have been adopted for these excluded entities.[20]

B. *Jurisdiction for Proceedings under the Regulation*

The Regulation provides for the opening of "main proceedings" in the State in which the "centre of a debtor's main interest" is situated.[21] In the case of companies there is a rebuttable presumption that this will be the State where it has its registered office.[22] This reflects the position under English law[23]

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15 M Balz, "The European Union Convention on Insolvency Proceedings" (1996) 70 American Bankruptcy LJ 485 at 501.

16 *Ibid*, at 501.

17 M Balz, "Das neue Europäische Insolvenzübereinkommen" (1996) ZIP 948 at 949.

18 See C III 2.

19 For the definition of an "insurance undertaking" see Council Directive EEC/73/279 (1973) OJ L 228/3 and Council Directive EEC/79/267 (1979) OJ L 63/1. "Credit institutions" are defined in Council Directive EEC/77/780 (1977) OJ L 322/30. An "investment undertaking" is defined in Council Directive EEC/93/22 (1993) OJ 141/27 and "collective investment undertaking" are subject to Council Directive EEC/85/611 (1985) OJ L 375/3.

20 Council Directive on settlement finality in payment and securities settlement systems No 98/26/EC of 19 May 1998 (1998) OJ L166/45.

21 Council Reg 1346/2000, Art 3.

22 U Weinbörner, "Die neue Insolvenzordnung und das EU-Übereinkommen über Insolvenzverfahren" (1996) Rpfleger 494 at 497.

and deviates from German law, where the "centre of independent economic interest" is to be determined independently from its place of registration.[24] There can only be one "main proceedings", which must be recognized in all other Member States.[25]

The Regulation, however, permits the opening of "secondary proceedings" in States, other than that of the main proceedings, where the debtor has an "establishment".[26] The effects of "secondary proceedings" are restricted to the assets of the debtor situated in the territory of that State.[27] The law applicable shall be that of the Member State where the secondary proceedings are opened.[28] Therefore, this law decides who is entitled to request the opening of such proceedings.[29] The underlying disassociation of the notion of universality from the ideal of unity and the acceptance of certain local interest leads to a modified, or mitigated, universality.[30]

Where secondary proceedings are opened before main proceedings, they are defined as "territorial proceedings". Territorial proceedings are only permitted if main proceedings cannot be opened because of the conditions laid down by the law of the Member State where the centre of the debtor's main interest is situated or if the proceedings are requested by a creditor who has its domicile, habitual residence or registered office in the Member State where the establishment is situated.[31] The reasoning behind this is to avoid parallel local proceedings from taking place without the co-ordination umbrella of the main proceedings.[32] Territorial proceedings can be either liquidation or rescue/rehabilitation measures. Once main proceedings are opened they become "secondary proceedings" and rescue/rehabilitation

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23 RM Goode, *Principles of Corporate Insolvency Law* 2nd ed (London: Sweet & Maxwell, 1997) at 499; IF Fletcher, *supra* note 4 at 125; *Reuss v Bos* [1871] LR 5 (HL) 176; *Re Tumacacori Mining Co* [1874] LR 17 Eq 534.

24 BT-Drucks. (Report of the German *Bundestag*) 12/2443 (15 April 1992) reasons given for s 3 InsO.

25 M Balz, *supra note* 17 at 949. On the other hand, the Regulation results in a wide restriction of the ability of the UK courts to open main insolvency proceedings based on assets in the UK or simply a sufficient connection to the UK as regards a company whose centre of main interests was situated in another Member State, see *Re Eloc Electro-Optieck and Communicatie BV* [1982] Ch 43; *Re Azoff-Don Commercial Bank* [1954] Ch 315; RM Goode, *supra note* 23 at 500; *International Westminster Bank plc v Okeanos Maritime Corporation* [1988] Ch 210 at 226-7; *Re Harrods (Buenos Aires) Ltd* (1992) Ch 72 (CA); *Re Real Estate Development Co* [1991] BCLC 210; *Re International Tin Council* [1989] Ch 309 (CA); *Re Witney Town Football and Social Club* [1993] BCC 874. German law, on the contrary, remains unchanged in that respect as the wording of s 3(1)(2) of the InsO ("centre of independent economic interest") is almost identical with Article 3(1) of the Regulation ("centre of the debtor's main interests").

26 See for details C III 1.

27 Council Reg 1346/2000, Art 27.

28 *Ibid*, Art 28.

29 *Ibid*, Art 29(b). A Strub, *supra* note 13 at 72.

30 M Balz, *supra* note 15 at 496.

31 For an example see U Weinbörner, *supra* note 22 at 498.

32 M Balz, *supra* note 17 at 949.

proceedings may, at the instance of the liquidator in the main proceedings, be converted to liquidation proceedings.[33] Conversely, any kind of closure of the secondary proceedings shall not become final without the consent of the liquidator in the main proceedings.[34] For this purpose the liquidator is entitled to demand a stay of liquidation of secondary proceedings.[35] The concept of "secondary proceedings" is equally found under English (so-called ancillary proceedings)[36] and German law,[37] whereby the existence of assets in both countries are sufficient in contrast to an "establishment" under the Regulation.[38]

C. *Recognition and Enforcement of Judgments*

Any judgment of a court in one Member State opening either main or secondary insolvency proceedings should be recognized with no further formalities[39] such as exequatur or publication[40] in all other Member States[41] and should have the same effect in other Member States as it has in that of the opening of proceedings.[42] As the Regulation defines the insolvency proceedings falling under its scope and determinates the jurisdiction for the EU in detail, the Regulation provides itself, as opposed to the national laws, for the simplification in terms of a mutual recognition. It should be noted, however, that equally to the current national laws, recognition is still almost exclusively[43] restricted by different national public policy rules.[44] Judgments relating to the conduct and closure of insolvency proceedings must also be recognized. Enforcement of those judgments as well as the

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33 Council Reg 1346/2000, Arts 34 and 37.

34 A Strub, *supra* note 13 at 73 and Council Reg 1346/2000, Art 34(2).

35 Council Reg 1346/2000, Art 33(1).

36 RM Goode, *supra* note 23 at 507; *Re English, Scottish and Australian Chartered Bank* (1893) 3 Ch 385 at 394; *Re Commercial Bank of South Australia* (1886) 33 ChD 174 at 178; *Re Hibernian Merchants Ltd* [1958] 1 Ch 76; *Re Bank of Credit and Commerce International SA (No 10)* [1996] 4 All ER 796 at 814-22.

37 D Leipold, "Miniatur oder Bagatelle: das internationale Insolvenzrecht im deutschen Reformwerk 1994" in W Gerhardt, U Diederichsen, B Rimmelspacher and J Costede, eds, *Festschrift für Wolfram Henckel* (Walter de Gruyter Berlin, 1995) 533 at 540; E Braun R Riggert and T Kind, *Die Neuregelungen der Insolvenzordnung in der Praxis* (Richard Boorberg Verlag, 1999) at 262; BM Kübler and H Prütting, ed, *InsO Kommentar zur Insolvenzordnung* Vol 1 (Köln: RWS Verlag, February 2000) Introduction at 104.

38 M Balz, *supra* note 17 at 949. Both English and German law, therefore, lose part of their jurisdiction in terms of secondary proceedings, as the Regulation demands in Article 3(2) and (4) an establishment rather than the pure existence of an asset. See Article 102(4) EGInsO for German law

39 M Balz, *ibid* at 951 and Council Reg 1346/2000, Art 25(1)1.

40 M Balz, *supra* note 15 at 496.

41 Council Reg 1346/2000, Art 16.

42 *Ibid*, Art 17. A Strub, *supra* note 13 at 72.

43 The only exception being Article 25(3) Council Reg 1346/2000 as far as limitations of personal freedom or postal secrecy are concerned. See M Balz, *supra* note 17 at 953.

44 Council Reg 1346/2000, Art 26.

recognition and other enforcement of judgments arising from the insolvency proceedings shall be in accordance with Articles 31 to 51, with exception of Article 34(2), of the Brussels Convention.[45]

As regards the position of the liquidator in the main proceedings, his appointment and powers must be recognized in all Member States. He enjoys in all Member States the powers given to him in the State where the main proceedings are opened,[46] and may in particular remove the debtor's assets from the territory of any Member State in which they are situated,[47] except where territorial/secondary proceedings (even if subsequently) have been opened.[48] This restriction preserves national creditor interests and has the same roots as the so called "controlled universality" under German law.[49] As a result, the local liquidator has exclusive powers over these assets and may recover from other Member States property which has been removed there.[50] The liquidator in the main proceedings and the liquidators in secondary proceedings are under a duty to co-operate and give each other information[51] in order to maximise the benefits for all creditors. This includes the respective lodging and admission of claims,[52] rescue plans, any measures to close proceedings and the sale of essential assets.[53] However, there is no explicit duty to provide information amongst different liquidators of secondary proceedings themselves, but on the other hand the liquidator of the main proceedings is entitled to pass on information regarding all secondary proceedings upon his own discretion.

D. *Conflict of Laws Rules*

The Regulation provides rules in order to harmonize a number of important uniform conflict rules on insolvency related issues. The provisions refer to substantive rules of Member States only, exclusive of a Member State's set of conflicts rules. In other words, *renvoi* is excluded. The purpose behind this is not only to achieve legal certainty but to reduce the incentives for forum shopping.[54] Conflicts between the laws of third parties and those of a Member State are not covered by the Regulation. This is unfortunate. It was argued in the Brussels negotiation that a full harmonization of the conflicts

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45 Council Reg 1346/2000, Art 25.
46 A Strub, *supra* note 13 at 72.
47 Council Reg 1346/2000, Art 18(1)2. M Balz, *supra* note 17 at 951.
48 *Ibid*, Art 18(1)1.
49 H Hess, *InsO Kommentar zur Insolvenzordnung mit EGInsO* (Heidelberg: C F Müller Verlag, 1999) Art 102 EGInsO at 110; G Paulus, "Protokolle – ein anderer Zugang zur Abwicklung grenzüberschreitender Insolvenzen" (1998) ZIP 977 at 978; A Flessner, "Internationales Insolvenzrecht in Deutschland nach der Reform" (1997) IPRax 1 at 4.
50 Council Reg 1346/2000, Art 18(2).
51 *Ibid*, Art 31.
52 A Strub, *supra* note 13 at 73.
53 M Balz, *supra* note 17 at 954.
54 M Balz, *supra* note 15 at 507.

rules of Member States, including conflicts with laws of third parties, would have been possible, and it certainly would have been desirable to exclude the possibility of a split conflict regime in Member States.[55]

As regards the opening, conduct and closure of the proceedings – including the rights of creditors after closing or the discharge of the debtor[56] – the law of the State in which the proceedings are opened is the applicable law (*lex fori concursus*).[57] From this general rule and non-exhaustive list in Article 4 the Regulation systematically adds in Articles 5-15 several exceptions and conflict of laws rules to address particular cross-border issues which replace existing national rules of private international law.[58]

These rules deal with third party security rights,[59] set-off of claims,[60] reservation of title,[61] contracts relating to immovable property and of employment,[62] rights subject to registration,[63] Community patents and trade marks.[64] Exceptions are also provided for action to set aside transactions which took place before the opening of insolvency proceedings, protection to third parties to whom the debtor has disposed of specified forms of property after the opening of insolvency proceedings and pending lawsuits.[65]

Another important rule of substantive law is established by Article 39 of the Regulation, laying down the right of foreign creditors, *ie* of any creditor who has his habitual residence, domicile or registered office in another Member State, to lodge claims in insolvency proceedings. This provision derogates from the application of national law, pursuant to Article 4(2)(h). Establishing the right of foreign creditors to lodge claims means that their claims cannot be disallowed on the grounds that the creditor is situated abroad or that the claim is governed by foreign public law. According to Article 40 prompt notice of the opening of proceedings must be given to such creditors, as well as information concerning the proceedings. The Regulation stipulates the content of the lodgement of a claim in Article 41. It should be noted that Article 32 allows all creditors to participate in the main or secondary proceedings, as they choose, and even in several proceedings.

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55 See M Balz, *supra* note 15 at 507.

56 Council Reg 1346/2000, Art 4(2)(k). It has long been argued that the *lex contractus*, at least cumulatively to the *lex concursus*, should be applied to the issue of discharge, see M Balz, *supra* note 15 at 508.

57 Council Reg 1346/2000, Art 4.

58 M Balz, *supra* note 17 at 950.

59 Council Reg 1346/2000, Art 5.

60 *Ibid*, Art 6.

61 *Ibid*, Art 7.

62 *Ibid*, Arts 8 and 10.

63 *Ibid*, Art 11.

64 *Ibid*, Art 12.

65 *Ibid*, Arts 13-15.

III. The Regulation And Important Questions Of Interpretation

A. *General Rules of Interpretation*

The Regulation does not contain any provision for its interpretation. Just as in the 1968 Brussels Convention and the 1980 Rome Convention, two principles should be followed – which are likely to be safeguarded by the European Court of Justice (ECJ) exercising its power according to Article 234 of the EU Treaty – when interpreting its provisions. The first is the principle of respect for the international character of the rule and the second the principle of uniformity. The Regulation is a self-contained legal structure, and its concepts cannot simply be assimilated into concepts belonging to the national system into which it is incorporated. The Regulation must retain the same meaning within different national systems. When the substance of a problem is governed by the Regulation, the international character of the Regulation requires an autonomous construction and interpretation of its concept. An autonomous interpretation implies that the meaning of its concepts be determined by reference to the objectives of the rule, the Regulation's system, and the function of these concepts within this system. At the same time, the general principles which can be inferred from all the national laws of the Member States must be taken into account. Sometimes, the aim and purpose of a provision of the Regulation expressly or implicitly requires that a particular national law is referred to, so that the meaning of a concept can be found there. This is, for example, the case for the question as to whether or not a particular security right exists (*ie* has been created effectively) under the relevant national law, while on the other hand the question as to whether or not such a security right qualifies as a right *in rem*, as dealt with in Article 5 of the Regulation, is subject only to the interpretation of the Regulation itself.

Additionally, the Explanatory Report[66] of the former Insolvency Convention will provide a commentary and help to explain and clarify the provisions of the Convention. The Report was not, however, given any particular status by or under the Convention but as a document prepared virtually contemporaneously and agreed by all the parties to the Convention it is likely to be regarded as authoritative and to be influential.[67] Even though the Convention never entered into force and has already been replaced formally by the Regulation, the Report will also be essential for the interpretation of the Regulation. As the wording is almost identical, it

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[66] An English version of the Report on the Convention on Insolvency Proceedings (hereinafter referred to as "The Report"), prepared by Professor M Virgos and ME Schmitt, bearing the reference coding 11900/1/95 REV 1, was published as an Annex B to a Consultative Document, EC Convention on Insolvency Proceedings, published in February 1996 by the Insolvency Service of the Department of Trade and Industry.

[67] HL Select Committee on The European Communities Convention on Insolvency Proceedings 7th Report (HL Paper (1995-96) no 59), at 9.

seems, there is no legal impediment, that the ECJ and the national courts will consider the Report for the interpretation of the Regulation.

B. *Jurisdiction of the ECJ or the National Courts?*

According to Article 234 of the EU Treaty there is a mandatory reference to the ECJ to resolve problems of interpretation within the scope of the Regulation. Unlike Article 44 of the former Convention on Insolvency Proceedings 1995, there is no longer just the opportunity for a voluntary request of the national courts to the ECJ. As a consequence, this leads to the risk of having a two-year stay on any insolvency proceedings while the parties wait for a judgment from the ECJ. The only way to prevent this would have been to alter the EU Treaty in the way suggested by Article 44 of the Insolvency Convention.

Conversely, this problem will not occur if the national courts have to decide upon certain ambiguous parts of the Regulation. As far as the applicable law of the State of the opening of proceedings is concerned (Article 4, 28 of the Regulation) the national courts have exclusive jurisdiction.

Whether or not the same applies for the international jurisdiction pursuant to Article 3 of the Regulation seems questionable. In order to prevent a delay for the proceedings, an interpretation would be favourable, if it was only to determine by the national courts where the centre of a debtor's main interests is situated. Otherwise Article 16(1) in connection with Article 25 of the Regulation would not have the desired effect. A non-contentious automatic recognition of other Member States presupposes that an inappropriate delay through a mandatory reference to the ECJ, as it is the problem in other areas, is avoided.

On the other hand, Article 234 of the EU Treaty is designed to avoid different interpretations of European law in favour of the uniformity in the application of law. Certainly, this includes the question whether there are sufficient facts, apart from the registration of the company, to establish the centre of the debtor's main interests elsewhere. Hence, it is submitted that there is no exclusive responsibility for the national courts to decide this question, instead it should be acknowledged, to prevent long mandatory references, that the national courts have a wide discretion whether the question, where the centre of the main interest is situated, needs to be interpreted by the ECJ or not.

C. *Limited Scope of the Regulation*

(i) *Secondary Proceedings As Regards an "Establishment" under Article 3(2)*

Secondary proceedings can be conducted by foreign courts where the company has an establishment within the territory of that Member State. The term "establishment" is defined in Article 2(h) and "shall mean any

place of operations where the debtor carries out a non-transitory economic activity with human means and goods." The wording "non-transitory" and "human means and goods" needs to be interpreted. According to the Report[68] a broad interpretation is favourable due to the contentious discussion among the Member States. This interpretation is the result of a compromise as some countries were in favour of a far wider jurisdiction simply based on any asset situated in one of the Member States not demanding an "establishment"[69] while others in opposition to this concept feared a burgeoning number of small bankruptcies concerning real estate or bank accounts in Member States.[70] In order to achieve a consensus the adoption of the same concept of establishment in the Regulation as that given by the ECJ in its strict interpretation of Article 5(5) of the Brussels Convention[71] was ruled out in favour of an autonomous less restricted concept.

The consequence is, if secondary proceedings cannot be commenced, because of the absence of an establishment in the Member State, assets (such as insurance claims, book debts, stock in transit) situated in the Member State are likely be subject to seizure by individual local creditors to the disadvantage of creditors as a whole.[72] In other words, the provision of an establishment is preferential for local creditors and protects their interests.

(ii) *Subsidiaries and the Application of the Regulation*

Regrettably, the Regulation contains no special rules for dealing with the insolvency of groups. It is a fact that many companies, whether registered in the UK, Germany or elsewhere in the Community, now conduct their business in other Member States through the medium of locally registered subsidiaries rather than an establishment which is a branch of the parent company.[73] A registered subsidiary cannot fulfil the provision of an establishment under Article 3(2). It is itself a debtor with its own centre of main interest according to Article 3(1), even if it is totally dependent of the parent company due to a control agreement or an agreement to transfer profits.[74] The regulation applies for each single entity separately.[75]

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68 The Report para 39, 40.

69 M Balz, *supra* note 17 at 949.

70 M Balz, *supra* note 15 at 505.

71 *De Bloss v Bouyer* [1976] ECR 1497; *Somafer v Saar-Fernglas* [1978] ECR 2183; *Blanckaert & Willems v Trost* [1981] ECR 819; *SAR Schotte v Parfums Rothschild* [1987] ECR 4905; *Lloyd's v Campenon* [1995] ECR 961. For details see J Kropholler, *Europäisches Zivilprozessrecht* 6th ed (Heidelberg: Verlag Recht und Wirtschaft GmbH, 1998) at 136-40.

72 HL Select Committee on The European Communities Convention on Insolvency Proceedings 7th Report (HL Paper (1995-96) no 59) at 9.

73 P von Wilmowsky, "Internationales Insolvenzrecht – Plädoyer für eine Neuorientierung – " (1997) WM 1461 at 1462.

74 See s 291, 292 of the German Stock Corporation Act (*Aktiengesetz, AktG*).

Therefore, cases like *Maxwell*[76] cannot be dealt with under the Regulation. Due to the non-applicability of the Regulation, especially Articles 27-38, the developed national rules of co-operation remain essential.[77] Determining the centre of main interest of a holding company might be particularly difficult.[78] As far as the existence of subsidiaries are concerned the importance of the Regulation will rise with the implementation of multi-national companies limited by shares through EU legislation. Sooner or later new European legal structures, in particular the new European joint stock company, will replace the current system of subsidiaries and form legal entities without the necessity of various national registration procedures.[79]

Due to the system of subsidiaries, it is also possible that within the same group more than one main insolvency proceeding is conducted at the same time. In terms of efficiency this is surely a disadvantage especially if one takes into consideration that rescue proceedings, for example, are far more beneficial if not only one arm of the company is subject to a sale or restructuring measures. To decrease the problems it is suggested that the liquidators of the main proceedings are co-operating in the same way as it has happened occasionally without any Insolvency Regulation. Additionally, it might be a worthwhile thought whether the ECJ could apply Article 31 analogously in the case of different main proceedings within one group.

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75 M Balz, *supra* note 17 at 949.

76 *Re Maxwell Communications Corporation plc* [1992] BCC 757.

77 For the English law as regards international co-operation in cross-border insolvency cases *see Felixstowe Dock and Railway Co v US Lines Inc* [1989] QB 360; *Re Maxwell Communications Corporation plc* [1992] BCC 757; Fletcher, *supra* note 4 at 178-82; Millett L J, "Cross-Border Insolvency: The Judicial Approach" (1997) 6 IIR 99 at 107-8; JL Westbrook, "The lessons of Maxwell Communication" (1996) 64 Fordham L Rev 2531; Lord Hoffmann, "Cross-border insolvency: a British perspective" (1996) 64 Fordham L Rev 2507 at 2515; Farley J, "A judicial perspective on international cooperation in insolvency cases" (1998) Abl Jnl LEXIS 59 (March 1998) 6. For the international assistance under Section 426(4) and (5) of the Insolvency Act 1986 see RM Goode, *supra* note 23 at 504; J Goldring and J Perry, "Mutual co-operation in multinational insolvencies – approach of the English courts" (2000) 16 ILP 110; L Kosmin, "Obtaining information in support of a foreign liquidation: the impact of the Insolvency Act 1986, s 426" (2000) CFILR 209; Millett L J, "Cross-Border Insolvency: The Judicial Approach" (1997) 6 IIR 99, 104; A Borrowdale, "Developments in transnational insolvencies" (1998) 14 ILP 161; *Re Bank of Credit and Commerce International SA (No9)* [1994] 3 All ER 764 at 785; *Re Dallhold Estates (UK) Pty Ltd* [1992] BCC 394; *Hughes v Hannover* [1997] 1 BCLC 497, at 519-24 (CA). An order was also declined in *Re Focus Insurance Co Ltd* [1997] 1 BCLC 219; *Re JN Taylor Finance Pty Ltd, England v Purves* [1998] BPIR 347; *Re Southern Equities Corp Ltd* [2000] 1 BCLC 21. As regards the less developed German law see M Balz, *supra* note 15 at 489; G Paulus, *supra* note 49 at 977.

78 HL Select Committee on The European Communities Convention on Insolvency Proceedings 7th Report (HL Paper (1995-96) no 59) at 9.

79 In this respect see the draft of the EU Regulation regarding the new European joint stock company, draft Regulation 14717/00 SOC 500 SE8 which is supposed to be enacted in summer 2001.

Another problem emerges where not only Member States and third States are involved which hitherto might give rise to considerable practicable difficulties where the different sets of rules conflict but also a group or holding containing companies, subject to the Regulation, and a bank, subject to the separate EU Winding Up Directive.[80] It is not difficult to imagine that this diversity will lead to severe problems applying the law which is likely to infringe the *par est condicio omnium creditorium* rule.

Conversely, the Regulation provides also an advantage, because the Regulation assists a parent company in protecting its interest as a shareholder in a company which is the subject of main proceedings in another Member State. For example, if an English holding company has a Spanish subsidiary it may be necessary to enforce the rights as a Spanish shareholder and the fact that it is recognized by the Spanish court as being the owner of those shares gives it a good position.

IV. Unsolved Conflict of Laws Problems

A. *English Security Rights*

(i) *Implications of Article 5 and Article 26 on English security rights*

One of the major problems in cross-border insolvency proceedings is certainly whether a security right has to be recognized in an insolvency proceeding opened in a foreign country. It becomes even more complicated if the concept of the security right in question is not known in this country. Such a situation would occur if a German liquidator had to deal with an English charge, in particular a floating charge.

European laws take quite different approaches to the treatment of secured creditors in insolvency proceedings. Some procedures, like the French *redressement judiciaire*, tend to substantially interfere with the general civil law rights of security holders and inflict considerable losses on secured creditors for the benefit of the debtor and its rehabilitation. Other insolvency laws leave secured creditors largely unaffected. This is true of all systems, *eg* in Germany and the UK, that adhere to the composition paradigm of enterprise rescue which aims at a rescheduling of unsecured and non-priority debt only.

Article 5 of the Regulation provides that security interest (rights *in rem*) of third parties in assets of the debtor which are situated in a Member State other than the opening State at the time of opening of proceedings (foreign situated collateral) will not be affected by the proceedings.

As a consequence, the holder of a security interest in foreign situated collateral may proceed as if there were no insolvency of the debtor. The secured party may, for example, dispose of the secured assets, foreclose a

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[80] Council Directive (EC) 98/26 on settlement finality in payment and securities settlement systems (1998) OJ L166/45.

mortgage under the conditions set out by the general law of the *situs* or demand the assets from anyone having possession of them. With regard to secured book debts, the creditor is still exclusively entitled to have a claim met. These creditors are not affected by a stay issued in connection with foreign insolvency proceedings, and they may not be impaired by a plan. If, as may be the case, a main liquidator wants to benefit from the insolvency law of the *situs* of foreign situated collateral, he may file for secondary proceedings if the debtor owns an establishment in the State of the *situs*.[81] The law of the secondary forum may, for instance, include secured creditors in the automatic stay or otherwise subject secured creditors to insolvency specific restraints.[82]

In general, Article 5 seems to provide a reliable protection of a security interest. It should be noted, however, that Article 26 of the Regulation allows exceptions of this rule if the right *in rem* leads to a judgment that would be contrary to the public policy of a Member State. Article 26 states that a Member State may refuse to recognize or to enforce a judgment where the effects would infringe the public policy rule of that Member State, in particular its fundamental principles or the constitutional rights and liberties of the individual.

If, therefore, an English court or liquidator recognizes a fixed charge or a floating charge under English law, assuming the security qualifies as a right *in rem*, a German liquidator or insolvency court could still refuse to enforce this decision if the recognition of the security infringes the German public policy rule.[83] As a result, it is – despite Article 5 of the Regulation – still questionable if an English liquidator is entitled to enforce his right according to Article 18 of the Regulation to remove the debtor's assets situated in Germany although they are secured by an English security right which had been recognized in the English insolvency proceedings.[84]

The same problem arises when an English creditor, according to Article 39 of the Regulation, lodges a claim, *eg* based on a floating charge in a main or secondary insolvency proceeding opened in Germany with regard to assets located in Germany. Article 26 applies a *maiore ad minus* even if this situation – because no prior judgment has been made by an English authority – is not expressly regulated. In this case the German liquidator has

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81 Council Reg 1346/2000, Art 29(a).

82 M Balz, *supra* note 15 at 509-10.

83 The public policy rule is applicable even where the English charge relied upon was taken over movable assets and the *lex situs* of these movable assets at the time of creation was England. All assets which are situated in Germany at the time of opening the insolvency proceedings are subject to Article 26 of the Regulation, irrespective of the jurisdiction where the security interest has been created.

84 In the House of Lords Report this uncertainty is expressed as follows: "It is uncertain, if an English creditor lodges a claim in insolvency proceedings (see Articles 39 and 41 of the Regulation) based upon a floating charge, to what extent the floating charge is recognized in other Member States", HL Select Committee on The European Communities Convention on Insolvency Proceedings 7th Report (HL Paper (1995-96) no 59) at 16.

to decide whether or not the English security is to be recognized in the insolvency proceeding. The German liquidator has to consider if the recognition as a right *in rem* and the effects resulting from this decision are compliant with the fundamental principles of German law.

Hence, it is insufficient for the creditor to look simply on the scope of Article 5 of the Regulation and rely on the fact whether or not a security qualifies as a right *in rem*. This is only one side of the coin, and legal certainty will only be achieved if the relevant public policy rule is taken into account as well.

(ii) *Fixed and Floating Charge under English Law*

In order to deal with the above described problem in more detail, the focus of the analysis shall be the recognition of the English fixed and floating charge from a German perspective. Apart from mortgages of freehold or leasehold interests in land, fixed and floating charges are the most common securities granted to English creditor banks. Before focusing on the scope of Article 26 and the key question whether an English charge is contrary to fundamental principles of German law, the character of fixed (1) and floating charges (2) shall be briefly described and compared to securities known in the German jurisdiction (3).

(1) *Fixed charge*: Generally speaking, a charge is an interest in company property created in favour of a creditor to secure the amount owing to the creditor.[85]

A "fixed charge" is usually attached to present assets such as land (if this is not secured by a mortgage), machinery, furniture, vehicles, the company's intellectual property and goodwill, rights to insurances *etc*, but it can also cover circulating assets like book debts. The company is not allowed to dispose of any property secured by a fixed charge without prior consent of the creditor bank. The right to deal with the secured assets is also the crucial criteria to distinguish between a fixed and a floating charge rather than if the assets secured by the charge are fixed or circulating.[86] However, a charge over fixed assets is presumptively intended to be a fixed charge and a charge over circulating assets rather implies the intention to create a floating charge.[87] Unlike a mortgage, the creation of a fixed charge does not involve a transfer of title to the assets which are subject-matter of the security.[88] Rather, the bank holding a fixed charge is entitled to take the

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85 E Martin and S Singleton *Oxford Dictionary of Law* 4th ed (Oxford University Press, 1997) at 68.

86 RM Goode, *Commercial Law* 2nd ed (London: Butterworths, 1995) at 735; E Ferran, "Floating Charges – The Nature of the Security" (1988) 47(2) Cambridge Law Journal 213 at 229.

87 RM Goode, *Legal Problems of Credit and Security* 2nd ed (London: Sweet & Maxwell, 1988) at 55-6; *Re Cimex Tissues Ltd* (1994) BCC 626 *per* SJ Burnton QC at 635.

88 E Ferran, *supra* note 86 at 213.

contractually defined property into its possession and turn it into cash if the debtor company is in default of payment of the secured loan or other contractually agreed events occur, *eg* the appointment of an administrative receiver by a third party.

(2) *Floating charge*: The fixed charge will often be less suited as security for assets which are likely to be changing in the course of the company's business, *eg* raw materials, stocks in trade *etc*. For such assets the "floating charge" is the more appropriate instrument. Floating charges are common in England and Ireland, and, albeit to a lesser extent, in Sweden and Finland.[89]

While the fixed charge is attached to a specific item or a number of specific items of the company's property, the floating charge covers present and future assets which are generally defined in the agreement between the creditor bank and the debtor company.[90] In contrast to the situation under a fixed charged, the debtor company is allowed to dispose of such assets in the ordinary course of the business.[91] This right to deal with the assets terminates upon certain contractually defined events which cause the floating charge to "crystallize" into a fixed charge. As Lord Justice Buckley perceptively described it:

> "A floating charge is not a future security; it is a present security, which presently affects all the assets of the company expressed to be included in it … A floating security is not a specific mortgage of the assets, plus a licence to the mortgagor to dispose of them in the course of his business, but is a floating mortgage applying to every item comprised in the security but not specifically affecting any item until some event occurs or some act on the part of the mortgagee is done which causes it to crystallise into a fixed security".[92]

Accordingly, the floating charge is like a net situated – relatively high – above the contractually defined assets of the company waiting to fall down

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89 M Balz, *supra* note 15 at footnote 98.

90 It is necessary to express the intention to cover present and future assets to create a floating charge. Expressions such as "the company's undertaking" or "present and future property" are sufficient; see RM Goode, *supra* note 86 at 735.

91 "Ordinary course of business" has been generally defined "as authorised by the memorandum of association" or "as the object of its incorporation". This also includes exceptional and unusual transactions such as the sale of part of the company's business, but not the entire undertaking, see *Re Borax Co* [1901] 1 Ch 326; *Re Vivian & Co Ltd* [1900] 2 Ch 654; *Re Automatic Bottle Makers Ltd* [1926] Ch 412 at 421*; Hubbuck v Helms* [1887] 56 LJ Ch 536. In acting outside the limits of the trading power, the company will be in breach of contract and the debenture holder maybe entitled by the contract to appoint a receiver to ensure that there is no recurrence of such activities or such activity might cause automatic crystallisation, E Ferran, *supra* note 86 at 231.

92 *Evans v Rival Granite Quarries Ltd* [1910] 2 KB 979 at 999.

to cover and secure such assets for the benefit of the debenture holder. The character as a present security becomes apparent in relation to other charges. Basically, a floating charge has priority over any subsequent charge taken with notice of a negative pledge clause in the floating charge instrument. However, in the absence of such provision in the agreement between the company and the creditor bank, the company's right to deal with the assets in the ordinary course of its business also implies the right to grant subsequent fixed charges ranking in priority to the floating charge.[93] A subsequent charge has also priority when the other encumbrancer has no notice of such restriction and therefore acts in good faith. The same applies to a *bona fide* purchaser of the property secured by a charge. It is also argued that the floating charge is a present security because it gives rise to an interest amounting to an equitable interest even before crystallisation.[94] This aspect, resulting in the debenture holder of an uncrystallised floating charge having an interest in the secured property which can be recognized in an insolvency proceeding, is still debated.[95]

Typically, a floating charge is taken over circulating assets, such as stocks in trade, raw materials, book debts and other receivables, while a fixed charge – often granted in the same contract together with the floating charge – covers the fixed assets of the company. Nonetheless, a floating charge could also cover any other kind of property, including interest in real estate.

"Crystallisation" of the floating charge occurs upon a variety of events usually agreed in the contract between the debtor company and the creditor bank. Firstly, the bank is often contractually entitled to turn the floating charge into a fixed security at any time upon written notice to the company. This right might be restricted to be executed only after serving a demand for payment of outstanding amounts or only if the bank has reason to believe that the secured assets are in jeopardy. Secondly, the floating charge automatically crystallises into a fixed charge without the need of the bank's notice upon certain events defined in the floating charge instrument. Because a floating charge presupposes the continuance of the company's business it crystallises when the company ceases to carry on its business or a substantial part thereof whether this happens voluntarily or in response to a winding-up petition.[96] In this case there is even no need for a separate

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93 *English & Scottish Mercantile Investment & Co Ltd v Brunton* [1892] 2 QB 700; *Cox v Dublin City Distillers Co* [1906] IR 446; *Griffiths v Yorkshire Bank Ltd* [1994] 1 WLR 1427; WJ Gough, *Company Charges* 2nd ed (London: Butterworths, 1996) at 156-7.

94 JH Farrar, "World Economic Stagnation puts the Floating Charge on Trial" (1980) 1 Co Lawyer 83. This view is denied by WJ Gough, "Company Charges in Equity and Commercial Relationship", PD Finn, ed, (North Ryde, NSW: Law Book Co, 1987) Chapter 9; E Ferran, *supra* note 86 at 213.

95 E Ferran, *supra* note 86 at 213.

96 *Re Woodroffes Musical Instruments Ltd* [1986] 2 All ER 908 *per* Nourse LJ at 913-4; *Edward Nelson & Co Ltd v Faber & Co* [1903] 2 KB 367 *per* Joyce J at 376-7; *Re Victoria Steamboats Ltd* [1897] 1 Ch 158 *per* Kekewich J.

contractual provision to cause crystallisation because it happens *de facto* as the company has no longer a "business" in which ordinary course it would be allowed to sell the secured assets.[97] The limits of the company's ordinary business could be, of course, doubtful if the company has not completely ceased to carry out its business. Automatic crystallisation is a function of the terms of the charge[98] and can be caused when the company stops making payments to its creditors or gives notice that it intends to stop payment, or, further, when the creditor bank itself appoints an administrative receiver or when the management of the company passes a resolution for a voluntary winding-up of the company. Understandably, there is tendency to expand crystallisation clauses in order to protect the bank's interests in the secured assets. The earlier automatic crystallisation occurs the less the risk that assets are disposed of by the company.[99] Therefore, other events might be agreed in the contract between the creditor bank and the company.

When crystallisation has taken place the floating charge turns into a fixed charge. Therefore, the floating charge is deemed to be created as a fixed charge at the time of crystallisation. The company loses its authority to deal with the assets in the ordinary course of its business. The creditor bank is entitled to appoint an administrative receiver who has all powers to turn the secured assets into cash to the benefit of the bank.[100] This includes to take possession of the assets and to sell, to license, to grant leases, to apply for foreclosure or dispose otherwise of them.[101] Until such actions has taken place, a third party dealing with the debtor company may be unable to discover whether or not a floating charge has automatically crystallised. Hence, there is still a risk of a *bona fide* disposition of the assets.

(3) *Equivalents in the German jurisdiction*: Although there are a number of security instruments under German law, there are no real equivalents to the

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97 *Re Woodroffes Musical Instruments Ltd* [1986] Ch 366; E Ferran, *supra* note 86 at 229.

98 To what extent the crystallisation clauses can be expanded is still under discussion, see RM Goode, *supra* note 86 at 738.

99 There is of course still a remaining risk as third parties which continue to deal with the company *bona fide* might not be bound by crystallisation and receive full title in the purchased assets. *Eg* this should be the case when a purchaser dealt with the company prior to crystallisation and continues to deal with it thereafter without having notice of crystallisation. Such person is entitled to assume the continuance of the authority of the company to deal with its goods unless it receives the information revealing the opposite (or does not have such information due to gross negligence). See also RM Goode, *supra* note 86 at 743; *Fire Nymph Products Ltd v The Heating Cente Pty Ltd* [1992] ACSR 365.

100 The wide powers of the administrative receiver create a "fear factor" in borrowing as Sir M Grylls MP, "Insolvency Reform: Does the United Kingdom need to retain the floating charge?" (1994) Journal of International Banking Law 10, 391 at 392, critically puts it, because the directors immediately lose their control over the company upon appointment of a receiver. Grylls also argues for the elimination of the floating charge to create a "more robust lending environment in the UK".

101 RM Goode, *supra* note 86 at 740.

fixed or the floating charge in the German jurisdiction. The German law focuses on the different types of property over which security rights shall be taken. Accordingly, there is not only one instrument, such as a charge, which is suitable for all kinds of assets but a variety of different instruments that are subject to different regulations. Notwithstanding the fact that it is also feasible to create security rights in all kinds of property and assets under German law, those securities are not created in the same contract whereas German banks usually have to enter into a number of security agreements with the debtor company in order to achieve the same result than under an English charge.

The German chattel mortgage (*Sicherungsübereignung*) might come close to a charge as far as movables are concerned. It is also possible to take a chattel mortgage in present movables? as well as in movables which are bought by the debtor company in future (*Sicherungsübereignung von Sachgesamtheiten mit wechselndem Bestand*). Similar to a party of a floating charge, the company is also entitled to deal with the goods in the course of its ordinary business but has to make sure that a certain value of goods always remains secured by the chattel mortage. But unlike in a floating charge instrument, all movables which shall be secured by the chattel mortgage in present or in future have to be described very clearly and specifically at the time the parties enter into the contract (*Bestimmtheitsgrundsatz*) as full title to the respective assets is transferred to the debenture holder. General descriptions of future assets in the contract are not sufficient to transfer property in future movables effectively under German law.[102] In any case of non-determinability the creditor bank has no rights in the assets at all.

With regard to book debts German banks are able to take assignment of all present and future debts to secure loans provided to companies (*Globalzession*). The requirements for assigning future debts are not as strict as for transfer of title to movables but the debts also have to be defined clearly so that at the time they arise (in future) there is no doubt whether or not they are covered by the assignment (*Bestimmbarkeitsgrundsatz*). However, because of the creditor bank's problems to carry out claims against the numerous debtors of the company successfully, this kind of security is only taken as a second or third choice to mortgages in real estate (*Grundschulden*) and chattel mortgages, respectively.

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[102] For more details see Section B, Part 2(2)(b) below.

B. *Recognition of English Security Rights in Germany*

(i) *English Security Rights as a Right* In Rem *under Article 5 of the Regulation?*

As there is no equivalent to the English charge in Germany it is most questionable if such a security can be recognized as a right *in rem* in German insolvency proceedings. Article 5(2) of the Regulation contains a rather elaborate typological explanation and not a precise definition of what is meant by a right *in rem*. Suffice it to say that liens, mortgages and pledges would all be considered to be rights *in rem*.

It is crucial to point out that whether the security right exists (has been created effectively) or not is a question only of national law. A *renvoi* is excluded as Article 4 to Article 15 of the Regulation provide for a self-containing set of conflict of laws rules. In other words, a German court has to apply English domestic law to determine whether or not an English security has been created.

(1) *Fixed charge*: The fixed charge is undoubtedly within the definition of Article 5(2)(a) whereas it seems certain that any fixed charge will be considered as a right *in rem* according to the Regulation.

(2) *Floating charge*: Whether the floating charge is a right *in rem* according to Article 5 is not expressly stated in the Regulation. An earlier version of the Report only mentioned that a crystallised floating charge "may qualify" as a right *in rem*[103] but nonetheless the better arguments fundamentally speak in favour of the floating charge as a right *in rem*. Throughout the discussions of the Convention it has been emphasized by the English delegation that this is of vital interest for English creditors. This is reflected by the final version of the Report which explicitly states that

> security rights such as the floating charge recognized in United Kingdom and Irish law can, therefore, be characterised as a right *in rem* for the purposes of the Convention.[104]

Even if the floating charge, therefore, generally has to be recognized as a right *in rem* it still remains doubtful whether this is also the case before crystallisation.[105] This is likely to become a question for a preliminary ruling of the European Court of Justice under Article 234 of the EU Treaty. It is difficult to see how a floating charge can, before crystallisation, be a

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[103] The Report para 85.

[104] The Report para 104; IF Fletcher, *supra* note 4 at 272.

[105] HL Select Committee on The European Communities Convention on Insolvency Proceedings 7th Report (HL Paper (1995-96) no 59) at 48.

right *in rem* according to the criteria set out in the Report.[106] This describes the features of such a right thus:

> it has a direct immediate relationship with the asset it covers; its creation involves an absolute alienation to the acquirer of the right, which enables the holder to resist the alienation of the asset to which it relates to a third party; and to resist individual enforcement by third parties.

A floating charge does not have these properties, at least until crystallisation. It is difficult to accept that it creates a "direct and immediate relationship" with the assets it covers; and it is the essence of a floating charge that it does not, of itself, prevent the alienation of those assets to third parties. As we have seen, the floating charge should become a right *in rem* on crystallisation. Even then, however, it seems doubtful that it can be said with confidence that there arises a "direct and immediate relationship" between the charge and the assets secured.[107] Furthermore, the Regulation does not recognize a right *in rem* which did not exist "at the time of the opening of proceedings".[108] The crystallisation of a floating charge may well not occur before insolvency proceedings are opened elsewhere. Even though the opening of proceedings elsewhere cause the charge to crystallise, it seems likely that the crystallisation would be regarded as occurring after the opening of the proceedings, however short the space of time before this effect occurs. Alternatively, it might be decided that it was contemporaneous with that event. At any rate, it could not be said to precede it. It is therefore suggested that Article 5(1) of the Regulation only recognizes a floating charge as a right *in rem* if the crystallisation has already been taken place before the opening of insolvency proceedings.

(ii) *Infringement of the German Public Policy Rule?*

(1) *Scope of Article 26*: Even if English security rights eventually qualify as rights *in rem* there is a further impediment to overcome in Article 26 of the Regulation. Article 26 provides that an English security is not enforceable if it infringes the public policy rule of a Member State. Whether or not the public policy rule is violated is a question of the respective national law

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[106] The Report para 84.

[107] In contrast thereto, although the German chattel mortgage allows the debtor company to dispose of the secured assets in the course of its ordinary business as well, the creditor bank receives full titled in the assets at the time the parties enter into the agreement. At this time the property right in the assets is already transferred to the bank so that there is an "immediate relationship" with the assets.

[108] Council Reg 1346/2000, Art 5(1).

only. The Regulation does not attribute a more restrictive content to the concept of public policy than that of the Member State.[109]

As far as the German public policy rule is concerned the question is as to whether the judgment or the claim of a foreign liquidator is compliant with fundamental principles of German law and does not in particular infringe s 138 of the BGB (*Verstoß gegen die guten Sitten*) containing the *contra bonos mores* principle (no transactions contrary good morals). The *contra bonos mores* principle is a well established case of a public policy infringement under Article 6 of the German EGBGB (Introductory Law of the Civil Code which contains the international German conflict of laws rules according to the Rome Convention) and s 328 of the ZPO (German Code of Civil Proceedings) which have the same wording as Article 26 of the Regulation.[110] In order to apply the *contra bonos mores* principle it is possible to revert to the judgments developed under s 138 and s 826 of the BGB.[111] This is of particular importance as thereby all cases of creditor discrimination which violate s 138 of the BGB and therefore the public policy rule in general[112] form a violation of the public policy rule under Article 26 of the Regulation as well.

(2) *Violation of German law*: In this section it is analysed whether an English charge in Germany is compliant with Article 26 of the Regulation, *ie* with fundamental principles of German law and does not in particular infringe s 138 of the BGB containing the *contra bonos mores* principle. This is questionable in different respects.

(a) *Security rights in German real estate*: First, the most obvious inconsistency with German law occurs if a fixed or floating charge is also attached to real estate owned by the debtor company in Germany. It is a fundamental principle of German property law (s 854 – 1296 of the BGB) that rights in land and in movables have to be made obvious to third parties (*Offenkundigkeitsprinzip*).[113] Therefore, according to s 873 I of the BGB, to create any right in land in Germany it is an indispensable requirement that such right is registered in the *Grundbuch* (lands registry). Insofar English creditors are restricted to the security rights provided by the German law like the *Grundschuld* (mortgage). Hence, there is no way to create a security

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109 The Report para 191.

110 S Homann, *System der Anerkennung eines ausländischen Insolvenzverfahrens und die Zulässigkeit der Einzelrechtsverfolgung* (Münster: Juristische Schriftenreihe Lit Verlag, Diss, 2000) at 100; J Kropholler, *supra* note 71 at 229; Stein/Jonas-Schumann, *ZPO*, 21st ed (Tübingen: Verlag J C B Mohr, 1998) s 328 at 123 pp; MüKo-Sonnenberger, *Münchener Kommentar zum Bürgerlichen Gesetzbuch, EGBGB* 3rd ed (München: Verlag C H Beck, 1998) Art 6 at 63.

111 S Homann, *ibid* at 100.

112 S Smid, "Das Deutsche Internationale Insolvenzrecht und das Europäische Insolvenz-Übereinkommen" (1998) DZWir 432 at 435; S Homann, *supra* note 110 at 100.

113 J Baur and R Stürner, *Sachenrecht* 17th ed (München: Verlag C.H. Beck, 1999) at 31.

right in German land by registering an English fixed or floating charge instrument as the German BGB does not contain such rights in real estate at the moment. Therefore, any English security right covering land in Germany is contrary to fundamental principles of the German property law and has to be regarded as void as long as it is not possible to register such rights in the German *Grundbuch*. This is a necessary consequence in order to protect creditors who rely on the registry and act in good faith according to the German property law (s 892 of the BGB).

(b) *Security rights in movables situated in Germany*: With regard to security rights in movables in Germany the main problem with respect to Article 26 of the Regulation is the non-determinability of the assets attached to a floating charge. As already mentioned above, the German law is very strict as far as the creation of security rights in property is concerned as this involves full transfer of title to the respective assets. Therefore, it has to be regarded as a fundamental principle of German property law that assets which shall be covered by a security instrument have to be described in a very specific way so that they can be undoubtedly identified only with the help of the contract itself (*Bestimmtheitsgrundsatz*), for instance by including machine numbers or by enclosing a ground plan to the contract describing where the relevant assets are stored and by using so called "catch-all-clauses" in order to avoid cases of doubt.

English creditors usually work with very broad "catch-all-clauses" in their fixed and floating charge instruments in order to cover all kinds of assets, for example:

> The Company, with full title guarantee, hereby charges to the Bank as a continuing security for the payment or discharge of the Secured Amounts:
> …
> by way of first floating charge the undertaking of the Company and all its property, assets and rights, whatsoever and wheresoever, both present and future (including all stock in trade and including all freehold and leasehold property) …

General descriptions like "the undertaking" are definitely not appropriate to create an effective security right in movable property under German law. From a German law perspective it is absolutely unclear which assets are supposed to be secured by the term "the undertaking". The catch-all-clause "all its property, assets …" may be sufficient to fulfil the required standard of determinability under German law if there is no doubt which assets shall be covered by the security. However, it is insufficient if it is only referred to

"all its property" without further specification.[114] This has to be decided on a case by case basis. It is crucial that the terminology used to describe the secured assets is absolutely clear and sufficient to specify the secured assets undoubtedly. In any case of ambiguity the security right will not be created effectively according to consistent practice of the German courts.[115] For a sufficient determinability it is vital that a third party would be able to decide undoubtedly whether an asset is secured by the charge or not with the help of no other documents but the contract itself. Catch-all-clauses only fulfil this requirement if there is no doubt about the meaning of the used wording. For instance, the term "all inventory" or "all raw material" is only sufficient if there is no doubt what belongs to the "inventory" or the "raw material" respectively. Given that there are many differences in meaning and interpretation of the same words in England and in Germany, this aspect is most problematic. Additionally, the translation of the words is often equivocal what makes the situation even worse. Furthermore, any restriction of a catch-all-clause will inevitably result in the security being void under German law because of non-determinability. *Eg* "all assets except those which do not belong to the debtor company or which are subject to rights of a third party", "75 % of the assets", "assets worth … Pounds Sterling in total" or similar language is definitely not sufficient under German law.[116]

Hence, because of the strict requirement of determinability under German law which is to such an extent unknown in the English jurisdiction, it is probably most questionable in the majority of cases whether the English terms in fixed and floating charge instruments are sufficient to specify the secured assets from a German law perspective. If this is not the case, the contract infringes fundamental principles of the German property law. Consequently, the public policy rule according to Article 26 of the Regulation is violated when an English creditor bank lodges a claim based on such a security instrument. Therefore, even if German law has to recognize the fixed or floating charge as a right *in rem* according to Article 5, provided a broad interpretation of the ECJ, it is unlikely that it has any legal effect and serves as a useful security for English creditors in Germany. A German liquidator or court will not, for instance, decide in favour of an English bank requesting to take the assets in possession on the basis of a floating charge instrument if such assets cannot be undoubtedly specified according to German law standards.

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[114] "Catch-all-clauses" are dealt with in BGH (1986) NJW 1985, 1986, see also MüKo-Quack, *Münchener Kommentar zum Bürgerlichen Gestzbuch*, 3rd ed (München: Verlag C H Beck, 1997) s 929 at 83; D Reinicke and K Tiedtke, *Kreditsicherung* 3rd ed (Neuwied: Verlag Luchterhand, 1994) at 138; H-J Lwowski, *Das Recht der Kreditsicherung* 8th ed (Berlin: Erich Schmidt Verlag, 2000) at 470 pp. The use of catch-all-clauses may also lead to the problem of over security which can also result in the agreement being void under German law; see (d) below.

[115] See the examples at H-J Lwowski, *ibid*, at 471.

[116] BGH (1989) WM 1904 pp; BGH (1962) WM 740; H-J Lwowski, *supra* note 114 at 472.

Apart from that the recognition of general descriptions like the example above in English security instruments would also be disadvantageous and discriminatory for local German creditors who have to fulfil the standard set forth by German law and cannot secure their loans in the same broad sense as English creditors. This is likely to be against the principle of equal treatment set out by Article 3(1) of the *Grundgesetz* (the German Constitution) and might therefore also infringe constitutional rights of German creditors.

(c) *Security rights in book debts*: Another problem will arise with regard to security rights in book debts. Under English law book debts can be secured by both fixed and floating charges. As explained above, under German law security rights in book debts are taken by assignment of all present and future claims against the debtor company's customers. According to a consistent practice of the German *Bundesgerichtshof* (Federal High Court of Justice) such an assignment is void if it undermines the security rights of other creditors. This is the case if the assignment does not contain an automatic release of book debts which are secured by an extended retention of title as regards the debtor's proceeds of sales held by suppliers of the debtor company (*verlängerter Eigentumsvorbehalt*).[117] It is consistent practice in Germany that contracts between the supplier and the purchaser of goods contain a retention of title so that the property in the sold goods remains with the seller until full payment is made to its benefit. Notwithstanding this title of retention, the debtor company has the contractual right to sell the goods in the ordinary course of its business. In this case the claim, in other words the proceeds, arising from such a contract between the debtor company and its customer is automatically assigned to the supplier. Frequently, there is a collision between security rights of the supplier and a creditor bank which has taken assignment of all present and future book debts. According to German law the earlier assignment basically has priority over the later on a first come – first served basis (*Prioritätsprinzip* – principle of priority). Banks usually secure their loans at a very early time when the company commences its business and has to provide securities for the bank loans. Consequently, the principle of priority leads to the problem that the debtor company would constantly breach its contracts with suppliers whereby it is also obliged to assign certain book debts which had already been assigned to the creditor bank. Therefore the German *Bundesgerichtshof* held in consistent practice that an assignment of book debts taken by a creditor bank is void as inducing a breach of contract

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[117] As regards Article 7 of the Regulation, dealing with retention of title, it is not clear whether the protection given is confined to assets to which title has been retained or whether it also extends to the proceed of sales of those assets (extended retention of title). As Article 7 follows a German proposal it is suggested to apply the German definition of retention of title which includes the extension to the proceed of sales as one variation ("*verlängerter Eigentumsvorbehalt*"), see M Balz, *supra* note 17 at 950.

(*Verleitung zum Vertragsbruch*) according to s 138(1) of the BGB if it does not contain an automatic release of book debts which are usually secured by security rights of suppliers.[118] The same must apply to an English fixed or floating charge instrument. As the current standard forms of fixed and floating charges do not contain such release of book debts they have to be regarded as void according to s 138(1) of the BGB and accordingly as an infringement of the public policy rule of Article 26 of the Regulation as far as security rights in book debts are concerned. A different result would be an unjustified discrimination for local German creditors according to Article 3(1) of the German *Grundgesetz*, as they could not secure their loans in the same broad sense as English creditors.

(d) *Over security at the cost of other creditors and the debtor company*: Another potential issue with regard to the recognition of English fixed and floating charge instruments is the risk of so called "excessive or over security". Over security occurs if there is a considerable and not only temporary discrepancy between the value of the securities and the sum of the secured loans.[119] Under German law it has to be distinguished between initial and later over security. In the event of an initial over security there must be such considerable discrepancy at the time the parties enter into the contracts and at that time it also has to be certain that this will also be the case when the bank realises its securities in the event of default of the debtor company. As a result of initial over security the entire contract is void according to s 138(1) of the BGB.[120] In contrast hereto, later over security usually only occurs because the debtor company has paid off substantial parts of the secured loans while the value of the securities is still at a similar level like it was at the time when the parties entered into the contracts. As the value of the securities at that time was adequate, later over security only results in the obligation of the creditor bank to release a part of its security rights.[121]

As English creditor banks usually take fixed and floating charges in all present and future assets of the debtor company by using broad catch-all-

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[118] BGH (1999) WM, 126 pp; BGH (1998) NJW-RR, 123 pp; BGH (1995) WM 939; BGH (1994) WM 104; BGH (1991) WM 1273; BGH (1987) WM 775; BGH (1989) WM 11; BGH (1986) WM 1545; BGH (1983) WM 953.

[119] BGH (1994) WM 419, 420; BGH (1998) WM 1037, 1041; BGH (1966) WM 13, 15; H Ganter, "Die ursprüngliche Übersicherung" (2001) WM at 1.

[120] H-J Lwowski, *supra* note 114 at 137; see also H Ganter, *ibid* at 1; H-J Lwowski, "Die anfängliche Übersicherung als Grund für die Unwirksamkeit von Sicherheitenbestellungen" (§ 138 BGB) Festschrift für Schimansky (Köln: RWS Verlag, 1999) 389; G Nobbe, "Konsequenzen aus dem Beschluss des Großen Senats für Zivilrecht des Bundesgerichtshofes zur Sicherheitenfreigabe" Festschrift für Schimansky (Köln: RWS Verlag, 1999) at 433.

[121] BGHZ 137, 212. In its decision of 27 November 1997 the *Bundesgerichtshof* expressly gave up its view that a security instrument is void if it does not contain a clause which entitles the debtor company to claim the release of a part of the security rights in the event of later over security.

clauses there is always a serious risk of initial over security involved. It is difficult to describe in general terms to what extent the value of the securities has to exceed the sum of secured loans to cause initial over security. This is because the value of the securities can change rapidly until it is realised by the creditor bank. Therefore, an initial over security could be justified to a certain extent if the secured assets in question quickly lose their value in future. Of course this depends on the type of assets and has to be decided on a case by case basis. However, as of a percentage of more than 100% over security at the time the parties enter into the contracts, the possibility of initial over security at least has to be taken into consideration. According to the *Bundesgerichtshof* the debtor company can claim release of securities due to a later over security when the value of the securities exceeds the sum of the secured loans by more than 50%.[122] However, this could not be regarded as the limit for an initial over security as the consequences of initial and later over security are completely different.[123] As initial over security causes the contract being void the discrepancy must be higher than 50%.[124] However, if the value of the assets secured by the charge exceeds the secured loans to a considerable extent which is likely to occur in the case of the use of catch-all-clauses, the security might be void pursuant to s 138(1) of the BGB and therefore lead to an infringement of Article 26 of the Regulation. Even if the charge instrument contains a clause whereby the creditor bank is obliged to release securities if the security value exceeds the sum of loans to a certain extent, the charge could be void due to initial over security. The reason for this is that it is extremely unlikely that the debtor company would claim the release of securities which were just given to the bank.[125] Of course, whether or not there is a case of initial over security has to be decided carefully on a case by case basis and there is no automatism with regard to a certain percentage of over security. But there is always a serious risk of an initial over security involved in a floating charge instrument covering all present and future assets because the value of such assets is completely out of the control of the creditor bank and therefore could easily exceed the secured loans to an unforeseeable extent.

V. CONCLUSION

With the EU-Regulation on Insolvency Proceedings coming into force on 31 May 2002 one has to be aware of even more diversified international

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[122] BGH (1998) WM 227, 235.

[123] H Ganter, *supra* note 119 at 4; G Nobbe, *Bankrecht – Aktuelle höchst- und obergerichtliche Rechtsprechung* (Köln: RWS Verlag, 2000) at 248.

[124] The exact minimum percentage is still under discussion: for details see H Ganter, *supra* note 119 at 3; H-J Lwowski, *supra* note 120 at 391; G Nobbe, *supra* note 120 at 451. From 100% up to 300% discrepancy to cause initial over security almost everything is argued.

[125] BGHZ 26, 178, 186; H Ganter, *supra* note 119 at 4 pp.

cross-border insolvency rules. Its aim is to secure the simplification of formalities governing the reciprocal recognition and enforcement of judgments of courts and tribunals in insolvency proceedings, which have an intra-Community dimension. The Regulation is, therefore, only applicable for insolvency proceedings where the centre of the debtor's main interest, *ie* in the absence of proof to the contrary the place of the registered office, was situated within the European Union (intra-Community insolvencies). *Vis-á-vis* non-EU Member States, the Regulation does not impair the freedom of Member States to adopt the rules they desire. Moreover, for all other companies which are registered outside the European Union the current private international insolvency laws of the Member States will still play an important role in the future, regardless of the new Regulation. The scope of the Regulation is even more reduced, as regards to corporate groups which are commonly organised through subsidiaries which means insolvency proceedings have to be commenced against each entity separately.

The Regulation permits the opening of "secondary proceedings" in States, other than that of the main proceedings, where the debtor has an "establishment". The effects of "secondary proceedings" are restricted to the assets of the debtor situated in the territory of that State. Where secondary proceedings are opened before main proceedings, they are defined as "territorial proceedings" already known under German law as independent territorial insolvency proceedings. The concept of "secondary proceedings" is equally found under English (so-called ancillary proceedings) and German law, whereby the existence of assets in both countries are sufficient in contrast to an "establishment" under the Regulation. Therefore, England and Germany lose part of their jurisdiction in terms of secondary proceedings.

Any judgment of a court in one Member State opening either main or secondary insolvency proceedings will be recognized in principle with no further formalities in all other Member States, restricted only by different national public policy rules. The Regulation is applicable to different national rescue proceedings but does not recognize the English administrative receivership.

With respect to Article 39 of the Regulation, the English public policy rule which forbids the direct or indirect enforcement of foreign penal or revenue claims cannot be upheld in the future. As far as tax and social security claims are concerned, the Regulation has a superior effect on English national law.

The Regulation provides rules in order to harmonize a number of important uniform conflict rules on insolvency related issues. However, the Regulation does not solve all conflict of laws problems. The Regulation provides in Article 5 for the protection of rights *in rem*. However, Article 26 of the Regulation allows exceptions of this rule if the right *in rem* leads to a judgment that would be contrary to the public policy of a Member State.

English fixed charges will be considered a right *in rem*. In contrast the Regulation only recognizes a floating charge as a right *in rem* if the

crystallisation has already been taken place before the opening of insolvency proceedings. If the floating charge crystallises with the opening of insolvency proceedings it does not qualify as a right *in rem*, because it does not exist "at the time of the opening of proceedings" according to Article 5(1) of the Regulation.

Although there are a number of security instruments under German law, there are no real equivalents to the fixed or the floating charge in the German jurisdiction. The German law focuses on the different types of property in which security rights shall be taken.

English security rights are in various aspects not in compliance with Article 26 of the Regulation as far as the German public policy rule is concerned. Despite the Regulation they are not enforceable in Germany. Any English security right covering land in Germany is contrary to fundamental principles of the German property law and has to be regarded as void as long as it is not possible to register such rights in the German *Grundbuch*.

Due to the strict requirement of determinability concerning security rights in movables under German law which is to such an extent unknown in the English jurisdiction, it is probably most questionable in the majority of cases whether the English terms in fixed and in particular floating charge instruments are sufficient to specify the secured assets from a German law perspective. If this is not the case, the contract infringes fundamental principles of the German property law. Consequently, the public policy rule according to Article 26 of the Regulation is violated when an English creditor bank lodges a claim based on such a security instrument.

As regards book debts an assignment of book debts taken by a creditor bank is void under German law as inducing a breach of contract according to s 138(1) of the BGB if it does not contain an automatic release of book debts which are usually secured by security rights of suppliers. The same applies to an English fixed or floating charge instrument. As the current standard forms of fixed and floating charges do not contain a release of such book debts they are void according to s 138(1) of the BGB and have to be regarded as an infringement of the public policy rule of Article 26 of the Regulation as far as security rights in book debts are concerned.

English creditors should be aware of the German concept of initial and later over security. There is always a serious risk of an initial over security involved in a floating charge instrument covering all present and future assets because the value of such assets is completely out of the control of the creditor bank and therefore could easily exceed the secured loans to an unforeseeable extent. This will almost inevitably occur in the event of catch-all-clauses. The consequence is that the security is void pursuant to s 138(1) of the BGB and therefore leads to an infringement of Article 26 of the Regulation.

The aforementioned risks prove that the EU-Regulation is not designed to solve problems in terms of security rights in Europe. All creditors have always to consider the different national laws, in order to minimize the risk

of a non-enforceable security agreement. With respect to these risks it is advisable to use limited liability clauses when dealing with German assets in security agreements.