NCBJ EDUCATIONAL MATERIALS 2018 SAN ANTONIO

Presented by: NCBJ | National Conference of Bankruptcy Judges 2018

Monday, October 29

3:30 - 5:00 PM | Marriott Rivercenter Salon AB

NCBJ & American College of Bankruptcy Joint International Program:

Bankruptcy Sin Fronteras (Bankruptcy Without Borders): Voices and Videos From Around the World

92nd Annual National Conference of Bankruptcy Judges
October 28-31, 2018 San Antonio, TX

BANKRUPTCY *SIN FRONTERAS* (BANKRUPTCY WITHOUT BORDERS) VOICES AND VIDEOS FROM AROUND THE WORLD

Hon. Louise Adler , Judge, US Bankruptcy Court for the Southern District of California

Jay Westbrook, Professor, University of Texas School of Law

Patrick Ang, Deputy Managing Partner, Rajah & Tann Singapore LLP

Agustín Berdeja-Prieto, Partner, Berdeja y Asociados

Jenny Clift, Principal Legal Office, UNCITRAL

Daniel M. Glosband, Of Counsel, Goodwin Procter LLP

Patricia Godfrey, Partner, CMS Cameron McKenna Nabarro Olswang LLP

Luis Manuel C. Méjan, Professor, Law School of Instituto Tecnológico Autónomo de México

William J. Perlstein, Senior Deputy General Counsel, BNY Mellon

Christoph Paulus, Professor, Humboldt - Universität zu Berlin

Stathis Potamitis, Managing Partner, Potamitis Vekris

John Pottow, Professor, University of Michigan Law School

Justice Kannan Ramesh, Justice of the High Court, Singapore

Christopher Redmond, Attorney, Christopher Redmond Law

Steven L. Schwarcz, Professor, Duke University School of Law

BANKRUPTCY *SIN FRONTERAS* (BANKRUPTCY WITHOUT BORDERS) VOICES AND VIDEOS FROM AROUND THE WORLD

International Insolvency & Restructuring Report
2018/19

capital
markets
intelligence
cmi

Recent developments: Insolvency and restructuring in Singapore

by Patrick ANG Peng Koon and LIM Wee Teck Darren, Rajah & Tann Singapore LLP

The year 2017 was a tough year for the financial markets, in particular for the oil and gas industry. As indispensable commodities, the poor performance of the oil and gas markets ripples and impacts other industries such as the off shore and marine industry. The high degree of inter-dependency between stakeholders in the oil and gas industry exacerbates the domino effect, leading to related insolvencies throughout the globe.

Prominent entities which have bore the brunt of the ailing oil and gas industry include Swiber Holdings which filed for judicial management (with operations in India and Mexico), Nam Cheong Group Bhd (which had operations in Singapore and Malaysia) which filed an application for a moratorium pending restructuring of its debts,[1] oilfield service provider Ezra Holdings Ltd which had sought to restructure its debt through Chapter 11 Bankruptcy proceedings in the United States supported by creditor proceedings in Singapore,[2] and commodity trader Noble Group which was forced to abandon its oil and gas operations while grappling to restructure the company's debt.[3]

The trend of increasing cross-border insolvency is by no means restricted to the oil and gas industry. In the present commercial environment, companies strive to go beyond territorial borders, seeking expansion on a global scale. This increasing internationalisation of commerce is matched with a corresponding internationalisation of insolvency bringing issues of cross-border insolvency to the fore.[4]

Singapore's debt restructuring hub

As businesses today have extended their operations and own substantial assets in foreign jurisdictions, any form of insolvency and/or restructuring will inevitably involve cross-border elements.[5] Despite the global nature of cross-border insolvency, it is commonly observed that management of such insolvency proceedings is typically coordinated from one main jurisdiction. This is a position which Singapore seeks to fill.

Recognising the changing nature of modern day insolvencies and the rising trend of global corporate defaults, Singapore has sought to establish itself as a centre for international debt restructuring. This aspiration serves as a perfect complement to Singapore's established reputation as a major financial and investment hub, as well as a dispute resolution hub. Home to one of the busiest ports and airports in the world and a favoured location for global financial institutions, Singapore's position as a central location where commerce and investment flow would naturally be an appealing site for centralised insolvency or restructuring proceedings to be coordinated.

Singapore's position as a conduit for commerce and investment is further strengthened by its critical involvement in the Belt and Road Initiative ("BRI") proposed by the Chinese government. The BRI, a hallmark initiative of President Xi Ji Ping's Chinese administration, aims to enhance China's position as a global economic power by developing infrastructure and policies to encourage better economic integration between China and its global trade partners.[6]

Some key projects of the BRI include enhancing the infrastructures in various industries such as transport with the development of railway networks connecting regions in Asia, Europe, and Africa and energy by constructing and maintaining cross-border power supply networks.[7] The BRI also seeks to enhance financial cooperation between China and their trade partners through the development of integrated financial systems.[8] Notably, Singapore is reported to be one of the leading investment destinations amongst countries involved in the BRI and a sizeable proportion of investments in relation to the BRI moves through Singapore, with almost one third of all outward investments related to the BRI flowing through Singapore, while 85% of inbound investments for the initiative makes its way into China through Singapore.[9]

Apart from leveraging on business connectivity, Singapore seeks to tap on the reliability and robustness of its legal system to attract restructuring work. In this regard, Singapore's legal system is well equipped to not only manage issues in relation to domestic law but thrive in relation to disputes with shades of international character. This is assisted by the presence of the Singapore International Commercial Court which permits proceedings of international character to be heard by a combination of local and foreign judges and provides a suitable forum to ventilate complicated issues of international and foreign laws.[10] The strength of the Singapore legal system in managing cases of cross-border restructuring is further enhanced by recent legislative amendments.

Legislation changes in May 2017

The statutory regime in relation to debt restructuring in Singapore has also undergone a substantial re-work with the Companies (Amendment) Act 2017.[11] The amendments to the Companies Act (the "Act") introduced a variety of changes to the insolvency regime in Singapore. The key focus of these amendments can be classified into the two areas of restructuring and cross-border insolvency.

Drawing inspiration from Chapter 11 of the United States' Bankruptcy Code, companies intending to present a restructuring proposal will now be automatically guarded against creditor action for an initial period of 30 days.[12] It is also noteworthy that this moratorium will have extra-territorial effect, enforceable in foreign jurisdictions as long as the creditor is subject to the *in personam* jurisdiction of Singapore.[13] Another Chapter 11 feature adapted would be the introduction of "pre-packs": schemes of arrangement negotiated by the company and other stakeholders such as creditors of the company prior to the application to court to commence scheme proceedings.[14] The Court may sanction these pre-packed schemes without a meeting of creditors which leads to expediency and lower costs.[15]

One of the key aspects of the amendments to the restructuring regime is the introduction of rescue financing provisions to schemes of arrangement and judicial management. A distressed company may now apply to Court for an order that financing provided to the company be accorded priority, encouraging rescue financiers to extend funds to assist the restructuring of the company in question.[16]

Judicial management was made available to foreign companies (which are liable to be wound up in Singapore), bringing it in line with the other insolvency regimes in Singapore such as the scheme of arrangement and liquidation.[17] The amendments also include the codification of the factors to be taken into consideration for determining if there was a substantial connection between the liquidating entity and Singapore to determine if the insolvency regimes in Singapore should apply to the foreign entity.[18]

The ring-fencing rule was also abolished for most companies in Singapore.[19] Prior to the amendments, where a company with assets in Singapore is subject to foreign insolvency proceedings, the Singapore liquidator of the foreign company would be required to satisfy the debts incurred in Singapore before remitting funds back to the foreign jurisdiction. This had the effect of granting priority to Singapore creditors over foreign creditors. The amendment has now removed this requirement and remission of local assets to the foreign liquidator is permissible.[20]

Finally, and significantly, the UNCITRAL Model Law on Cross-Border Insolvency (the "Model Law") was given the force of law in Singapore.[21] The enactment of the Model Law promises to establish a clearer and more comprehensive framework for cross-border cooperation in insolvency matters. The invocation of the Model Law permits a simplified process for the recognition of both foreign liquidators and foreign liquidation process which provides for appropriate relief from the time an application under the Model Law is made.[22] Such recognition of foreign liquidation and the consequential recourse available is further nuanced by the distinction between "main" and "non-main foreign liquidation"; a "main" proceeding is one which take place in the company's centre of main interests[23] and an automatic stay of proceedings will be granted upon recognition of a foreign "main" proceedings.[24]

Overall, the amendments in 2017 are largely motivated by Singapore's ambition to establishing herself as an international debt restructuring hub. First, these amendments imbue Singapore with a flexible debt restructuring regime by widening the available resources a distressed company may employ to support its restructuring efforts. Second, the amendment aims to make the establishment of jurisdiction over a foreign debtor for restructuring clearer and more certain. Finally, the amendments also reflect Singapore's transition towards a more cooperative and universalist approach in relation to foreign insolvency proceedings, giving due regard to foreign insolvency practitioners and proceedings.

The JIN network

Another development reaffirming Singapore's commitment to nurturing a conducive cross-border insolvency framework involves the establishment of guidelines between members of the judiciary with their foreign counterparts through the Judicial Insolvency Network ("JIN"). The JIN is effectively a collective effort by various insolvency judges from various courts around the world which aims to increase judicial cooperation in matters of cross-border insolvency.

The JIN currently comprises courts from 10 jurisdictions:[25] Argentina (National Commercial Court of Bueno Aires), Australia (Federal Court and New South Wales), Brazil (First Bankruptcy Court of Sao Paulo), Bermuda, the British Virgin Islands, Canada (Ontario), the Cayman Islands, England & Wales, Hong Kong SAR and the United States (Delaware and Southern District of New York).

In matters of cross-border insolvency, courts have relied on communication protocols between themselves and their foreign counterparts to assist coordination between the courts. Such use of protocols seeks to prevent conflicting decisions and reduce duplicative use of resources.[26] Furthermore, for the purposes of restructuring, such protocols would permit better flow of information between the courts, permitting better understanding and resolution of the issues while strengthening comity at the same time.[27]

On February 1, 2017, the Supreme Court of Singapore, together with the United States Bankruptcy Court for the District of Delaware formally implemented the Guidelines for Communication and Cooperation between Courts in Cross-Border Insolvency Matters (the "Guidelines").[28] Conceived collectively by various judges at the inaugural JIN conference in October 2016,[29] the guidelines would provide a template for the customisation of protocols facilitating judicial cooperation on cross-border insolvency matters. These include the facilitation of communication between courts of the various jurisdictions by sharing documents involving insolvency proceedings with other courts and presents the possibility of joint hearings assisted by video-conferencing. This would permit courts from various jurisdictions to simultaneously record evidence and hear arguments.[30]

The availability of protocols which may be employed between members of the JIN would not only lead to lower costs for all stakeholders but would further lead to greater cooperation between the courts, ensuring more efficacious insolvency proceedings and ensuring the maximisation of resources available for distribution. The availability of such protocols would thus enhance the attractiveness of Singapore as a location for complex cross-border insolvency proceedings to be conducted.

The efficacy of the JIN guidelines was tested by the restructuring of Ezra Holdings which has applied for Chapter 11 bankruptcy in the US while applying for the convening of creditor meetings in Singapore. Ezra Holding has obtained approval from both the Singapore High Court and the Bankruptcy Court of New York for cross-border protocols derived from the Guidelines to be put in place.[31]

Future of debt restructuring in Singapore

Despite making substantial progress towards establishing itself as a debt restructuring hub,[32] Singapore has shown no sign of slowing down. The coming year will spell a new chapter in Singapore's insolvency regime, with a focus on developing measures aimed at streamlining insolvency processes and integrating cross-disciplines involved in restructuring works.

The task of restructuring a company is multi-faceted and spans across multiple professional disciplines such as accountancy and finance. To succeed in becoming a debt restructuring hub, interdisciplinary cooperation both locally and internationally would be necessary. In this regard, new measures will be implemented to better integrate processes from various professional service providers and provide inter-disciplinary exposure to future legal practitioners.

One such manner of exposure would be through the Professional Services Industry Transformation Map ("PSITM"). An inter-agency effort led by the Economic Development Board of Singapore,[33] the PSITM is a roadmap to further improve the professional services industry in Singapore by both building innovation capabilities and by equipping the present workforce with new skill-sets to better adapt to needs for cross-disciplinary expertise.[34] One of the highlights of the PSITM include cooperation with Government agencies to facilitate collaboration between companies across different disciplines and forge strategic partnerships and networks with other foreign professional services firms. The area of debt restructuring carries with it opportunities not just for lawyers but other professions whose expertise involves distressed debt such as financiers and accountants.

With a view of improving inter-disciplinary competency, the Government seeks to provide multi-disciplinary education and training to existing professionals. One such suggestion involves the introduction of courses run by the accounting profession in fulfilment of the continuing professional development requirements.[35]

Also in the pipe-line and scheduled for release in the second half of the year is the Insolvency Bill. Currently, Singapore's insolvency regime is prescribed in two separate pieces of legislation, mainly the Bankruptcy Act and the Companies Act. The Insolvency Bill will seek to combine provisions from both legislation in relation to both personal and corporate insolvency and restructuring, aiming to provide greater clarity and consistency to the insolvency regime in Singapore.[36] Apart from importing the new amendments made to the Companies Act, the proposed Insolvency Bill will also provide consolidated regulations in relation to the licensing and discipline of insolvency-office holders and seek to produce a clear and common standard for insolvency office-holders.[37]

Finally, the JIN is expected to increase in membership attracting the participation from other jurisdictions. For instance, Japan and South Korea have recently assumed observer status to the JIN with representatives from the Supreme Court of Japan and the Seoul Bankruptcy Court respectively.[38] This trend is likely to continue after protocols derived from the guidelines are demonstrably applied in court.[39]

Conclusion

The changes to Singapore's debt restructuring regime are much welcomed, marking a key step in Singapore's establishment as an eminent debt restructuring hub not only in ASEAN but in Asia. The success of Singapore as a debt restructuring hub would lead to commensurate increase in investments and growth in the region with investors assured of easy access to effective restructuring mechanisms.

There is therefore much anticipation as Singapore continues building on its success, seeking to continue its stellar developments in the field of debt restructuring and insolvency.

Notes:

1 Business Times, "*Nam Cheong submitted an application to restructure its debts on 6th October 2016, seeking a six month moratorium on legal proceedings and execution against it*" (October 9, 2017), retrieved from: http://www.businesstimes.com.sg/companies-markets/nam-cheong-files-for-scheme-of-arrangement-moratorium-with-high-court. Also see Business Times Singapore, "*The requisite number of votes from scheme creditors in Singapore has been obtained*" (January 24, 2018), retrieved from: http://www.businesstimes.com.sg/companies-markets/creditors-grant-nod-for-nam-cheongs-singapore-scheme.

2 See CNBC, "*Singapore's Ezra Holdings files for US bankruptcy*" (March 19, 2017), retrieved from: https://www.cnbc.com/2017/03/19/singapores-ezra-holdings-files-for-us-bankruptcy.html.

3 See Channel Newsasia, "*Noble Group to*

sell oil liquids business to Vitol for US$580 million" (October 23, 2017), retrieved from: https://www.channelnewsasia.com/news/business/noble-group-to-sell-oil-liquids-business-to-vitol-for-us-580-million-9334650; http://www.businesstimes.com.sg/companies-markets/noble-restructuring-in-doubt-as-founder-elman-said-to-push-for-new-deal.

4 The year 2017 saw the highest global corporate default rates in a year since the 2008 global financial crisis. See Kannan Ramesh JC (as he was), Supreme Court of Singapore, Speech delivered at the International Association of Insolvency Regulators' 2016 Annual Conference and General Meeting in Singapore on September 6, 2016.

5 See Indranee Rajah SC, *Keynote Address by Ms Indranee Rajah, Senior Minister of State, Ministry of Law and Ministry of Finance at the Regional Insolvency Conference 2016 on September 2016 at the Fullerton Hotel Singapore.*

6 See The State Council of the People's Republic of China, "Full text: Action Plan on the Belt and Road Initiative" (March 30, 2015), retrieved from http://english.gov.cn/archive/publications/2015/03/30/content_281475080249035.htm.

7 National Development and Reform Commission, People's Republic of China, "Vision and Actions on Jointly Building Silk Road Economic Belt and 21st-Century Maritime Silk Road" (March 28, 2015), retrieved from: http://en.ndrc.gov.cn/newsrelease/201503/t20150330_669367.html.

8 Supra. Also see Dr E Zhihuan, Chief Economist, Bank of China (Hong Kong), "*Outlook of financing along the road from the perspective of international cooperation in 'One Belt One Road' strategy*" (May 2017), retrieved from: http://www.bochk.com/dam/investment/bocecon/SY2017014(en).pdf.

9 See K Shanmugam SC, Minister for Home Affairs and Minister for Law, Opening Remarks at the 2017 Asia Economic Forum Seminar (August 28, 2017), retrieved from: http://lkyspp2.nus.edu.sg/aci/wp-content/uploads/sites/4/2017/12/2017-Asia-Economic-Forum-sem1-FINAL-ENGLISH-31-Oct-2017-Seminar-1-Proceedings.pdf. Also see Straits Times, "33% of all outward investments related to the BRI flows through Singapore, while 85% of inbound investments for the initiative makes its way into China through Singapore" (January 25, 2018),: https://www.straitstimes.com/world/europe/spore-can-play-key-role-in-belt-and-road-chun-sing.

10 Speech by Minister for Law K Shanmugam at the Committee of Supply Debate 2017 on March 3, 2017. Retrieved from https://www.mlaw.gov.sg/content/minlaw/en/news/parliamentary-speeches-and-responses/speech-by-minister-for-law-k-shanmugam-sc-during-the-committee-of-supply-debate-2018.html.

11 The Companies (Amendment) Act 2017 was brought into force on May 23, 2017 and may be retrieved from https://sso.agc.gov.sg/Acts-Supp/15-2017/Published/20170330?DocDate=20170330.

12 ss. 211B and 211C of the Act.

13 s. 211(B)(5) of the Act.

14 s. 211I of the Act.

15 The Singapore High Court has sanctioned Singapore's first pre-packaged scheme of arrangement on January 22, 2018 as reported at: http://www.mondaq.com/x/698526/Corporate+Commercial+Law/Singapores+First+PrePackaged+Scheme+Of+Arrangement.

16 s. 211E (for scheme of arrangements) and s. 227HA (for judicial management) of the Act.

17 s. 227AA, read with s. 351 of the Act. Also, s. 211A read with s. 351 of the Act (scheme of arrangements for foreign companies) and s. 351 of the Act (winding up of foreign companies).

18 s. 351(2A) of the Act.

19 s. 377(3)(c) read with s. 377(14): The ring-fencing of Singapore assets is still applicable to specifically identified classes of foreign companies such as banks licensed under the Banking Act, finance companies licensed under the Financial Companies Act.

20 s. 377(4A) of the Act.

21 s. 354B of the Act.

22 Article 19 of the Tenth Schedule of the Act, the Model Law.

23 Article 2(f) and (g) of the Tenth Schedule of the Act, the Model Law.

24 Article 20 of the Tenth Schedule of the Act, the Model Law. This is compared with foreign

"non-main" proceedings which require the grant of relief subject to the court's view that it is "necessary to protect the property of the debtor or the interests of the creditors".

[25] Supreme Court Media Release, "*Argentina and Brazil – Latest to join the Judicial Insolvency Network*" (September 18, 2017), retrieved from: https://www.supremecourt.gov.sg/news/media-releases/argentina-and-brazil-latest-to-join-the-judicial-insolvency-network.

[26] *Re Nortel Networks Corporation* [2015] ONSC 2987: A protocol was developed between the parties which led to a joint trial of the Ontario Superior Court of Justice (Commercial List) and the US Bankruptcy Court for the District of Delaware. Also see the use of protocol for the insolvency proceedings of Lehman Brothers Holding Inc. titled "Cross-Border Insolvency Protocol for the Lehman Brothers Group of Companies', retrieved from: http://bobwessels.nl/site/assets/files/1522/cross-borderprotocol-lehman-bros.pdf and the protocol for the insolvency of Madoff Investments titled "Cross-Border Insolvency Protocol for the Bernard Madoff Group of Companies" retrieved from http://iiinstitute-new.demosites.ca/sites/default/files/media/MadoffSecuritiesCrossBorderInsolvencyProtocollOrder.pdf.

[27] See Kannan Ramesh JC's (as he was then) comments at parties' refusal to formulate and adopt protocols for communication in *Pacific Andes Resources Development Ltd and other matters* [2016] SGHC 210 at [75] – [78].

[28] Presently, three other courts who have also adopted the Guidelines are the Chancery Division of the High Court of England & Wales, the Supreme Court of Bermuda and the United States Bankruptcy Court for the Southern District of New York.

[29] See Supreme Court Media Release, "*Judicial Insolvency Network Initiated by Supreme Court of Singapore*" (October 6, 2016), retrieved from: https://www.supremecourt.gov.sg/news/media-releases/judicial-insolvency-network-initiated-by-supreme-court-of-singapore.

[30] See Schedule 1 of Registrar's Circular No. 1 or 2017, Issuance of Guidelines for Communication and Cooperation between Courts in Cross-Border Insolvency Matters for the Guidelines. https://www.supremecourt.gov.sg/docs/default-source/module-document/registrarcircular/rc-1-2017 – issuance-of-guidelines-for-communication-and-coorporation- -courts-in-cross-border-insolvency-matters-.pdf.

[31] See the Straits Times, "*High Court approves cross-border protocol for Ezra Holdings' bankruptcy proceedings in US and Singapore*" (March 13, 2018), retrieved from https://www.straitstimes.com/singapore/courts-crime/high-court-approves-cross-border-protocol-for-ezra-holdings-bankruptcy; and the Business Times, "*Ezra gets nod from US Bankruptcy Court for cross-border protocol on bankruptcy proceedings*" (April 2, 2018), retrieved from: https://www.businesstimes.com.sg/companies-markets/ezra-gets-nod-from-us-bankruptcy-court-for-cross-border-protocol-on-bankruptcy.

[32] See Ministry of Law Press Release dated June 22, 2017, "*Singapore Recognized as Most Improved Jurisdiction at Inaugural Global Restructuring Review Awards*".

[33] Other agencies involved include the Building Construction Authority, IE Singapore, Infocomm Media Development Authority, Ministry of Law, Singapore Accountancy Commission, SPRING Singapore, SkillsFuture Singapore and WorkForce Singapore. Media Release by EDB Singapore on January 24, 2018, "*Singapore's Professional Services Industry to lead globally in high-value, specialist services*". https://www.gov.sg/~/sgpc-media/media_releases/edb/press_release/P-20180123-1/attachment/FINAL-Press%20Release%20-%20Professional%20Svcs%20ITM-24Jan2018.pdf.

[34] Speech by Ms Indranee Rajah, Senior Minister of State for Law and Finance, at the Launch of the Professional Service Industry Transformation Map & Opening of Dentsu Aegis Network's Asia Pacific Headquarters (January 24, 2018).

[35] See Indranee Rajah SC, Senior Minister of State for Law and Finance, "*Enhancing Singapore as an International Debt Restructuring Centre for Asia and Beyond*" (June 20, 2017), retrieved from: https://www.mlaw.gov.sg/content/dam/minlaw/corp/News/Note%20on%20Debt%20Restructuring.pdf.

[36] The Omnibus Insolvency Bill is forecasted to be introduced in the second half of 2018: https://www.mlaw.gov.sg/content/minlaw/en/news/speeches/keynote-address-by-mr-k-shanumgam-minister-for-home-affairs-and.html.

[37] Opening Address by Ng How Yue, Permanent Secretary for Law, At the 2nd National Insolvency Conference 2015. Also see Report of the Insolvency Law Review Committee, *Final Report* (2013).

[38] Supreme Court Media Release, "*Japan and South Korea Joins the Judicial Insolvency Network as Observers*" (7 February 2018), retrieved from:https://www.supreme-court.gov.sg/news/media-releases/ja-pan-and-outh-korea-joins-the-judicial-insol-vency-network-as-observers.

[39] Ezra Holdings has obtained approval from both the Singapore High Court and the US Bankruptcy Court to implement protocols between the courts based on the Guidelines.

Authors:
Patrick Ang, Deputy Managing Partner
Darren Lim, Practice Trainee
Rajah & Tann Singapore LLP
9 Battery Road #25-01
Singapore 049910
Tel: +65 6232 0400
Tel: +65 6236 3600
Email: patrick.ang@rajahtann.com
Email: darren.lim@rajahtann.com
Website: http://sg.rajahtannasia.com

30/07/2018

The UNCITRAL Model Law on Cross-Border Insolvency: an introduction

Prepared by the UNCITRAL Secretariat

One of the problems with insolvency laws is that generally they can only be effective within the confines of the jurisdiction in which those laws had been enacted. Problems arise when an insolvent debtor from one State has assets and affairs in another State. Even if the national law of the debtor's State purports to give to the debtor's insolvency representative control over the assets and affairs located in the other State, the representative can take effective control of those assets only to the extent permitted by the law of the other State.

This inability to effectively control a debtor's assets has several potentially detrimental consequences. Debtors with assets in different countries can shield or conceal them from their creditors and from their insolvency representative. Where an insolvency representative cannot get access to those assets, they may be unable to reorganize the debtor and save an essentially viable business or, where the debtor has to be liquidated, be unable to realize those assets in an effective manner that will maximize returns for creditors.

What is needed is a framework for cooperation and coordination that both respects the sovereignty of national laws and procedural systems and allows the assets located in different countries to be treated comprehensively, transparently and fairly. Such a framework is provided by the UNCITRAL Model Law on Cross-Border Insolvency. It focuses upon what is required to facilitate the administration of cross-border insolvency cases, but does not address issues of substantive law, which are left up to the law of the State enacting the Model Law.

What is cross-border insolvency?

- Where the insolvent debtor has assets in more than one State
- Where some of the creditors of the debtor are not from the State where the insolvency proceeding is taking place
- Where insolvency proceedings concerning the same debtor have commenced in more than one State

Why are we concerned about cross-border insolvency?

- Increasing incidence of cross-border insolvency proceedings
- Numerous difficulties associated with those proceedings – delay, cost, cumbersome procedures and formal requirements, lack of authorization to cooperate, conflicting court decisions on the same or similar matters, uncertainty and unpredictability
- Lack of national and international legal regimes providing solutions
- Insolvency law as a "frontline factor" in financial crisis prevention and management

A. BACKGROUND

1. The Model Law was negotiated between 1995 and 1997 by an intergovernmental working group comprising representatives of 72 States, seven inter-governmental organizations (IGOs) and ten non-governmental organizations (NGOs). This diversity of representation may be seen as key to the wide acceptance and adoption of the text by States from different legal traditions and stages of economic development.

2. The negotiation of the Model Law had a number of clear objectives, which are set out in the Preamble:

(a) Promoting cooperation between the courts and other competent authorities of this State and foreign States involved in cases of cross-border insolvency;

(b) Providing greater legal certainty for trade and investment;

(c) Facilitating the fair and efficient administration of cross-border insolvencies in a manner that protects the interests of all creditors and other interested persons, including the debtor;

(d) Protecting and maximizing the value of the debtor's assets; and

(e) Facilitating of the rescue of financially troubled businesses, thereby protecting investment and preserving employment.

Does not attempt unification of substantive insolvency law

Respects differences in procedural law

4. The framework provided is ***unilateral*** – the Model Law relies for its effect on enactment by individual States. Such enactment generally signals that a State will accept applications for recognition of foreign insolvency proceedings from all other States, irrespective of whether those other States have adopted the Model Law. The only exception is where the Model Law has been enacted on the basis of reciprocity and provides, for example, that applications for recognition will only be accepted from other enacting States.

- *Article 8*

5. Because of its unilateral nature, it is important for its effective cross-border application that the text be interpreted uniformly by different States. That interpretation is aided by the objectives set out in the preamble and also by article 8. This article encourages States to have regard to the international origin of the text and the need to promote uniform interpretation. In practice, this may mean considering the decisions of courts of other States when determining how certain issues should be resolved – some States have included this provision as a direction to the courts (USA). This uniform interpretation is facilitated by tools prepared by UNCITRAL. These include the system which reports case law on the application of the Model Law (Case Law on UNCITRAL Texts or CLOUT), and a guide for judges on how to apply and interpret the Model Law (The Judicial Perspective).

B. ENACTMENTS BASED ON THE MODEL LAW

6. As at the end of February 2017, legislation based on the Model Law has been enacted by 43 States in a total of 45 jurisdictions:

Australia (2008); Benin (2015); Burkina Faso (2015); British Virgin Islands (overseas territory of the United Kingdom of Great Britain and Northern Ireland) (2003); Cameroon (2015); Canada (2005); Central African Republic (2015); Chad (2015); Chile (2013); Colombia (2006); Comoros (2015); Republic of the Congo (2015); Côte d'Ivoire (2015); Democratic Republic of Congo (2015); Dominican Republic (2015); Equatorial Guinea (2015); Gabon (2015); Gibraltar (overseas territory of the United Kingdom of Great Britain and Northern Ireland) (2014); Greece (2010); Great Britain (2006); Guinea (2015); Guinea-Bissau (2015); Israel (2018); Japan (2000); Kenya (2015); Malawi (2015); Mali (2015); Mauritius (2009); Mexico (2000); Montenegro (2002); New Zealand (2006); Niger (2015); Philippines (2010); Poland (2003); Republic of Korea (2006); Romania (2002); Senegal (2015); Serbia (2004); Seychelles (2013); Singapore (2017); Slovenia (2007); South Africa (2000); Togo (2015); Uganda (2011); the United States of America (2005); and Vanuatu (2013).

A number of States are actively considering enacting the Model Law or have already drafted legislation to enact it, including: Brazil, India, Ireland, Israel, and Thailand.

7. As a model law, the text is flexible and can be amended by enacting States. In recommending the text to States, the United Nations General Assembly suggests it be given favourable consideration, "bearing in mind the need for an internationally harmonized legislation governing instances of cross-border insolvency". Clearly, the more changes made to the text, the less the harmonizing effect of the

resulting legislation and the less certainty and predictability there will be for cross-border insolvency proceedings.

8. While many of the States noted above have followed the Model Law quite closely in enacting their legislation, some changes have been made and the enacting legislation needs to be carefully examined; it should not be assumed that it corresponds exactly to the terms of the Model Law. Some of the changes made expand the application of the Model Law to reflect local insolvency law (e.g. the US provisions on automatic relief refer to the relief available under the Bankruptcy Code, which is somewhat broader in scope than that available under the Model Law); other changes limit the application of the Model Law (e.g. in Japan the relief available on recognition is not automatic but requires an application to the court or may be ordered by the court on its own initiative, art. 25 is omitted and art. 26 is limited to cooperation between insolvency representatives; South Africa, Romania, Mexico and Uganda have included a reciprocity provision).

9. Different methods of enactment have been used. Some States have drafted specific provisions either using the drafting of the Model Law or based, to a greater or lesser extent, upon that drafting (many enacting States); some have included the Model Law, as drafted, in a schedule to the enabling legislation (Australia and New Zealand); some have enacted it by way of regulation (Great Britain).

C. SCOPE

10. The Model Law applies in 4 specified situations, where (art.1):

(a) Requests from a foreign court for assistance from the enacting State (inbound requests);
(b) Request by the enacting State to a foreign State (outbound requests);
(c) There are concurrent proceedings concerning the same debtor;
(d) Creditors or other interested parties in a foreign State have an interest in requesting commencement of, or participation in an insolvency proceeding under the law of the enacting State.

11. The text covers foreign proceedings that (art.2):

(a) Relate to insolvency
(b) Are for the purpose of reorganization or liquidation of the debtor
(c) Are "collective" and
(d) Subject the assets and affairs of the debtor to control or supervision by a court.

12. Under the Model Law scheme, proceedings that do not meet those criteria would not qualify for recognition. The 2013 revision of the Guide to Enactment provides more information on the meaning of article 2, clarifying for example, that:

(a) A "collective proceeding" is one in which substantially all of the assets and liabilities of the debtor are dealt with, subject to local priorities and statutory exceptions, and to local exclusions relating to the rights of secured creditors. A proceeding that does not deal with a certain class of claim, such as those of secured creditors, should not be excluded if it satisfies the other elements of article 2, subparagraph (a) (for court decisions on this point see The Judicial Perspective (2013), paras. 71-78);

(b) A simple proceeding for a solvent legal entity that does not seek to restructure the financial affairs of the entity, but rather to dissolve its legal status, is likely not one pursuant to a law relating to insolvency or severe financial distress for the purposes of the subparagraph. Financial adjustment agreements or similar contractual arrangements that do not lead to the commencement of an insolvency proceeding also would not generally satisfy the requirements of subparagraph (a). However, such agreements would clearly be enforceable outside the Model Law without the need for recognition; and

(c) Control or supervision by an insolvency representative may be sufficient to satisfy the requirements of subparagraph (a), even if it is potential rather than actual; mere supervision of an insolvency representative by a licensing authority however would not be sufficient (for court decisions on this point see The Judicial Perspective (2013), paras. 84-90).

13. Exclusions are contemplated by the Model Law. Banking and insurance institutions are a common example – generally on the ground that they are subject to special regulatory regimes. Exclusions for financial and investment institutions, clearing houses and commodity brokers have also been introduced in some enacting legislation.

Reciprocity

14. UNCITRAL decided against including a requirement for reciprocity in the ML, but several enacting jurisdictions have done so:

South Africa: requires designation by Minister [s. 2(2)(a)] – no countries designated, moves to remove requirement

Mexico: requires "international reciprocity" [art. 280]

Romania: requires reciprocity with respect to the effects of foreign judgements [art. 18 (1)(e)]

Uganda: requires designation by Minister, as well as reciprocal agreements, treaties etc. [ss. 212-213]

Philippines: adds a requirement for reciprocity to the public policy exception [s4, Rule 5 of FR Rules].

D. KEY ELEMENTS

15. The basic premise is that the Model Law establishes **simple, straightforward requirements that**

Minimize formality for recognition of foreign proceedings,

Facilitate predictable outcomes,

Reduce scope for disputes, and

Recognize the need for speedy outcomes.

16. The text is organized around four key elements, identified through a series of studies and consultations conducted in the early 1990s as being the areas upon which international agreement might be possible:

(a) <u>Access</u> to local courts for representatives of foreign insolvency proceedings and for creditors

(b) <u>Recognition</u> of certain orders issued by foreign courts

(c) <u>Relief</u> to assist foreign proceedings

(d) <u>Cooperation</u> among the courts of States where the debtor's assets are located in order to facilitate <u>coordination</u> of proceedings

1. ACCESS

17. When a foreign representative seeks to manage the assets of the debtor in a foreign country they have to obtain access to the assets. The Model Law does this by giving the foreign representative a right of direct access to the courts of the State where the Model Law has been enacted (art. 9). This right of access is not subject to any special conditions, but what the foreign insolvency administrator will be able to achieve is largely left to the local law and, in a large measure, to the discretion of the local court.

18. These provisions address inbound and outbound aspects of cross-border insolvency. An insolvency representative of the enacting State is authorised to act in a foreign State (art. 5) on behalf of local proceedings. A foreign representative has:

(a) A right of direct access to courts in the enacting State (art. 9);

(b) A right to apply to commence a local proceeding in the enacting State on the conditions applicable in that State (art. 11); and

(c) A right to participate in insolvency-related proceedings in the enacting State under the law of that State (art. 12).

19. The right to commence a local proceeding under art. 11 is not limited to cases where a foreign proceeding has already been recognized. Some States however, have adopted a different view and subjected that right to prior recognition (USA).

20. The fact that a foreign representative has the right to apply to the courts of the enacting State does not subject him/her/the foreign assets and affairs of the debtor to the jurisdiction of the enacting State for any purpose other that that application (art. 10).

21. Foreign creditors have the same right as local creditors to commence proceedings and participate in proceedings (art. 13).

2. RECOGNITION

22. A foreign representative can apply for recognition of a foreign proceeding (art. 15.1). One of the key objectives of the Model Law was to establish simplified procedures that would avoid time-consuming legalization or other processes and provide certainty with respect to the decision to recognize. Where the foreign proceeding is a foreign proceeding within the definition of art. 2 (as discussed above) and certain evidential requirements relating to the appointment of the foreign representative and commencement of the foreign proceedings are met (art. 15.2), the court <u>should</u> recognize the foreign proceedings [subject only to the public policy exception of art. 6].

23. In terms of evidence, the foreign representative is required to provide:

(a) A certified copy of the decision commencing the foreign proceedings and appointing the foreign representative; or

(b) A certificate from the foreign court as to the matters in (a); or

(c) Evidence acceptable to the recognizing court as to the matters in (a); plus

(d) A statement identifying all foreign proceedings against the debtor that are known to the foreign representative.

24. The only proviso to recognition is found in art. 6, which allows recognition to be refused where it would be "manifestly contrary to the public policy" of the recognizing State. No definition of what constitutes public policy is attempted as notions vary from State to State. However, the intention is that it be interpreted restrictively and that art. 6 be used only in exceptional circumstances. Several United States cases note the need for limited use of this article (for a discussion of article 6, see The Judicial Perspective (2013), paras. 48-54).

25. The court should recognize foreign proceedings as either (art. 17.2):

(a) Main proceedings, that is proceedings taking place where the debtor has its centre of main interests or COMI as it is commonly known. This concept is not defined in the Model Law, but is based on a presumption of the registered office or habitual residence (in the case of an individual) of the debtor (art. 16.3); or

(b) Non-main proceedings, that is proceedings taking place where the debtor has an establishment. This is defined as "any place of operation where the debtor carries out non-transitory economic activity with human means and goods or services" (art.2 (f)).

Revision of the Guide to Enactment

26. While the majority of applications for recognition and relief made under the Model Law appear to proceed without issue, a number of cases have raised questions relating to the interpretation of certain provisions. These have included, for example, what is required to satisfy the various elements of the definitions in article 2 of the Model Law, particularly "foreign proceeding" under subparagraph (a); the factors to be considered with respect to rebuttal of the presumption in article 16, paragraph 3 that the centre of the debtor's main interests is its place of registration (or incorporation under some laws); the relevant time for consideration of the location of the debtor's centre of main interests; and the scope of the public policy exception under article 6.

27. The degree of unpredictability and uncertainty produced by some of the different decisions on these issues has been the subject of numerous articles and discussions. Although the Guide to Enactment accompanying the Model Law, together with the original working group papers and reports, serve as key sources of information on the policy settings of the Model Law and are often cited by judges in numerous jurisdictions as tools for its interpretation, they do not always provide ready answers to all of the questions that have arisen.

28. In response to a proposal from the United States in 2010 (UNCITRAL document A/CN.9/WG.V/WP.93/Add.3), work was undertaken to provide additional information and clarify a number of the issues arising from its application and interpretation, without revising the text of the Model Law itself. UNCITRAL's Working Group V decided that that information should be provided by way of revision of the Guide to Enactment of the Model Law on the basis that having a single source of information and guidance might avoid any confusion that potentially could arise from the preparation of a document additional to the existing Guide. The revision was finalised in July 2013 and the resulting text, adopted by the Commission in 2013, is entitled the Guide to Enactment and Interpretation of the UNCITRAL Model Law on Cross-Border Insolvency.

29. The revisions relate, firstly, to the elements of article 2, subparagraph (a), which define what is required for a foreign proceeding to be recognized under the Model Law. That foreign proceeding is required to be (i) a collective judicial or administrative proceeding, (ii) pursuant to a law relating to insolvency, (iii) in which the assets and affairs of the debtor are subject to control or supervision by a foreign court, and (iv) for the purpose of reorganization or liquidation.

30. The Guide to Enactment and Interpretation clarifies that:

(a) A "collective proceeding" is one in which substantially all of the assets and liabilities of the debtor are dealt with, subject to local priorities and statutory exceptions, and to local exclusions relating to the rights of secured creditors. A proceeding that does not deal with a certain class of claim, such as those of secured creditors, should not be excluded if it satisfies the other elements of article 2, subparagraph (a) (for court decisions on this point see The Judicial Perspective (2013), paras. 71-78);

(b) With respect to the requirement for the proceeding to be one "pursuant to a law relating to insolvency", the Guide suggests that a simple proceeding for a solvent legal entity that does not seek to restructure the financial affairs of the entity, but rather to dissolve its legal status, is likely not one pursuant to a law relating to insolvency or severe financial distress for the purposes of the subparagraph;

(c) Control or supervision of the assets and affairs of the debtor may be exercised directly by a court or by an insolvency representative where the insolvency representative is itself subject to control or supervision by the court, even if that control is potential rather than actual. Mere supervision of an insolvency representative by a licensing authority however would not be sufficient (for court decisions on this point see The Judicial Perspective (2013), paras. 84-90);

(d) Financial adjustment agreements or similar contractual arrangements that do not lead to the commencement of an insolvency proceeding also would not generally satisfy the requirements of subparagraph (a) that the proceedings be "for the purposes of liquidation or reorganization". However, such agreements would clearly be enforceable outside the Model Law without the need for recognition.

31. Central to the revision of the Guide to Enactment is the concept of "centre of main interests" or COMI, in particular identification of factors that might be relevant to rebutting the presumption under article 16, paragraph 3 that the debtor's COMI is its place of registration. The revisions note that where the debtor's COMI coincides with its place of registration, no issue concerning rebuttal of the presumption will arise. In reality, however, the debtor's COMI may not always coincide with its place of registration. The party alleging that it is not at that place will be required to satisfy the court of the State receiving an application for recognition as to its location. The court will be required to consider independently where the debtor's COMI is located. Two principal factors have been identified. Considered together, these factors should indicate whether the location in which the foreign proceeding has commenced is the debtor's COMI, namely that: (a) the location is where the debtor's central administration takes place, and (b) the location is readily ascertainable by creditors.

32. Where those two factors don't yield a ready answer, the Guide suggests that additional factors may be considered, with the court giving greater or less weight to a given factor, depending on the circumstances of the individual case. These factors include, in no particular order or priority: the location of the debtor's books and records; the location where financing was organized or authorized, or from where the cash management system was run; the location in which the debtor's principal assets or operations are found; the location of the debtor's primary bank; the location of employees; the location in which commercial policy was determined; the site of the controlling law or the law governing the main contracts of the company; the location from which purchasing and sales policy, staff, accounts payable and computer systems were managed; the location from which contracts (for supply) were organized; the location from which reorganization of the debtor was being conducted; the jurisdiction whose law would apply to most disputes; the location in which the debtor was subject to supervision or regulation; and the location whose law governed the preparation and audit of accounts and in which they were prepared and audited.

33. The final key revision concerns the time by reference to which the debtor's COMI (or establishment) should be determined. The revised text suggests that the date of commencement of the foreign proceeding provides a test that can be applied with certainty and consistency to all insolvency proceedings, wherever commenced; the date of an application for recognition, in comparison, will vary from jurisdiction to jurisdiction. Moreover, the choice of the date of commencement also addresses issues that may arise where the business activity of the debtor has ceased at the time of the application for recognition, and, as may occur in cases of reorganization, it is not the debtor entity that continues to have a COMI, but rather the reorganizing entity.

34. The Judicial Perspective has been updated to reflect the changes included in the Guide to Enactment and Interpretation, as well as judicial decisions issued after the first edition was completed in 2011. Quite a few cases of importance were decided in that time, not least of which are those relating specifically to the work being done to identify factors relevant to determining COMI. A number of recent cases also address aspects of the relief provisions of the Model Law (articles 19-21), including the enforceability of insolvency-derived judgements under article 21.

3. RELIEF

35. The Model Law principle is that the relief considered necessary for the orderly and fair conduct of a cross-border insolvency should be available to assist foreign proceedings, whether on an interim basis or as a result of recognition. The Model Law provides that:

(a) Interim relief is available at the discretion of court between the making of an application for recognition and the decision on that application (art. 19);

(b) Automatic relief specified in the Model Law is available on recognition of main proceedings (art. 20); and

(c) Relief at the discretion of the court is also available for both main and non-main proceedings; for main proceedings it would be in addition to that available automatically on recognition (art. 21).

36. The Model Law adopts the approach of specifying the types of relief that should be automatically available as a minimum. That approach is a compromise between importing the relief available to the foreign proceeding under the law of the foreign State and applying the relief that would be available under the law of the recognizing State.

37. All States that have enacted legislation based on the Model Law, except for Japan and Korea, provide for automatic relief on recognition (both of those States provide for it to be available at the discretion of the court); but the scope of that relief varies slightly. The Model Law provides that with respect to the automatic relief, the scope of the effects of commencement depends upon exceptions/limits existing in the laws of the recognizing State with respect to the stay or suspension (art. 20.2). This might include, for example, exceptions allowing the enforcement of security over the debtor's property (Great Britain) or allowing commencement or continuation of action or proceedings against the debtor or its assets except execution against its assets (Mexico).

38. With respect to both interim relief and discretionary relief, the court can impose conditions and modify or terminate the relief to protect the interests of creditors and other interested persons affected by the relief ordered (art. 22).

4. COOPERATION and COORDINATION

a. *Cooperation*

39. The Model Law expressly empowers courts to cooperate in the areas governed by the Model Law and to communicate directly with foreign counterparts. This is not dependent upon recognition and may thus occur at an early stage and before an application for recognition. Nor is it limited to proceedings that would qualify for recognition under art. 17 and may thus apply with respect to proceedings commenced on the basis of presence of assets.

40. Cooperation is authorized between courts, between courts and foreign representatives and between foreign representatives.

41. Recognizing that the idea of cooperation might be unfamiliar to many judges and insolvency representatives, art. 27 sets out some of the possible means of cooperation. That article is the basis of further work by UNCITRAL - the UNCITRAL Practice Guide on Cross-Border Insolvency Cooperation (2009) discusses the various elements of article 27 and in particular, compiles practice and experience with respect to the use and negotiation of cross-border agreements or protocols as they are often known.

b. *Concurrent proceedings*

42. The Model Law contains several provisions addressing coordination of concurrent proceedings, which aim to foster decisions that would best achieve the objectives of all of those proceedings.

43. The recognition of foreign main proceedings does not prevent commencement of local proceedings (art. 28), nor does the commencement of local proceedings terminate recognition already accorded to foreign proceedings or prevent recognition of foreign proceedings.

44. Article 29 addresses adjustment of the relief available where there are concurrent proceedings. The basic principle is that relief granted to a recognized foreign proceeding should be consistent with local proceedings, irrespective of whether the foreign proceeding was recognized before or after the commencement of the local proceeding. For example, where local proceedings have already commenced at the time the application for recognition is made, relief granted to the foreign

proceeding must be consistent with the local proceeding. If the foreign proceeding is recognized as a main proceeding, the automatic relief generally available on recognition (art. 20) does not apply.

5. RECOGNITION AND ENFORCEMENT OF INSOLVENCY-RELATED JUDGMENTS

45. Work on this topic was taken up in order to address both the lack of an international instrument covering the recognition and enforcement of these judgments, as well as some uncertainty as whether articles 7 and 21 of the MLCBI explicitly provided the necessary authority for such recognition and enforcement.

46. The UNCITRAL Model Law on Recognition and Enforcement of Insolvency-Related Judgments with Guide to Enactment was finalized and adopted by the Commission in July 2018.[1]

47. A key issue in defining the judgments to be covered by the new text is ensuring consistency with relevant regional and international instruments, as well as with work being undertaken by the Hague Conference on Private International Law to prepare a future instrument on recognition and enforcement of judgments more generally.

48. An insolvency-related judgment is defined as one that arises as a consequence of or is materially associated with an insolvency proceeding (whether or not that proceeding has closed), and was issued on or after the commencement of the insolvency proceeding. It does not include a judgment commencing an insolvency proceeding, but the guide to enactment makes it clear that some of the orders made at the time of commencement, those that are referred to in some jurisdictions as first day orders, would fall within the definition.

49. The provisions address the procedure for applying for recognition and enforcement, including the availability of provisional relief, grounds for refusal, effect and enforceability of an insolvency-related judgment, effect of review in the originating State on recognition and enforcement, equivalent effect and severability. Article 3 deals with the relationship of the model law to treaties that might address the same subject matter, stipulating that where there is a treaty in force for the enacting State that concerns the recognition and enforcement of civil and commercial judgments and that treaty applies to an insolvency-related judgment, the treaty will prevail. It might be noted that the draft convention currently being developed by the Hague Conference on Private International Law excludes judgments relating to "insolvency, composition, resolution of financial institutions and analogous matters".[2]

50. Another issue addressed by the draft text concerns its relationship to the MLCBI and, in particular, its possible limitation to recognition and enforcement of judgments issued in main and non-main proceedings. Although potentially most relevant for States having enacted the MLCBI, the draft guide indicates that other States may also choose to enact that limitation. Where the MLCBI or the limitation have been enacted, the draft model law includes an exception. This would allow a judgment relating to the recovery of assets of the debtor to be enforced, notwithstanding the existence of those assets in a jurisdiction whose insolvency proceeding would not be capable of recognition under the Model Law (i.e. it is neither a main nor a non-main jurisdiction), provided certain conditions are met.

[1] The text of the Model Law is an annex to the report of the fifty-first session of the Commission (document A/73/17), which will be available on the UNCITRAL website at: http://www.uncitral.org/uncitral/commission/sessions/51st.html. The guide to enactment is contained in document A/CN.9/WG.V/WP.157 (http://www.uncitral.org/uncitral/en/commission/working_groups/5Insolvency.html), as amended by document A/CN.9/955 (available at http://www.uncitral.org/uncitral/commission/sessions/51st.html).

[2] See article 2(1)(e) of the November 2017 draft available at https://www.hcch.net/en/projects/legislative-projects/judgments/special-commission1 and Prel. Doc No. 1A of March 2018, the draft explanatory report of the draft text, available at https://www.hcch.net/en/governance/council-on-general-affairs.

6. CROSS-BORDER TREATMENT OF ENTERPRISE GROUPS IN INSOLVENCY

51. Since the focus of the MLCBI is the conduct of cross-border insolvency proceedings for individual debtors, it can be difficult to apply to situations involving complex relationships between multiple related debtors, such as members of an enterprise group, where the relationships between those debtors might need to be factored into decisions to be taken during the insolvency process.

52. To address that issue, UNCITRAL's Working Group V (WG V) commenced work on the insolvency treatment of enterprise groups in 2010. That work resulted in an addition to the UNCITRAL Legislative Guide on Insolvency Law (part three), which includes both domestic provisions to facilitate the conduct of enterprise group insolvencies, as well as provisions on cooperation and coordination in the cross-border context. The latter extend the cooperation and coordination principles of chapter IV of the MLCBI to multiple debtors connected by membership of an enterprise group.

53. Part three of the Legislative Guide thus represents a forward step in addressing enterprise group insolvencies. While the domestic law of many States has yet to embrace the solutions proposed in the recommendations of part three, there is nevertheless support for developing a legislative regime on group insolvencies that extends those recommendations, particularly as they relate to the cross-border context. The goal is to address enterprise group insolvency in a manner that would allow a certain degree of centralization of insolvency proceedings to support the negotiation of an insolvency solution for the group as a whole or for different parts and to reduce the number of parallel insolvency proceedings required to address financial difficulty in the group.

54. In the current work, the idea of centralization focuses on commencement of insolvency proceedings in the jurisdiction that is the COMI of at least one group member, where that group member is a necessary and integral part of the insolvency solution to be developed for all or part of the group. The commencement of multiple parallel insolvency proceedings for the same or different group members might be reduced by using mechanisms that would permit, for example, the treatment of foreign creditor claims in the commencing jurisdiction in accordance with the law applicable to those claims (often referred to as "synthetic" measures), whilst at the same time protecting the interests and expectations of creditors. Voluntary participation of other group members, including solvent group members, in the development of the group insolvency solution should be permitted when it would be of assistance in achieving an effective outcome.

55. The model law being developed by WG V contains 5 chapters. Chapters 1-4 form a set of basic or core provisions, amenable to broad agreement, while chapter 5 addresses more contentious issues and includes options for those States wishing to enact provisions that go beyond the scope of the other provisions. The text is based upon several widely agreed foundational principles: preservation of the jurisdiction of the State in which each group member has its COMI; preservation of the ability to commence insolvency proceedings in respect of a group member as and when such proceedings might be required; designation of a proceeding commenced in a jurisdiction that is the COMI of one group member as the planning proceeding for the purpose of developing a group insolvency solution and enabling other group members with their COMI in different jurisdictions to voluntarily participate in the development of the solution; recognition of the planning proceeding in other jurisdictions as required; provision of appropriate relief in a recognizing jurisdiction to assist development of the group solution; and approval of the group solution on a local basis, so that creditors and stakeholders of each affected group member vote on approval in accordance with the applicable domestic law.

56. Chapter 1 contains a number of general provisions, including definitions, a public policy exception (along the lines of article 6 of the MLCBI) and clarification as to the scope and intent of the provisions. New terms introduced include: "group representative", being a person or body including one appointed on an interim basis authorized to act as a representative of a planning proceeding and "planning proceeding", being an insolvency proceeding commenced in respect of an enterprise group member at its centre of main interests, provided: (i) one or more other group members are

participating in that proceeding for the purposes of developing and implementing a group insolvency solution, (ii) the enterprise group member subject to the proceeding is a necessary and integral part of the group insolvency solution, and (iii) a group representative has been appointed. "Group insolvency solution" means a set of proposals developed in a planning proceeding for the reorganization, sale or liquidation of some or all of the operations and assets of one or more enterprise group members, with the goal of preserving or enhancing the overall combined value of the group members involved.

57. Chapter 2 contains coordination and cooperation provisions based upon chapter IV of the MLCBI and part three of the Legislative Guide. An additional provision addresses participation by a an enterprise group member in an insolvency proceeding commenced under the law of the enacting State. Such a proceeding could be a planning proceeding, but that is not a requirement to facilitate cooperation and coordination. Participation is envisaged as meaning that an enterprise group member has the right to appear, make written submissions and be heard in the proceeding on matters affecting its interests and to take part in the development and implementation of a group insolvency solution. The provisions stress that participation is voluntary and may commence or end at any stage of the proceeding.

58. Chapter 3 deals with conduct of a planning proceeding in the enacting State and covers appointment of a group representative and specification of its powers, as well as relief that should be available to support the conduct of a planning proceeding in the enacting State. While many States may already provide some or all of the relief detailed, the intention of the provision is to specify the minimum relief that should be available in the group context.

59. Chapter 4 provides a cross-border recognition regime, based upon the analogous provisions of the MLCBI (chapter III). The provisions address the application procedure, the provisional relief that should be available between the time of application for and granting of recognition, as well as relief that should be available on recognition at the discretion of the court, as well as protection of creditors and other interested persons. An additional provision deals with approval of a group insolvency solution. Although negotiated in a centralized procedure, the text envisages the relevant elements of the solution being approved locally in accordance with the applicable law.

60. Chapter 5 contains provisions on the treatment of foreign claims. The first group of these form part of the core provisions and permit the use of "synthetic" measures, on the basis of an undertaking given by an insolvency representative, in lieu of commencing non-main proceedings. The second group addresses the use of those measures in lieu of commencing main proceedings, as well as approval of a group insolvency solution on a more streamlined basis, at the discretion of the court where it is satisfied that the interests of creditors of affected group members are or will be adequately protected by that group solution. The second group of provisions are identified as being optional or supplemental provisions, rather than core provisions.

61. The draft model law will be further considered at the forthcoming session of WG V in Vienna from 10-14 December 2018. It is anticipated that sufficient progress will be made with resolving. outstanding drafting issues for the text to be circulated for comment to States and relevant international organizations in early 2019 and then for the text to be submitted for finalization and adoption by the Commission in 2019. The first draft of a guide to enactment will also be considered at the December session.

62. Participation in the development of a group insolvency solution may have implications for the obligations of directors of affected group members, particularly if that member is approaching insolvency. Once the provisions on enterprise groups are finalized, the work that has been undertaken on the obligations of directors of enterprise group companies in the period approaching insolvency (building upon part four of the Legislative Guide) will be adjusted and an addition to part four submitted for finalization and adoption at the same time in 2019 as the draft model law on enterprise groups.

INSOL International

The Implications of Brexit for the Restructuring and Insolvency Industry

A Collection of Essays

United States of America*

Hon. Leif Clark (Ret.)**

and

Daniel M. Glosband***

INTRODUCTION

Unless Brexit stimulates changes to the internal United Kingdom laws that apply to insolvency and restructuring (including the interpretation of applicable common law), US insolvency professionals can safely sleep through the UK's great escape from the European Union (although they may want to take advantage of the Brexit-driven drop in the exchange rate and the enhanced purchasing power of the dollar). The excellent "centrepiece" essay by Gerard McCormack and Hamish Anderson – "The Implications of Brexit for the Restructuring and Insolvency Industry in the United Kingdom" ("Centrepiece") – comprises six sections: the current cross-border insolvency landscape – pre-Brexit; the current corporate restructuring law – pre-Brexit; how current law deals with foreign insolvency proceedings that purport to deal with English law governed obligations; the effect of a "hard" Brexit resulting in separation from the European Insolvency Regulation ("EIR"); what the UK and EU might each do to fill the gap; and the terms of a possible replacement regime.

This essay will review the scenarios for inbound US cross-border insolvency and restructuring proceedings emanating from the UK. It will also consider certain of the deficiencies in the current approach to assisting US insolvency proceedings outbound to the UK, with a view to supporting positions discussed in the Centrepiece. The likely Brexit from the EIR - itself not very relevant to the US insolvency community - is not discussed.

Brexit alone is not likely to dampen the US receptivity to UK restructuring and insolvency proceedings, so the current landscape under chapter 15 for cross-border insolvency assistance and recognition of insolvency proceedings and schemes of arrangement ("Schemes") will remain unaltered. Conversely, Brexit will not directly breach the barricades that English courts interpose to assisting foreign insolvency proceedings.[1] Since chapter 15 has no reciprocity requirements, US courts have not closed their doors to UK cases because of the UK's parsimonious approach to assisting foreign insolvency proceedings. Brexit will not change the attributes of UK proceedings that render them eligible for chapter 15 recognition, so Brexit should not make any difference to US courts' decisions on recognition and relief under chapter 15.

The Centrepiece suggests possible salutary post-Brexit changes to the limitations imposed by the *Gibbs* principle, constraints on relief available under the Cross-Border Insolvency Regulations, restriction to former British Commonwealth members of section 426 of the Insolvency Act 1986 and the limited adoption of the Model Law by additional EU Member

* The views expressed in this essay are the personal views of the authors, which are not to be taken as representing the views of INSOL International or any of its affiliates or representatives.

** Former Bankruptcy Judge, W.D. Texas; principle, CBInsolvency, LLC.

*** Retired Partner and Of Counsel, Goodwin Procter LLP; principle, CBInsolvency, LLC.

1 See Centrepiece, p. 5 ("The presently restrained approach to judicial innovation is likely to continue.").

States. Ameliorative changes to any of these impediments to universality would be welcome, but will not automatically follow Brexit.

CROSS-BORDER INSOLVENCY LANDSCAPE

In 2005, the US adopted its version of the UNCITRAL Model Law on Cross-Border Insolvency as chapter 15 of the Bankruptcy Code, *Ancillary and Other Cross-Border Cases.*[2] Chapter 15 is divided into several subchapters that address general provisions, access of foreign representatives and creditors to courts in the United States, recognition of foreign proceedings and relief, cooperation with foreign courts and foreign representatives and coordination of concurrent proceedings. Insofar as possible and as recommended by the UNCITRAL Guide to Enactment and Interpretation of the Model Law, chapter 15 follows the language, section numbering and general structure of the Model Law to promote uniformity in its adoption and application. The Cross-Border Insolvency Regulations 2006[3] ("CBIR") also track the Model Law and provide that it shall have the force of law, in the form appended as Schedule 1.[4] The Model Law was nipped, tucked and adapted to accommodate existing legislation in both the US and the UK but, unlike the CBIR, chapter 15 became part of an existing statute and not a separate statutory instrument. While there are a handful of chapter 15-specific provisions in the US Federal Rules of Bankruptcy Procedure and in the accompanying Official Forms, the CBIR is accompanied by more expansive Procedural Matters (separate for (i) England and Wales and (ii) Scotland) and Forms.[5]

Both the US and UK versions of the Model Law embody provisions and procedures for "recognition" designed to test the eligibility of a foreign insolvency proceeding to request assistance from the respective domestic courts. In each case, recognition requires that there be a "foreign proceeding", commenced by a "foreign representative", on a prescribed form of application (or petition); and that the foreign proceeding be a "foreign main proceeding" or a "foreign nonmain proceeding". Recognition is specifically subject to the condition of Article 6, Schedule 1 (CBIR) and section 1506 (chapter 15); i.e. that it not be manifestly contrary to public policy. Each of the recognition elements is discussed in detail below in the context of analyzing the recognition and enforcement of Schemes.

As signaled in the Centrepiece and discussed below, the structural and terminological similarities between chapter 15 and the CBIR diverge when it comes to the relief that will actually be granted in reliance on the respective versions of the Model Law. US Courts treat the relief provisions of chapter 15 as empowering them to grant relief based on the statutory language, consistent with the overarching principles of comity and constrained only to assure sufficient protection of affected parties and the absence of a manifest violation of US public policy.[6] Subject to the same conditions, US courts will apply foreign law when appropriate.[7] The UK courts add a barrier of anachronistic principles which, in their view, the

[2] The Bankruptcy Code is Title 11 of the United States Code, 11 U.S.C. §101, *et seq.*
[3] 2006 SI 2006/1030.
[4] CBIR, Reg. 2(1).
[5] See, e.g., Federal Rules of Bankruptcy Procedure 1004.2, Petition in chapter 15 Case and 2002(q), Notice of Petition for Recognition of Foreign Proceeding and of Court's Intention to Communicate with Foreign Courts and Foreign Representatives, Official Form 401, Petition for Recognition of a Foreign Proceeding; *cf.* CBIR Schedule 2, Procedural Matters in England and Wales, CBIR Schedule 3, Procedural Matters in Scotland, CBIR Schedule 5, Forms.
[6] See, e.g. *In re AJW Offshore, Ltd.*, 488 B.R. 551, 559 (Bankr. S.D.N.Y. 2013) (finding that the foreign representative could, via section 1521(a)(7) ["granting any additional relief that may be available to a trustee…"] employ the turnover powers of ss. 542 and 543 to obtain books and records, subject to providing sufficient protection to creditors and other interested parties).
[7] *Fogerty v. Petroquest Res., Inc. (In re Condor)*, 601 F.3d 319, 329 (5th Cir. 2010) ("[a]s chapter 15 was intended to facilitate cooperation between US courts and foreign bankruptcy proceedings, we read section 1521(a)(7) in that light and hold that a court has authority to permit relief under foreign avoidance law under the section."); *In re Hellas Telecommunications (Luxembourg) II SCA*, 525 B.R. 543, 568 ("The Plaintiffs allege various avoidance claims under foreign law, which may be adjudicated by this Court under chapter 15 of the Bankruptcy Code.").

CBIR did not supersede.[8] Lord Neuberger understated the divergence: "The extent to which the Model Law promotes substantive universalism (i.e. the application of the law governing the foreign insolvency proceeding) appears to be answered differently in different jurisdictions. Thus, the US courts seem to have adopted a rather more universalist approach than the courts of the UK."[9] Even though the CBIR have the force of law, the English courts seem to require reassurance that Parliament meant what it said.

WE LIKE SCHEMES OF ARRANGEMENT BUT DO YOU FEEL THE SAME WAY ABOUT CHAPTER 11'S?

The friendly Americans began recognizing and enforcing Schemes before chapter 15 was adopted.[10] Attributes of Schemes that might cause UK courts to deny assistance to an analogous US proceeding have not discouraged US courts from embracing Schemes. For example, the primary reason to seek chapter 15 recognition of many UK Schemes is to ensure enforcement in the US of modifications of US law-governed debt (usually New York law). But the *Gibbs* principle would appear to prevent a UK court from enforcing a US reorganization plan that modified English law-governed debt:

> "There is a long-established principle of the common law that the discharge of a debt under foreign insolvency law will not be given effect in the UK where the contract creating the debt is governed by English law. This doctrine is reflected in *Gibbs v La Société Industrielle et Commerciale des Métaux* where it was held that the foreign bankruptcy law was irrelevant because it was "not a law of the country to which the contract belongs, or one by which the contracting parties can be taken to have agreed to be bound; it is the law of another country by which they have not agreed to be bound." (Footnotes omitted.)[11]

The High Court has recently recognized a chapter 11 proceeding of a UK-registered debtor whose COMI was in the US but the debtor's reorganization plan apparently did not implicate non-consensual modification of English law-governed debt.[12] 19 Entertainment Limited ("19 Entertainment") was one of nearly 50 direct and indirect subsidiaries of CORE Entertainment Inc. ("CORE Group") which all filed chapter 11 petitions in the United States Bankruptcy Court for the District of Delaware on April 28, 2016. The CORE Group is perhaps best known as the producer of American Idol. Unique among the members of the CORE Group, 19 Entertainment was incorporated in England and had its registered office in London.

The CORE Group defaulted on its secured bank debt and 19 Entertainment's former CEO served a demand for nearly $3 million that could have led to winding-up proceedings in the UK. To prevent this, 19 Entertainment sought recognition of its chapter 11 case under the CBIR. On the day following the chapter 11 filings, the UK court heard and granted 19 Entertainment's application for recognition, apparently on an *ex parte* basis.[13] The decision illustrates the contrast between the English common law approach and the UNICTRAL Model Law approach embodied in the CBIR. The former permits assistance only to foreign proceedings of companies domiciled in the foreign jurisdiction while the latter permits

[8] See the discussion of *Gibbs* at Centrepiece at 8, 9, of *Singularis* at 5 and *Pan Ocean* at 11.
[9] Keynote speech on June 19, 2017 to the International Insolvency Institute (III) Annual Conference 2017, London.
[10] See, e.g. *In re Board of Directors of Hopewell International Insurance Ltd.*, 275 B.R. 699 (S.D.N.Y. 2002).
[11] Centrepiece, at 8, 9.
[12] *In re AOG Entertainment, Inc., et, al*, Case No. 16-11090-smb (Bankr. S.D.N.Y. 2016).
[13] *Re 19 Entertainment Limited* [2016] EWHC 1545 (CH), (England and Wales High Court (Chancery Division) April 29, 2016) ("UK Decision").

assistance to companies which have their domicile in the forum country and their center of main interests (or an establishment) in the foreign jurisdiction.[14] As the UK Court notes:

> "…it is very clear that, although the registered office of the company is in London, at New Bridge Street, it is, in fact, the paradigm case of a letterbox company because its business, direction and operation is now entirely conducted in the United States of America and, in particular, in Los Angeles. It has closed down, as I mentioned a moment ago, its London office; its directors are United States citizens and are resident there. Its board meetings are held in the United States. The Company's website, or rather that of the group to which it belongs, makes it clear that it is a Los Angeles-based concern with a Los Angeles telephone number. Further, the major creditors of the company are in the United States and its business dealings are also conducted there, as is its banking …. In my judgment, the fact that its COMI is situated in that country is extremely clear and I shall approach this case on that basis."[15]

The UK Court goes on to find similarities between chapter 11 and "the administration order regime applicable in England" and acknowledges that "… the effect of the Model Law is to give to the English court the possibility of enabling the position of a company which is in chapter 11 Bankruptcy in the United States, to be put on a similar footing in England with regard to any action against it by creditors, such as it would be if proceedings were being conducted in the United States."[16]

Before granting relief, the UK Court addressed the requirements that the 19 Entertainment's chapter 11 case be a "foreign proceeding" and that the applicants, the debtor's directors, be foreign representatives. The UK Court easily concluded that the chapter 11 was a foreign proceeding under Article 2 of the Model Law and the 2006 Regulations; i.e. "a collective judicial or administrative proceeding in a foreign state pursuant to a law relating to insolvency in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court for the purpose of reorganisation or liquidation."[17]

To conclude that the applicants comprised a foreign representative under Article 2; i.e. "a person or body, including one appointed on an interim basis, authorised in a foreign proceeding to administer the reorganisation or the liquidation of the debtor's assets or affairs or to act as a representative of the foreign proceeding," the UK Court relied on an affidavit of the debtor's US counsel. The evidence explained that section 1107 of the Bankruptcy Code gave the debtor in possession the functions and duties of a trustee and that this sufficed to qualify the directors as foreign representatives.

The UK Court (Jeremy Cousins, QC sitting as a Deputy Judge of the High Court) entered an order recognizing the chapter 11 case as a foreign main proceeding (triggering an automatic stay under Article 20 of Schedule 1 of the CBIR) and also entered discretionary relief specifically staying enforcement of security, seizure of assets, appointment of an administrative receiver and the presentment of any winding-up petition or application for appointment of an administrator:

> "I turn then to the question of discretionary relief. As I have explained already, there is a degree of urgency in the matter which is now before me, in the light of Mr. Fuller's position and in the light of his entitlement, within a matter of days, to commence

[14] See *Northshore Mainland Services, Inc., et al, Commonwealth of the Bahamas Supreme Court*, 2015/COM/Com/00039 (July 31, 2015) (Bahamas court applies English common law in denying recognition of a US chapter 11 case filed by a Bahamian debtor).
[15] UK Decision at paras 4, 6.
[16] UK Decision, at paras 10, 11.
[17] UK Decision at para. 14.

> winding up proceedings. If discretionary relief were to be granted, he would not be able to take that step, nor would other creditors. In my judgment, it is entirely consistent with the policy behind the adoption of the Model Law that I should grant relief of a kind which is similar to the moratorium relief provided in para. 43 of sch. B1 of the 1986 Act."

The English court was not faced with the ultimate *Gibbs* question since 19 Entertainment's former CEO settled his disputes with the Core Group in the context of resolving his objection to its plan of reorganization.[18]

In contrast to the one recognition of a chapter 11 case under the CBIR, we found thirty-one English schemes of arrangement recognized under chapter 15 (unless we missed a couple),[19] as well as a few from other former British Commonwealth countries.[20]

In many of these cases, the foreign representative also sought "additional relief", with the primary relief comprising what the US vernacular denominates as "third-party releases," or releases of one non-debtor third party by other non-debtor third parties, accompanied by complementary injunctions. The third-party releases, discussed in more detail below, have regularly been enforced.

WHY SCHEMES OF ARRANGEMENT GENERALLY SATISFY THE RECOGNITION REQUIREMENTS

Section 1517 of the Bankruptcy Code sets forth the requirements for recognition of a foreign proceeding. If these requirements are met and if recognition would not be "manifestly contrary" to the public policy of the United States, a bankruptcy court should issue an order granting recognition of a foreign proceeding as either a "foreign main" proceeding or a "foreign nonmain" proceeding.[21] Sections 1521 and 1522 set forth the provisions for

---

[18] *Findings of Fact, Conclusions of Law and Order Confirming Second Amended Joint Chapter 11 Plan of Reorganization for AOG Entertainment, Inc. and Its Affiliated Debtors, In re AOG Entertainment, Inc., et al*, Case No. 16-11090 (BANKR. S.D.N.Y. Sept. 23, 2016).

[19] *In re Metinvest B.V.*, No. 17-10130-LSS (Bankr. D. Del. Feb. 8, 2017); *In re DTEK Finance (plc)*, No. 16-13521-shl (Bankr. S.D.N.Y. Jan. 18, 2017); *In re Abengoa Concessions Investments Limited*, No. 16-12590-kjc (Bankr. D. Del. Dec. 8, 2016); *In re Metinvest B.V.*, No. 16-11424-LSS (Bankr. D. Del. Jun. 30, 2016); *In re EnQuest PLC*, No. 16-12983 (Bankr. S.D.N.Y. Oct. 24, 2016); *In re YH Limited*, No. 16-12262 (Bankr. S.D.N.Y. Sep. 8, 2016); *In re Metinvest B.V.*, No. 16-10105-LSS (Bankr. D. Del. Jan. 29, 2016); *In re OIC Run-Off Limited*, No. 15-13054-scc (Bankr. S.D.N.Y. Jan. 11, 2016); *In re Codere Finance (UK) Limited*, No. 15-13017-jig (Bankr. S.D.N.Y. Dec. 22, 2015); *In re Towergate Finance*, No. 15-10509 (Bankr. S.D.N.Y. Mar. 27, 2015); *In re New World Resources N.V.*, No. 14-12226 (Bankr. S.D.N.Y. Sept. 9, 2014); *In re Zodiac Pool Solutions SAS*, No. 14-11818 (Bankr. D. Del. Aug. 29, 2014); *In re hibu, Inc.*, No. 8-14-70323-reg (Bankr. E.D.N.Y. Feb. 27, 2014); *In re Zlomrex International Finance S.A.*, No. 13-14138 (Bankr. S.D.N.Y. Jan. 31, 2014); *In re Magyar Telecom B.V.*, 2013 WL 10399944, No. 13-13508 (Bankr. S.D.N.Y. Dec. 11, 2013); *In re Allianz Global Corporate & Specialty (France)*, No. 10-4990-smb (Bankr. S.D.N.Y. Nov. 4, 2011); *In re Tokio Marine Europe Ins. Ltd.*, No. 11-13420-mg (Bankr. S.D.N.Y. Sep. 8, 2011); *In re Hellas Telecomms. (Luxembourg) V*, No. 10-13651 (Bankr. D. Del. Dec. 13, 2010); *In re Baloise Insurance Ltd.*, No. 10-15358-jmp (Bankr. S.D.N.Y. Dec. 9, 2010); *In re Highlands Ins. Co. (U.K.)*, No. 07-13970 (Bankr. S.D.N.Y. Aug. 18, 2009); *In re Minister Insurance Co. Ltd.*, No. 10-bk-13899 (Bankr. S.D.N.Y. Sept. 1, 2010); *In re Castle Holdco 4, Ltd.*, No. 09-11761 (Bankr. S.D.N.Y. May 7, 2009); *In re Global General and Reinsurance Co. Ltd.*, No. 08-14939 (Bankr. S.D.N.Y. Jan. 21, 2009); *In re Sphere Drake Insurance Limited*, No. 08-12832-jlg (Bankr. S.D.N.Y. Sep. 11, 2008); *In re Grayfriers Insurance Company Limited.*, No. 07-12934 (Bankr. S.D.N.Y. Oct. 23, 2007); *In re Compagnie Européenne d'Assurances Industrielles S.A.*, No. 07-12009-mg (Bankr. S.D.N.Y. Sep. 26, 2007); *In re Endresen (Oslo Re UK)*, No. 07-12211 (Bankr. S.D.N.Y. Aug. 29, 2007); *In re AXA Insurance UK PLC*, No. 07-12110 (Bankr. S.D.N.Y. Aug. 15, 2007); *In re Europaische Ruckversicherungs-Gesellschaft in Zurich*, No. 06-13061 (Bankr. S.D.N.Y. Jan. 22, 2007); *In re Gordian RunOff (UK) Ltd., f/k/a/ GIO (UK) Ltd.*, No. 06-11563 (Bankr. S.D.N.Y. Aug. 29, 2006); *In re Lion City Run-Off Private Ltd.*, No. 06-10461 (Bankr. S.D.N.Y. Apr. 13, 2006); *In re La Mutuelle du Mans Assurances IARD, U.K. Branch)*, No. 05-60100, 2005 WL 3764946 (Bankr. S.D.N.Y. Dec. 7, 2005).

[20] See, e.g., *In re Cell C Proprietary Limited*, case No. 17-11735 (Bankr. S.D.N.Y. July 27, 2017); *In re Winsway Enterprises Holdings Limited*, No. 16-10833-mg (Bankr. S.D.N.Y. Jun. 16. 2016) (Hong Kong); *In re Kaisa Group Holdings Ltd.*, No. 16-11303-shl (Bankr. S.D.N.Y. Jul. 14, 2016); *In re Murray Holdings Limited*, No. 15-11231-mg (Bankr. Jun. 25, 2015); *In re LDK Solar Co. Ltd. (in Provisional Liquidation)*, No. 14-12387 (PJW) (Bankr. D. Del. Nov. 21, 2014); *In re Chartis Excess Limited*, No. 13-10888-shl (Bankr. S.D.N.Y. May 1, 2013) (Ireland; no third-party release); *In re Arion Insurance Company Limited*, No. 07-12108-rdd (Bankr. S.D.N.Y. August 9, 2007) (Bermuda).

[21] Section 1517(a), (b)(1)-(2); s. 1506.

additional relief that may be granted upon recognition and the conditions to granting such additional relief.

As a threshold matter, the United States Court of Appeals for the Second Circuit[22] has held that a debtor that is the subject of a foreign proceeding must meet the requirements of section 109(a) of the Bankruptcy Code before a bankruptcy court may grant recognition of the foreign proceeding in chapter 15.[23] Section 109(a) provides the general criteria for eligibility to be a debtor under the Bankruptcy Code, and requires specifically that a debtor either reside, have a domicile, a place of business, or property in the United States. The decision in the *Barnet* case has been criticized.[24] As a practical matter, there is a very low threshold for satisfaction of the section 109(a) requirement. Either an attorney retainer account or contract rights under a US-law debt indenture constituted property that satisfied the Section 109(a) debtor eligibility requirements.[25]

Section 1517(a) provides that, subject to section 1506 (the public policy exception) an order recognizing a foreign proceeding shall be entered, after notice and a hearing, "if – (1) such foreign proceeding for which recognition is sought is a foreign main proceeding or foreign nonmain proceeding within the meaning of [section 1502]; (2) the foreign representative applying for recognition is a person or a body; and (3) the petition meets the requirements of [section 1515]."[26] Section 1517 employs terms defined elsewhere in the Bankruptcy Code and implicates those definitional provisions among the requirements for recognition. Specifically, section 101(23) defines "foreign proceeding", section 101(24) defines "foreign representative", section 1502(4) defines "foreign main proceeding" and section 1502(5) defines "foreign nonmain proceeding."

Section 101(23), states:

> The term "foreign proceeding" means a collective judicial or administrative proceeding in a foreign country, including an interim proceeding, under a law relating to insolvency or adjustment of debt in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation.

US bankruptcy courts interpret section 101(23) as imposing a seven-part test, each element of which must be satisfied before a proceeding may qualify as a "foreign proceeding" within the scope of chapter 15. These elements are (i) the existence of a proceeding; (ii) that is either judicial or administrative in nature; (iii) that is collective in nature; (iv) in a foreign country; (v) authorized or conducted under a law related to insolvency or the adjustment of

---

[22] The Federal courts for Connecticut, Vermont and the Eastern, Northern, Southern and Western Districts of New York comprise the Second Circuit.

[23] *In re Barnet (Drawbridge Special Opportunities Fund LP)*, 737 F.3d 238, 247 (2d Cir. 2013); *In re Suntech Power Holdings Co., Ltd.*, 520 B.R. 399 (Bankr. S.D.N.Y. 2014).

[24] See *In re Berau Capital Resources Pte Ltd*, 540 B.R. 80, 81-82 (Bankr. S.D.N.Y. 2015), citing Daniel M. Glosband and Jay Lawrence Westbrook, "Chapter 15 Recognition in the United States: Is a Debtor 'Presence' Required?", 24 Int. Insolv. Rev. 28 (2015).

[25] *In re Berau Capital Resources Pte Ltd*, 540 B.R. at 84 (Bankr. S.D.N.Y. 2015); *See also In re Cell C Proprietary Limited*, case No. 17-11735 (Bankr. S.D.N.Y.July 27, 2017); *In re Inversora Electric de Buenos Aires S.A.*, 560 B.R. 650, 654 (Bankr. S.D.N.Y. 2016) ; *In re Yukos Oil Co.*, 321 B.R. 396, 407 (Bankr. S.D. Tex. 2005); *In re Global Ocean Carriers Ltd.*, 251 B.R. 31, 38-39 (Bankr. D. Del. 2000). Following the decision by the Second Circuit in the *Barnet* case, the foreign representative in that case again sought recognition and the bankruptcy court, applying the Second Circuit's ruling, held that cash in a client trust account maintained by the foreign representatives' US counsel satisfied the section 109(a) requirement. *In re Octaviar Administration Pty Ltd. (Debtor in a Foreign Proceeding)*, 511 B.R. 361, 372 (Bankr. S.D.N.Y. 2014) (the court also found that causes of action manifested in US-filed lawsuits also satisfied s. 109(a)).

[26] Section 1517(a)(1)-(3). Section 1506 provides: "Nothing in this chapter prevents the court from refusing to take an action governed by this chapter if the action would be manifestly contrary to the public policy of the United States." A Scheme is roughly analogous to a consensual restructuring under chapter 11 of the Bankruptcy Code in which a sufficient majority of impacted creditors have, after notice of the proposed terms, voted to accept their treatment under the plan and the plan is ultimately approved by the Court. Therefore, it is consistent with US public policy.

debts; (vi) in which the debtor's assets and affairs are subject to the control or supervision of a foreign court; and (vii) which proceeding is for the purpose of reorganization or liquidation.[27]

A Scheme is a "proceeding"

For purposes of section 101(23), the *Betcorp* opinion endorses the broad definition of "proceeding" suggested by the EC Regulation on Insolvency Proceedings 1346/2000 and characterizes the essence of a proceeding as "acts and formalities set down in law so that courts, merchants and creditors can know them in advance, and apply them evenly in practice."[28] A Scheme meets the definition of a "proceeding."[29] In this case, the statutory framework is Part 26 of the UK Companies Act 2006, which sets forth the requirements for the company to apply to the English Court to initiate and implement a process by which its debts may be adjusted. The Scheme is subject to the provisions of the Companies Act 2006 and the company will be under the direction of the English Court up to and including final approval of the Scheme.

A Scheme is judicial in nature

A proceeding is deemed "judicial in nature" under section 101(23) where the proceeding is subject to review by a court.[30] An order of the English Court is required in order to convene a meeting of affected creditors and to sanction the Scheme before the Scheme can become effective. Because the procedures established by the Companies Act 2006 mean that involvement and oversight of the English Court is required to utilize the scheme of arrangement procedure, the Scheme clearly qualifies as "judicial in nature" under section 101(23).

A Scheme is collective in nature

Section 101(23) also requires that the proceeding be "collective". The legislative history of chapter 15 notes that it adopts the definition of "foreign proceedings" nearly verbatim from the Model Law.[31] It also directs reference to the Model Law and the Guide as aids to interpreting chapter 15.[32] The Guide, in turn, takes a broad view of collective proceedings which may include "a variety of collective proceedings ... be they compulsory or voluntary, corporate or individual, winding-up or reorganization."[33] Case law takes a similar approach.[34]

A Scheme Takes Place in a Foreign Country

A Scheme self-evidently will take place in England before the English Court.

---

[27] *ABC Learning Centres*, 728 F.3d 301, 307-08; *In re Betcorp Ltd.*, 400 B.R. 266, 276-77 (Bankr. D. Nev. 2009); *In re Ashapura Minechem Ltd.*, 480 B.R. 129, 136 (S.D.N.Y. 2012).

[28] *Betcorp*, 400 B.R. at 278.

[29] The fact that a Scheme may be deemed to involve a solvent debtor is no obstacle to recognition under ch. 15. As the US Bankruptcy Court for the Southern District of New York has held, it is the nature of the proceeding and not the status of the debtor which determines ch. 15 eligibility and there is no requirement that a foreign debtor in a foreign insolvency proceeding must actually be insolvent in order to gain recognition under ch. 15. See *In re Millard*, 501 B.R. 644, 649-50 (Bankr. S.D.N.Y. 2013).

[30] *Betcorp*, 400 B.R. at 280-81.

[31] House Report 109-31, pt. 1, 109th Cong., 1st Sess. (2005) ("H.R. Rep.") at 118.

[32] *Idem.* at 109; See also footnote 9, *supra*.

[33] Guide, para. 71.

[34] *Betcorp*, 400 B.R. at 281; *In re Gold & Honey, Ltd.*, 410 B.R. 357, 370 (Bankr. E.D.N.Y. 2009); *ABC Learning Centres*, 728 F.3d at 310 (internal citations omitted); *In re Board of Directors of Hopewell Int'l Ins. Ltd.*, 275 B.R. 699, 707 (S.D.N.Y. 2002).

A Scheme is under a law "relating to insolvency or adjustment of debt"

A Scheme will be conducted under Part 26 of the UK Companies Act 2006 for the purpose of reorganization. Numerous US courts have held that this manner of reorganization under the provisions of Part 26 of the Companies Act qualifies for purposes of section 101(23).[35]

The assets and affairs of the Company are subject to the control of a foreign court

Section 1502(3) defines "foreign court" as a "judicial or other authority competent to control or supervise a foreign proceeding." By virtue of the applicable provisions of the UK Companies Act 2006, the English Court has direct supervisory authority over a Scheme. In light of the direct involvement of the English Court in considering the application to convene a Scheme Meeting and entering a Convening Order and the requirement that the English Court ultimately sanction (approve) the Scheme, a Scheme certainly meets this element of the 101(23) analysis.[36]

A Scheme is for the purpose of reorganization

The final element of the 101(23) analysis requires that the proceeding be for a reorganization or liquidation purpose. US courts will often look to the debtor's own description of the proceedings to determine whether they are for the purpose of reorganization or liquidation.[37]

A scheme of arrangement is a statutory process under the applicable provisions of the UK Companies Act 2006 for the adjustment of debts. As such, a Scheme is "for the purpose of reorganization" within the meaning of section 101(23).

A Scheme must qualify for recognition as a "Foreign Main Proceeding" or a "Foreign Nonmain Proceeding"

In order to be recognized under chapter 15, a foreign proceeding must be either main or nonmain.[38] The essence of the requirement that there be either COMI or an establishment as a condition to recognition, is the determination of the legislators that a debtor must have an economic presence in the country that is conducting the foreign proceeding to be eligible for assistance from courts in the United States.[39]

Section 1502(4) defines a foreign main proceeding as a "foreign proceeding pending in the country where the debtor has the center of its main interests." Section 1502(5) defines a foreign nonmain proceeding as "a foreign proceeding, other than a foreign main proceeding, pending in a country where the debtor has an establishment." While no Scheme has been denied recognition because of the absence of the debtor's COMI or an establishment in the

[35] See, e.g., *In re New World Resources N.V.*, No. 14-12226 (Bankr. S.D.N.Y. Sept. 9, 2014); *In re hibu, Inc.*, No. 8-14-70323-reg (Bankr. E.D.N.Y. Feb. 27, 2014); *In re Magyar Telecom B.V.*, 2013 WL 10399944 (Bankr. S.D.N.Y. Dec. 11, 2013); *In re Hellas Telecomms. (Luxembourg) V*, No. 10-13651 (Bankr. D. Del. Dec. 13, 2010); *In re Highlands Ins. Co. (U.K.)*, No. 07-13970 (Bankr. S.D.N.Y. Aug. 18, 2009). See also the additional cases listed above.

[36] *Betcorp*, 400 B.R. at 284.

[37] *Betcorp*, 400 B.R. at 284-85 (noting that directors' minutes stated that winding-up was for the purpose of liquidation).

[38] *In re Bear Steams High-Grade Structured Credit Strategies Master Fund, Ltd.*, 374 B.R. 122, 126-27 (Bankr. S.D.N.Y. 2007), *aff'd*, 389 B.R. 325 (S.D.N.Y. 2008).

[39] *In re Bear Steams High-Grade Structured Credit Strategies Master Fund, Ltd.*, 389 B.R. 325, 333-334 (S.D.N.Y. 2008). ("The objective criteria for recognition reflect the legislative decision by UNCITRAL and Congress that a foreign proceeding should not be entitled direct access to or assistance from the host country courts unless the debtor had a sufficient pre-petition economic presence in the country of the foreign proceeding. *See* House Report at 110; s. 1509(b)(3).").

UK, other UK proceedings have been rejected as neither "foreign main proceedings" or "foreign nonmain proceedings".[40]

The foreign representative must qualify

The foreign representative applying for recognition must be a person or a body authorized to act on behalf of the foreign proceeding. Typically, the debtor's board of directors designates an officer to act as foreign representative for purposes of seeking chapter 15 recognition of a Scheme. Section 101(24) defines the term "foreign representative" as being "a person or body, including a person or body appointed on an interim basis, authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor's assets or affairs or to act as a representative of such foreign proceeding."[41] Under section 101(41), the term "person" includes an "individual". The definition of foreign representative in section 101(24) closely follows the language of the Model Law, Article 2(d), which provides that a foreign representative be a "person...authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor's assets or affairs ...or to act as a representative of such foreign proceeding."[42] This definition of "foreign representative" does not require that the individual be appointed by a foreign court or other judicial body.[43] Instead, it is sufficient that the foreign representative be authorized to act "in the context" of a foreign bankruptcy proceeding, such as by resolution of the debtor's board of directors authorizing the representative to commence foreign bankruptcy proceedings on the debtor's behalf.[44]

The tricky issue of third party releases

In cases under chapter 7 (Liquidation) and chapter 11 (Reorganization) of the Bankruptcy Code, third-party releases are unusual and difficult or impossible to obtain.[45] US bankruptcy courts have regularly recognized and given full force and effect to English schemes of arrangement that included third-party releases (i.e. of claims against third parties other than the debtor) and / or stays of actions against third parties.[46] In December of 2013, the United

[40] See *In re Kemsley*, 489 B.R. 346 (Bankr. S.D.N.Y. 2013) (Trustee of individual debtor denied recognition because debtor had neither his habitual residence / COMI nor an establishment in England). Recognition has also been denied when an individual debtor in an English bankruptcy was below the debt limits established by ss. 1501(c)(2) and 109(e) of the Bankruptcy Code. *In re Steadman*, 410 B.R. 397 (Bankr. D. N.J. 2009).

[41] Section 101(24).

[42] *In re Vitro S.A.B. de C.V.*, 701 F.3d 1031, 1045 (5th Cir. 2012); *see also* UNCITRAL Report of the Working Group on Insolvency Law on the Work of the Eighteenth Session, para. 110, U.N. Doc. A/CN.9/419 (Dec. 1, 1995).

[43] *Vitro*, 701 F.3d at 1047. See also *In re OAS S.A.*, 533 B.R. 83, 90, 94-95 (Bankr. S.D.N.Y. 2015).

[44] *Idem.* at 1047, 1049 (affirming recognition of foreign representatives nominated by boards of directors).

[45] *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 142 (2d Cir. 2005); some judicial circuits (the 5th, 9th an 10th) prohibit them entirely. See, e.g. *Resorts International v. Lowenschuss*, 67 F. 3d 1394 (9th Cir. 1995), cert. denied 517 U.S. 1243, 116 S.Ct. 2497 (1996). The US District Court for the District of Delaware ruled in an appeal from a bankruptcy court order confirming a ch. 11 plan in *In re* Millennium Lab Holdings II, LLC, *2017 WL 1032992* that the releases of a non-debtor third party's non-bankruptcy fraud and RICO (a civil cause of action for acts performed as part of an ongoing criminal organization) claims against equity holders was beyond the power of the bankruptcy court. Under the peculiar limitations on the jurisdiction that may be exercised by bankruptcy judges, who are not appointed under Art. III of the US Constitution and who do not have lifetime tenure and protection against salary reduction, the *Millennium* Court, citing *Stern v. Marshall*, 564 U.S. 462 (2011), stated that a bankruptcy court does not have final adjudicatory authority over "a private right, that is, of the liability of one individual to another."

[46] See, e.g. *In re Magyar Telecom B.V.*, 2013 WL 10399944 (Bankr. S.D.N.Y. Dec. 11, 2013). Likewise, in *Hellas Telecommunications (Luxembourg) V*, No. 10-13651, the United States Bankruptcy Court for the District of Delaware issued a similar order giving "full force and effect" to such an English scheme of arrangement and ordering broad injunctive orders that effected third-party releases. (Docket No. 38, Dec. 13, 2010). On February 27, 2014, the United States Bankruptcy Court for the Eastern District of New York in *In re hibu Inc.*, No. 14-70323 granted recognition to an English scheme of arrangement as a "foreign nonmain proceeding" and entered an order giving effect to a series of releases required for implementation of the scheme. On September 9, 2014, the United States Bankruptcy Court for the Southern District of New York in *In re New World Resources, N.V.*, No. 14-12226 granted recognition to an English scheme of arrangement as a "foreign main proceeding" and ruled that the scheme was entitled to full force and effect. The *New World* scheme of arrangement contemplated that existing scheme creditors would provide releases of the debtor and of affiliated persons and entities, including affiliates who had guaranteed the debtor's obligations to the scheme creditors. US Courts have also regularly granted recognition to schemes of arrangement emanating from former British Commonwealth countries other than

States Bankruptcy Court for the Southern District of New York entered an order granting recognition to an English Scheme and granting ancillary relief under sections 1520, 1521, 1507(a), 1509(b)(2)-(3), 1525(a) and section 105(a) of the Bankruptcy Code giving "full force and effect" to a Scheme and ordering broad injunctive orders that effected third-party releases. The courts that recognized and enforced Schemes that included third-party releases and complementary injunctive protection, primarily relied on precedent in US case law for the enforcement of third-party releases and related injunctions as additional relief upon recognition under chapter 15 where the releases are permissible under the law of the foreign proceeding, the affected parties had notice and an opportunity to be heard and the releases were approved by the foreign court.[47] These decisions each recognize that section 1507 provides authority to approve the release provisions under the doctrine of international comity.[48]

Brexit will not affect any of the recognition factors or the conditions for obtaining additional relief. If debtors establish a sufficient connection to the UK to qualify as Scheme debtors and if they have either their COMI or an establishment in the UK, then the US will welcome them and continue to grant chapter 15 recognition.

UNCITRAL, NOT BREXIT, MAY ENTICE THE UK TO BE MORE ACCOMMODATING

Brexit is also unlikely to have much of an impact, from the US perspective, on how foreign judgments are recognized on either side of the pond. The recast Jurisdiction and Judgments Regulation (Brussels 1) of course has no impact on the recognition of judgments as between Britain and the US (or between the EU and the US for that matter).

The history of recognition of foreign judgments on the part of the UK relative to the US has been less than felicitous, after the Supreme Court's ruling in *Rubin v Eurofinance SA*.[49] There, a lower court decision that had followed Lord Hoffman's decision in *Cambridge Gas* was reversed, the court holding that a judgment is a judgment from an English perspective, regardless whether it issued from a foreign bankruptcy proceeding. For such a judgment to be enforced in the UK, it must be established that the judgment debtor was present in the foreign jurisdiction at the time the action was initiated, was either a claimant or

England and have enforced third party releases granted pursuant to such schemes of arrangement. See *In re Winsway Enterprises Holdings Limited*, No. 16-10833-mg (Bankr. S.D.N.Y. Jun. 16, 2016) (Hong Kong); *In re Kaisa Group Holdings Ltd.*, No. 16-11303-shl (Bankr. S.D.N.Y. Jul. 14, 2016); *In re Murray Holdings Limited*, No. 15-11231-mg (Bankr. Jun. 25, 2015); *In re LDK Solar Co. Ltd. (in Provisional Liquidation)*, No. 14-12387 (PJW) (Bankr. D. Del. Nov. 21, 2014); *In re Chartis Excess Limited*, No. 13-10888-shl (Bankr. S.D.N.Y. May 1, 2013) (Ireland; no third-party release); *In re Arion Insurance Company Limited*, No. 07-12108-rdd (Bankr. S.D.N.Y. August 9, 2007) (Bermuda; no third-party release).

47 See, e.g., *In re Metcalfe & Mansfield Alt. Invs.*, 421 B.R. 685, 700 (S.D.N.Y. 2010); *In re Sino-Forest Corp.*, 501 B.R. 655, 666 (Bankr. S.D.N.Y. 2013); *In re Magyar Telecom B.V.*, 2013 WL 1039994 (Bankr. S.D.N.Y. Dec. 11, 2013). A notable exception occurred in the case of *In re Vitro, S.A.B. de C.V.*, 473 B.R. 117 (Bankr. N.D. Tex. 2012), *aff'd*, 701 F.3d 1031 (5th Cir. 2012) (cert. dismissed), where the bankruptcy court declined to enforce a Mexican *concurso* (similar to a Scheme) where the plan granted relief not available under US law and did not give "sufficient protection" to creditors. In our opinion, however, *Vitro* is distinguishable from the Scheme for at least two significant reasons: first, the *Vitro* opinion is peculiar to the United States Court of Appeals for the Fifth Circuit, which appears to take a different and altogether more stringent approach to the question of third-party releases, and second, the Scheme and surrounding facts are much more analogous to the circumstances of the *Metcalfe & Mansfield* and *Sino-Forest* proceedings, where the Scheme in question will require the support of the requisite majority of creditors in order to secure approval by the Hong Kong Court.

48 *Sino-Forest*, 501 B.R. at 663; *Metcalfe & Mansfield*, 421 B.R. at 699-700. The *Metcalfe & Mansfield* court noted that the Second Circuit Case law, which governs the Bankruptcy Court for the Southern District of New York, "places narrow constraints on bankruptcy court approval of third-party non-debtor release and injunction provisions" but that "the use of such provisions is not entirely precluded." *Metcalfe & Mansfield*, 421 B.R. at 697, citing *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 142 (2d Cir. 2005). The *Magyar* court adopted the following formulation in enforcing Scheme-related injunctions: "Each of the injunctions contained in this Order (i) is within the Court's jurisdiction, (ii) is essential to the success of the Scheme, (iii) is an integral element of the Scheme and / or to its effectuation, (iv) confers material benefits on, and is in the best interests of, the Debtor and its creditors, including without limitation the Scheme Creditors, and (v) is important to the overall objectives of the Restructuring." *Magyar Telecom B.V.*, 2013 WL 1039994, at *2.

49 [2012] UKSC 46.

counterclaimant in that proceeding and voluntarily submitted to the foreign court's jurisdiction by appearing voluntarily or by agreement.

The fact that the UK also subscribes to the principle of cooperation with foreign insolvency proceedings – both by virtue of its enactment of the Model Law in its Cross-Border Insolvency Regulations and by its continued use of Section 426 of the Insolvency Act of 1986 – did not seem to matter much in the court's analysis, perhaps because the court viewed the insolvency process itself as distinct from the discrete nature of an adversary proceeding resulting in a discrete judgment against a third party. Nonetheless, the decision in *Rubin* leaves open a number of unanswered questions, including whether the discharge or injunctive features of a confirmation order issued by a US court would also run afoul of its rule.

In point of fact, we already have some indication that the UK courts might be less than receptive toward a discharge or release injunction. In *Singularis Holdings Ltd. v. Pricewaterhouse-Coopers*,[50] the Privy Council found that a court could not via ancillary relief afford a remedy not available under its own law – at least not under the common law. While assistance at common law is generally recognized, such as in granting stays or the enforcement of judgments (when otherwise permissible under the common law), and statutory assistance for foreign insolvency proceedings is also appropriate, an English court can only apply its own law, and not the law of another jurisdiction, when it is functioning in an ancillary capacity. The court is particularly critical of the reasoning in *Cambridge Gas* that the US bankruptcy court's order be given effect in the Isle of Man, even though no proceeding for winding up, nor any Scheme under Manx law had been initiated and the US court had neither personal jurisdiction over the shareholders nor *in rem* jurisdiction over the shares. While the facts in *Singularis* render its holding reasonable, the sharp criticism of *Cambridge Gas* and its purported attempt at judicial legislation suggests an unwillingness on the part of the UK courts currently to stray far outside the lines already drawn by the common law over the last century or so.

The court's rulings in *Joint Administrators of Heritable Bank plc v Winding up Board of Landsbanki Islands HF*[51] and *Global Distressed Alpha Fund 1 Ltd Partnership v PT Bakrie*,[52] to the effect that the common law rule set out in *Gibbs v La Société Industrielle et Commerciale des Métaux*[53] is still good law and binding on the lower courts, gives further support to the sense that English courts draw a distinction between "judgment-like" rulings and ordinary assistance to a foreign insolvency proceeding (such as, by way of example, transferring assets within the jurisdiction to the foreign insolvency representative). The difficulty for US courts, of course, is that our chapter 11 process contains many "judgment-like" decisions, regardless whether they are so denominated. Decisions regarding executory contracts, for example, can alter the rights of the counterparty significantly and are deemed an essential part of the restructuring process.[54] Will such decisions be treated as insolvency-related matters, or will they too be deemed essentially as judgments? The question remains for future decision.

[50] [2014] UKPC 36.
[51] [2013] UKSC 13.
[52] [2011] EWHC 256 (Comm.).
[53] [1890] 25 QBD 399.
[54] See, e.g., *In re Abbott Laboratories Derivative Shareholders*, 325 F.3d 795 (7th Cir. 2003) (decision to assume or reject is solely within the business judgment of the estate and will be approved so long as conditions of s. 365 are otherwise satisfied). A counterparty has the right to insist on cure of outstanding liabilities in the event of assumption and assignment, as well as "adequate assurance of future performance." The counterparty cannot simply refuse the substitution of a third party on grounds that either local law or the terms of its own contract would otherwise forbid it. *See* 11 U.S.C. s. 365(f).

Of course, the UK adopted the Model Law on Cross-Border Insolvency, promulgated by UNCITRAL in 1997; so has the US.[55] However, the UK courts are not as expansive as the US courts in applying its provisions. Article 21 of the Model Law, for example, affords a court broad authority to enter such relief as may be appropriate to assist the foreign representative. In the US, the courts have been expansive in granting such relief (though not without limitation).[56] In the UK, however, the courts have taken a somewhat more restrained approach to the relief that ought to be accorded under Article 21. *In re Pan Ocean Co Ltd*,[57] the court ruled that relief could not exceed what would otherwise be available under domestic law, a decidedly more restricted approach than US courts would take. The court held that the contract in question was governed by English law, so English law, rather than the insolvency law of Korea, had to control the question whether the contract could be terminated. Not only does this ruling contrast with the US approach to the Model Law, it contrasts even with the approach counseled under UNCITRAL's Guide to Enactment.[58]

What is more, the ruling does not augur well for the unanswered question posed earlier, regarding how an English court might respond to a request under the CBIR to enforce terms of a US court order authorizing the assumption and assignment of an executory contract governed by English law (assuming, for the sake of discussion, that *in personam* jurisdiction were otherwise not an issue). *Gibbs* may thus control, even in the face of statutory authority to the contrary, undermining the nod to the legislature stated in *Singularis*.

The English Parliament may yet have more to say on the subject of recognition of foreign judgments originating in an insolvency proceeding if UNCITRAL's latest project ultimately reaches fruition and the UK opts to adopt it. UNCITRAL Working Group V is nearing completion of its work on a model law for the cross-border recognition and enforcement of insolvency-related judgments.[59] A draft of the Model Law was prepared at its 51st session and was attached as an annex to the Report. It will be taken up at its 52nd session in December. The draft is designed to be compatible with existing regimes for the recognition of foreign judgments (such as those adopted by The Hague Convention) and with general principles of private international law relating to conflicts of law and the enforcement of judgments. However, it seeks as well to complement the Model Law, encouraging broad enforcement along lines consistent with the Model Law if the judgment in question is "insolvency-related." Currently, that definition provides as follows:

> "(d) 'Insolvency-related foreign judgment' means a judgment that:
> (i) [Is related to] [Derives directly from or is closely connected to] [Stems intrinsically from or is materially associated with] an insolvency proceeding;
> (ii) Was issued on or after the commencement of the insolvency proceeding to which it is related; and
> (iii) Affects the insolvency estate;
> and subparagraphs (i), (ii) and (iii) shall apply irrespective of whether or not the proceeding to which the judgment is related has been concluded.

55 See 11 U.S.C. s.1501 *et seq.*

56 See *In re Metcalfe & Mansfield Alternative Investments*, 421 B.R. 685, 697 (Bankr.S.D.N.Y. 2010) ("The relief granted in the foreign proceeding and the relief available in a US proceeding need not be identical."); but see *In re Vitro SAB de CV*, 701 F3d 1031 (5th Cir. 2012) (declining to extend third party release granted in Mexican *concurso* proceedings because the relief exceeds relief otherwise appropriate under s. 1521, due to the restrictions of s. 1522, and relief under s. 1507 ought to be tested under a more rigorous standard).

57 [2014] EWHC 2124 (Ch).

58 1997 Model Law on Cross-Border Insolvency Law and Guide to Enactment and Interpretation (United Nations 2013). "The types of relief listed in art. 21, para. 1, are typical of the relief most frequently granted in insolvency proceedings; however, the list is not exhaustive and the court is not restricted unnecessarily in its ability to grant any type of relief that is available under the law of the enacting State and needed in the circumstances of the case. *Idem.*, at 87-88, para. 189.

59 See Report of Working Group V (Insolvency Law) on the work of its fifty-first session (New York, 10-19 May 2017), Doc. A/CN.9/903 (United Nations May 26, 2017) (hereinafter "Report"). "The Working Group completed its work by considering a revised text of the draft model law on the cross-border recognition and enforcement of insolvency-related judgments ...." *Idem.* at 3 (bracketed language indicates phraseology with regard to which either the Working Group has not reached consensus or which the Working Group intends to be left available as options for the enacting state).

For the purposes of this definition:

1. An 'insolvency-related foreign judgment' includes a judgment issued in a proceeding in which the cause of action was pursued by:
   (a) A creditor with approval of the court, based upon the insolvency representative's decision not to pursue that cause of action; or
   (b) The party to whom it has been assigned by the insolvency representative in accordance with the applicable law;

   and the judgment on that cause of action would otherwise be enforceable under this Law;

   and

2. An 'insolvency-related foreign judgment' does not include a judgment commencing an insolvency proceeding."[60]

The definition is sufficiently expansive to include not only an order authorizing the assumption and assignment of an executory contract of the type posited in the earlier question, but also the judgment rendered by the bankruptcy court that became the subject of *Rubin*.

The draft model law is intended to be broadly applied to the limits of an enacting state's treaty obligations and contains the same "manifestly contrary" public policy limitation as is found in the Model Law. Not surprisingly, the lengthiest article sets out the circumstances under which the enacting state may decline to grant recognition and enforcement of an insolvency-related judgment.[61] Of particular interest in the context of this paper is subparagraph (g):

"(g) The ***originating*** court did ***not*** satisfy one of the following conditions:
   (i) The court exercised jurisdiction on the basis of the explicit consent of the party against whom the judgment was issued;
   (ii) The court exercised jurisdiction on the basis of the submission of the party against whom the judgment was issued, namely that the defendant argued on the merits before the court without contesting jurisdiction within the time frame provided in the law of the originating State unless it was evident that an objection to jurisdiction or to the exercise of jurisdiction would not have succeeded under that law;
   (iii) The court exercised jurisdiction on a basis on which a court in this State could have exercised jurisdiction; or
   (iv) The court exercised jurisdiction on a basis that was not inconsistent with the law of this State."[62]

This last proviso thus would still leave the door open for UK courts to conclude that the originating court exercised jurisdiction on a basis that the common law as espoused by the UK courts would not recognize. However, it is helpful to note that the entirety of sub-paragraph (g) relates to an improper exercise of jurisdiction (from the point of view of the enacting state, i.e., the receiving court), not to the nature of the remedy afforded by the judgment. Thus, the model law, if enacted, might be viewed to overrule both *Singularis* and *Gibbs*. Of course, these are ruminations upon ruminations regarding events that may never take place and so are at this point only an academic exercise.

---

[60] See Report, at Annex, Draft model law on cross-border recognition of insolvency-related judgments: revised text, at Art. 2.
[61] See Report, at Annex, at Art. 13.
[62] See Report, at Annex, at Art. 13(g) (emphasis added for clarity).

CONCLUSION

While it is morbidly fascinating to watch the UK struggle with the consequences of its Brexit vote, it does not appear to make any difference from the perspective of US cross-border insolvency. The US is also coping with the aftereffects of surprising election results – empathy all around.

Your World First

CMS Law . Tax

BREXIT – EFFECTS ON CROSS-BORDER INSOLVENCY AND RESTRUCTURING

Patricia Godfrey
E: patricia.godfrey@cms-cmno.com
D: 020 7524 6444
M: 07879 602887

Current landscape – European Insolvency Regulation, Cross-Border Insolvency Regulations

- There are currently four methods for dealing with recognition and assistance in the UK cross-border tool kit:

  - Section 426 Insolvency Act 1986.
  - Common Law.
  - The EC Insolvency Regulation (EC Insolvency Regulation No 1346/2000 and EU Insolvency Regulation (Recast) 2015/848).
  - The Cross Border Insolvency Regulations 2006.

Section 426 Insolvency Act 1986

- Designated countries may apply to the UK courts for assistance.
- Discretionary power but presumption of assistance.
- Express choice of law.
- Examples of assistance include:
  - injunctions;
  - enforcing foreign judgments made in clawback proceedings;
  - making an administration order.
- For an administration order:
  - the local court must present a letter of request to the English court;
  - the request to the local court usually requires an opinion of a barrister that the English court is reasonably likely to make the administration order.
- <u>Impact of Brexit:</u> no impact, however, the UK and the Republic of Ireland are the only EU members.

Common Law Assistance

- It is important to note that the common law assistance provisions have been extensively used in a UK-US context both pre the EIR and Cross Border Regulations and post where it can be used as part of a combined approach.
- A gloss on the other frameworks.
- Based on the concept of "modified universalism" – one set of primary insolvency proceedings in which creditors may prove but local courts have the discretion to evaluate the fairness of foreign procedures to protect local creditors.
- No power to enforce judgments *in personam* handed down in insolvency proceedings (Rubin).
- Power to remit assets and grant assistance.

Common Law Assistance (cont'd)

- Discretionary assistance.
- No power to apply foreign law.
- Power to order a party to provide information to assist a foreign liquidator only if the power exists in the foreign jurisdiction (Singularis).
- Impact of Brexit: UK courts have a long standing tradition of granting assistance in foreign procedures which have purported universal effect. Brexit of itself should not impact this but even the Common Law's wings have been clipped in recent cases such as Singularis.

EIR

- **What is the EIR and how does it work?**
  - General:
    - The EIR is EC Insolvency Regulation (EC Insolvency Regulation No 1346/2000 and EU Insolvency Regulation (Recast) 2015/848) which establishes common rules on cross-border insolvency proceedings. It is based on recognition and cooperation.
    - An updated regulation came into force on 26 June 2017 – key features include:
      - COMI shifts are still permitted but there will be increased scrutiny;
      - secondary proceedings are no longer limited to winding-up proceedings;
      - extended list of main proceedings includes pre-insolvency proceedings.
    - Applies to proceedings listed in Annex A – not receivership.
    - Regulation in its original form and in its updated form does not apply to schemes of arrangement.
    - COMI determines the opening of main proceedings.
    - The English Court still has the discretion when deciding whether to wind-up a foreign company with its COMI in the UK.

EIR (cont'd)

- Main Proceedings:
  - The court where the debtor has its COMI has jurisdiction to open main proceedings.
  - The law of the main proceedings governs the law applicable to insolvency proceedings and their effects (with exceptions e.g. rights in rem/set off).
  - Regulation has helped co-ordination of pan-European group insolvencies, even though there have been no express group provisions until very recently.
  - Better co-ordination and communication in group insolvencies.

EIR (cont'd)

- Secondary Proceedings:
  - "Synthetic Secondary" proceedings are proceedings developed to mitigate against negative effects of forum shopping.
  - To minimise unnecessary secondary proceedings, there are now new provisions for synthetic insolvency proceedings.
  - Initially winding-up proceedings only – now not restricted to liquidation.
  - An "Establishment" is a place of operations where the debtor carries out a non-transitory economic activity with human means and goods.
  - Addressing the Olympic Airlines problem – an Establishment exists if it existed in the three months prior to the request to open main proceedings.
  - Limited to assets in that member state.
  - Governed by local law.

EIR (cont'd)

- Territorial Proceedings:
  - Before main proceedings have been opened; must be converted to winding-up proceedings once main proceedings opened.
  - Requires an Establishment.
  - Objective factors preventing main proceedings from being opened.

    OR
  - Territorial proceedings are requested by a creditor who is domiciled or has a registered office in that member state or whose claim arises from the operation of the debtor's establishment in that member state.

EIR (cont'd)

- Finding COMI:
  - Debtor's registered office does not need to be in a member state (BRAC Rent-A-Car).
  - Objective factors ascertainable by third parties needed to rebut the registered office presumption.
  - Some relevant factors include:
    - location of management / board meetings;
    - location of bank accounts, employees and assets;
    - governing law and exclusive jurisdiction clauses in principal agreements etc.

EIR (cont'd)

- Does it apply to the restructurings most commonly seen in U.S. (schemes of arrangement)?
  - No, as the regulation in its original form and in its updated form does not apply to schemes of arrangement.

EIR (cont'd)

- Post-Brexit, will the EIR apply to the UK?
  - No, however, the UK may unilaterally adopt the Recast EU Regulation into domestic law without the benefit of reciprocity (this is reflected in the draft Withdrawal Bill).
- If not, how will UK proceedings obtain assistance in the EU?
  - The UNCITRAL Model Law/Cross Border Insolvency Regulations will apply post-Brexit for private international law for outgoing applications for recognition and assistance. However, the Model Law is not very comprehensive and the only EU member states which have adopted the Model Law are Poland, Greece, Slovenia and Romania.
  - With regards to other EU member states, English insolvency proceedings will be recognised according to each member state's domestic rules on private international law.
  - Since the UK Supreme Court's decision in Rubin, the CBIRs cannot be relied upon to enforce foreign judgments *in personam.*

EIR (cont'd)

- How will EU-based proceedings obtain assistance in the UK?
  - The UK may unilaterally adopt the Recast EU Regulation into domestic law without the benefit of reciprocity (this is reflected in the draft Withdrawal Bill).
  - The UK will continue to recognise main and non-main insolvency proceedings within the EU (based on the concept of Centre of Main Interests) under the Cross Border Insolvency Regulations 2006 (the UK's adoption of the UNCITRAL Model Law). However, the UNCITRAL Model Law is not as comprehensive as the Recast EU Regulation and not all EU member states have adopted the UNCITRAL Model Law.

CBIR

- **What are the CBIR and can U.S. proceedings use them to obtain assistance in the UK?**
  - The CBIR are the Cross Border Insolvency Regulations (UNCITRAL Model Law), a legislative framework that deals with the recognition of foreign insolvency and the coordination of proceedings.
  - A foreign representative, such as the US, administering foreign insolvency proceedings may apply to the UK Courts for recognition of those proceedings.
  - Where there is a conflict between the Regulations and the EC Regulation, the latter prevails.
  - Foreign proceedings must be collective proceedings pursuant to an insolvency law and subject to the supervision and control of a foreign court.
  - Foreign Main Proceedings →Automatic Stay (Article 20):
    - Non-main proceedings → Discretionary relief (Article 21).
    - No power to apply foreign law.
    - Safeguards.

CBIR – Brexit impact?

- The UK will continue to recognise main and non-main insolvency proceedings within the EU (based on the concept of Centre of Main Interests) under the CBIR.
- However the CBIR (Model Law) is not as comprehensive as the Recast EIR on its predecessor.
- To date the only EU members to have adopted it are Poland, Greece, Slovenia and Romania.
- Doesn't require reciprocal adoption so EU and non EU parties coming to the UK with benefit from the UK's adoption.
- UK office holders will be recognised (or not) according to the domestic rules on private international Law applicable in the relevant country.
- Post Rubin, the CBIR cannot be relied on to enforce judgements in personam.

Conclusions

- The US position post Brexit:
  - Common Law alive and well, reliable and tested even if its wings have been clipped a bit.
  - CBIR relief available.
  - A long history of co-operation and assistance stretching on before the EIR and CBIR.
  - EIR and COMI: Debtors registered office does not need to be in a member state (BRAC Rent-A-Car)
- THE UK office holders position post Brexit:
  - We can only speculate at this point but certainty until the Transaction Period ends.
  - UK-US position tried and tested.
  - Impact on UK's popularity as a jurisdiction post Brexit?
  - Easier for overseas trustees coming here than for our officeholders seeking recognition and assistance abroad?

Disclaimer

This presentation is intended to highlight potential issues and provide general information and not to provide legal advice. You should not take, or refrain from taking, action based on its content. If you have any questions, please contact your main contact partner at the relevant CMS member firm.

Patricia Godfrey

E: patricia.godfrey@cms-cmno.com

D: 020 7524 6444

M: 07879 602887

CMS Firm

ARTICLES

MISALIGNMENT: CORPORATE RISK-TAKING AND PUBLIC DUTY

*Steven L. Schwarcz**

* Stanley A. Star Professor of Law & Business, Duke University School of Law; Founding Director, Duke Global Financial Markets Center; Senior Fellow, the Centre for International Governance Innovation. E-mail: schwarcz@law.duke.edu. For valuable comments, I thank Emilios Avgouleas, John de Figueiredo, Deborah DeMott, Lisa M. Fairfax, Jesse D. Gossett, Matthias Haentjens, John Hasnas, Edward Kane, Ian B. Lee, Robert T. Miller, Marc T. Moore, Peter O. Muelbert, Zhong Xing Tan, Gabe Shawn Varges, Charles Whitehead, and participants in the 2015 Distinguished Public Lecture in Corporate Governance at the University of Florence, in the 2016 Financial Regulation Roundtable at Columbia University, and in faculty workshops at the University of Iowa College of Law, the University of Zurich Institute of Law (co-sponsored by the University of Zurich Centre for Financial Regulation), and (jointly via virtual connection) Duke University School of Law and Shanghai University of International Business and Economics (SUIBE) School of Law. I also thank Brittany LaFleur, Tashi Sun, and Ruiyao Sun for invaluable research assistance. Support is provided in part by a Fuller-Purdue grant.

ABSTRACT

This Article argues for a "public governance duty" to help manage excessive risk-taking by systemically important firms. Although governments worldwide, including the United States, have issued an array of regulations to attempt to curb that risk-taking by aligning managerial and investor interests, those regulations implicitly assume that investors would oppose excessively risky business ventures. That leaves a critical misalignment: because much of the harm from a systemically important firm's failure would be externalized onto the public, including ordinary citizens impacted by an economic collapse, such a firm can engage in risk-taking ventures with positive expected value to its investors but negative expected value to the public. The Article analyzes why corporate governance law should, and shows how it feasibly could, take the public interest into account.

INTRODUCTION

Should corporate governance law take into account risk-taking that could systemically harm the public? Corporate risk-taking is certainly economically necessary and often desirable.[1] Successful risk-taking increases

1 *Cf.* Gabriel Jiménez et al., *How Does Competition Impact Bank Risk-Taking?* (Fed. Reserve Bank of S.F. Working Paper Series No. 2007-23, 2007), http://www.frbsf.org/eco-

profitability, thereby enhancing welfare by generating jobs and purchasing power.[2] But corporate risk-taking can sometimes cause harm. There is widespread agreement that excessive corporate risk-taking was one of the primary causes of the systemic economic collapse that became the 2008–2009 global financial crisis (the "financial crisis").[3] There is also a consensus that existing regulatory measures to curb that risk-taking and prevent another crisis are inadequate.[4]

Many of the regulatory responses to the financial crisis, both in the United States and abroad, seek to mitigate excessive risk-taking by systemically important financial firms.[5] Various of those responses are designed to control that risk-taking by aligning managerial and investor interests to reduce agency costs and make managers less likely to engage their firms in risky business ventures that could jeopardize investors. These responses

---

nomic-research/publications/working-papers/2007/wp07-23bk.pdf (arguing that increasing competition among banks increases the need to engage in risk-taking in order to maintain profitability).

2 *See, e.g.*, David Rosenberg, *Supplying the Adverb: The Future of Corporate Risk-Taking and the Business Judgment Rule*, 6 BERKELEY BUS. L.J. 216, 221–22 (2009) (observing that students of American law and economic history agree that much of the nation's technological progress and economic growth can be partly attributed to bold corporate risk-taking).

3 *See, e.g.*, FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES, xviii–xix (2011), http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf (identifying excessive risk-taking as a primary cause of the financial crisis); Jacob J. Lew, Opinion, *Let's Leave Wall Street's Risky Practices in the Past*, WASH. POST (Jan. 9, 2015), https://www.washingtonpost.com/opinions/jacob-lew-lets-leave-wall-streets-risky-practices-in-the-past/2015/01/09/cf25b5f6-95d8-11e4-aabd-d0b93ff613d5_story.html?utm_term=.d1eddb5d0774 (explaining that U.S. Treasury Secretary Lew repeatedly attributes the financial crisis to "excessive risks taken by financial" firms); *The Origins of the Financial Crisis: Crash Course*, ECONOMIST (Sept. 7, 2013), http://www.economist.com/news/schoolsbrief/21584534-effects-financial-crisis-are-still-being-felt-five-years-article (identifying excessive risk-taking as one of three causes of the financial crisis, the other causes being irresponsible lending and regulators being asleep at the wheels).

4 *See, e.g.*, Binyamin Appelbaum, *Skepticism Prevails on Preventing Crisis*, N.Y. TIMES, Oct. 5, 2015, at B1 (observing the "troubling reality highlighted at a conference . . . at the Federal Reserve Bank of Boston" that "policy makers have made little progress in figuring out how they might actually" prevent another financial crisis). Donald Kohn, former Vice Chairman of the United States Federal Reserve Board, observed at the conference that the Federal Reserve "doesn't really have the tools" to prevent another crisis. *Id.* at B3. Luc Laeven, European Central Bank Director General for Research, summarized the consensus reached at the conference: "Both monetary policy and macroprudential [regulatory] policy are not really very effective." *Id.* He then asked, "Do we have other policies?" *Id.* This Article seeks to provide an answer.

5 *Cf. infra* Part I (discussing regulatory responses to mitigate excessive corporate risk-taking by systemically important firms). This Article's references to systemically important firms, systemically important financial firms, and systemically important financial institutions all mean financial firms that are systemically important. Very large and highly interconnected non-financial firms that might be systemically important are beyond the Article's scope.

implicitly assume that the investors themselves would oppose excessively risky business ventures.

That assumption, however, is flawed, and therefore financial regulation based on the assumption's validity is unreliable. The assumption is flawed because what constitutes "excessive" risk-taking depends on the observer. Risk-taking is excessive from a given observer's standpoint if it has a negative expected value to that observer (i.e., the expected costs to that observer exceed the expected benefits). Thus, it is reasonable to assume that investors would oppose risky business ventures that have a negative expected value to them. The problem, however, is that systemically important firms—the primary focus of post-financial crisis regulation, and also the focus of this Article—can engage in risk-taking ventures that have a positive expected value to their investors but a negative expected value to the public. That is because much of the systemic harm from such a firm's failure would be externalized[6] onto other market participants as well as onto the public, including ordinary citizens impacted by an economic collapse.[7]

This misalignment occurs because corporate governance law requires managers of a firm—by which this Article means the most senior managers who have ultimate responsibility to manage the firm, such as a corporation's directors—to view the consequences of their firm's actions, and thus to view the expected value of corporate risk-taking, only from the standpoint of the firm and its investors.[8] That perspective ignores externalities[9] caused by the

6 This could be described as a type of "tragedy of the commons," insofar as market participants suffer from the actions of other market participants. But it also is a more standard externality insofar as non-market participants (i.e., the ordinary citizens impacted by an economic collapse) suffer from the actions of market participants; *cf.* Sean J. Griffith, *Governing Systemic Risk: Towards a Governance Structure for Derivatives Clearinghouses*, 61 EMORY L.J. 1153, 1156, 1210 (2012) (describing a similar misalignment as a free-rider and moral hazard problem).

7 Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 206 (2008); *see also* John Crawford, *The Moral Hazard Paradox of Financial Safety Nets*, 25 CORNELL J.L. & PUB. POL'Y 95, 138 (2015) (observing that "financial firms . . . are under-incentivized to insure at the optimal level, given the fact that the potential systemic costs of their *own* failure would be borne primarily by others"). The collapse of Lehman Brothers illustrates this. Lehman Brothers had engaged in highly profitable, but also high-risk and high-leverage, business strategies. The financial stresses caused by "defaults in the subprime mortgage and commercial real estate markets" then caused Lehman Brothers to default, roiling financial markets and threatening the entire U.S. economy with collapse. Edward J. Estrada, *The Immediate and Lasting Impacts of the 2008 Economic Collapse—Lehman Brothers, General Motors, and the Secured Credit Markets*, 45 U. RICH. L. REV. 1111, 1115–18 (2011).

8 *See, e.g.*, RICHARD A. BREALEY ET AL., PRINCIPLES OF CORPORATE FINANCE 9–10 (10th ed. 2011); *cf.* BD. OF GOVERNORS OF THE FED. RESERVE SYS., CALIBRATING THE GSIB SURCHARGE 1 (2015) [hereinafter BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM], https://www.federalreserve.gov/aboutthefed/boardmeetings/gsib-methodology-paper-20150720.pdf (observing that systemically important financial institutions "themselves lack sufficient incentives to take precautions against their own failures"). In some jurisdictions, however, managers may also be allowed or required to take into account other interests, such as those of employees, suppliers, customers, creditors, and communities, *see infra* note

actions. In general, that makes sense because myriad externalities result from corporate risk-taking;[10] it would not be feasible to take all those externalities into account. Even the Federal Reserve's regulations requiring systemically important financial firms to establish risk committees direct those committees to consider risks to the firm, not to the public.[11] But risk-taking that causes the failure of a systemically important firm could trigger a domino-like collapse of other firms or markets, causing systemic externalities that damage the economy and harm the public.[12] This Article argues that corporate governance law should, and feasibly could, take into account risk-taking that causes systemic externalities.

The Article proceeds as follows. Part I examines the "macroprudential" regulatory responses to the financial crisis—that is, regulatory responses intended to protect against "systemic" risk to the integrity of the financial system[13]—that purport to mitigate excessive corporate risk-taking by systemically important firms.[14] To the extent these responses attempt to mitigate that risk-taking by aligning interests, they seek to align managerial and investor interests (collectively, the "firm's interests"). That leaves a critical misalignment: even if those interests could be perfectly aligned, that would be insufficient to control excessive risk-taking that causes systemic externalities. Part I also shows that the regulatory responses to the financial crisis that profess to mitigate excessive corporate risk-taking in other ways (i.e., without aligning managerial and investor interests) are also inadequate to prevent systemic externalities.

Part II examines and compares possible regulatory redesign options to help align the firm's interests with the public's interests, in order to control excessive risk-taking that causes systemic externalities. Although financial regulation traditionally focuses on regulating substance, such as imposing capital-adequacy standards, this Part argues that these redesign options should additionally focus on reforming a firm's governance.

Part III analyzes how a firm's governance should be reformed to reduce systemic externalities. To that end, it first shows how imposing a public governance duty to help align the firm's interests with the public's interests would fit within corporate governance legal theory. Thereafter, it shows how such a duty could be feasibly and efficiently implemented. Finally, the

---

160 and accompanying text (discussing the Pennsylvania constituency statute), and "the entire national economy," *see infra* note 158 (discussing legislation in Iceland).

9 I am talking, of course, about non-investor externalities; *cf.* Griffith, *supra* note 6, at 1210 (in the context of derivatives transactions, observing that "[b]ecause no private party can enjoy the full benefit of eliminating systemic risk, no private party has an incentive to fully internalize the cost of doing so").

10 *See infra* notes 84–85 and accompanying text.

11 *See infra* notes 168–70 and accompanying text.

12 Schwarcz, *supra* note 7, at 198.

13 *Id.* (defining systemic risk).

14 *Cf. supra* text accompanying notes 5–13; *infra* notes 15–68 (discussing why such risk-taking occurs).

Appendix to the Article proposes possible model language, in the form of a Public Governance Duty Act, for regulation imposing the duty.

I. The Regulatory Misalignment

Various types of macroprudential regulatory responses to the financial crisis purport to mitigate excessive corporate risk-taking by systemically important firms.[15] Certain of these responses attempt to mitigate that risk-taking by aligning managerial and investor interests. Thus, requiring a systemically important firm to tie management compensation to the firm's long-term performance is intended to better align managerial and investor interests by penalizing managers who engage such firms in risky ventures that, notwithstanding short-term appeal, ultimately jeopardize investors.[16] Requiring a systemically important firm to maintain so-called contingent capital, in which debt securities convert into equity securities upon specified conditions, is designed to motivate holders of those convertible debt securities to better monitor and impose covenants against excessive risk-taking, since they more clearly bear the risk of the firm failing.[17] As shown below, however, these types of responses are insufficient: even if managerial and investor interests to engage in risk-taking could be perfectly aligned, that would be insufficient to control risk-taking that causes systemic externalities.

Other types of regulatory responses that are currently used to control excessive corporate risk-taking by systemically important firms do not profess to align managerial and investor interests. Because there is no formal categorization of macroprudential regulatory responses,[18] there is no formal categorization of this subset of responses. For discussion purposes, this Article

15 Recall that macroprudential regulation focuses on the integrity of the financial system, as a system, in contrast to microprudential regulation, which focuses on the safety and soundness of individual firms. *See supra* note 13 and accompanying text. These forms of regulation have an indirect overlap: reducing the likelihood that individual firms will fail can help to partially reduce systemic risk by making it less likely that individual systemically important firms will fail. Microprudential regulation does not, however, generally address correlations among failing firms, nor does it address how to protect the financial system as a system. Rizwaan Jameel Mokal argues that trying to make the financial system stable by making it less likely that individual systemically important firms will fail can actually increase financial instability. Rizwaan Jameel Mokal, *Liquidity, Systemic Risk, and the Bankruptcy Treatment of Financial Contracts*, 10 BROOK. J. CORP. FIN. & COM. L. 15, 20 (2015).

16 *See infra* Section I.A.

17 *See infra* Section I.B. These convertible debt securities are sometimes called contingent convertible securities, or "CoCos." *See, e.g.*, John Glover & Tom Beardsworth, *Contingent Convertibles*, BLOOMBERG VIEW (July 29, 2016), http://www.bloombergview.com/quicktake/contingent-convertible-bonds.

18 Policymakers and regulators tend to view macroprudential regulation as a loose assortment of "tools" in their toolkit. *See, e.g.*, Robert Hockett, Implementing Macroprudential Finance-Oversight Policy: Legal Considerations 12–13 (Jan. 20, 2013) (unpublished manuscript) (on file with author) (discussing the "emergent macroprudential toolkit as currently constituted"). Even the theoretical scholarship on macroprudential regulation takes a somewhat similar ad hoc approach, yielding "propositions [that] can serve as a tool kit" for regulatory scrutiny. Daniel Awrey, Colleen Baker & Katharina Pistor,

categorizes these responses along functional lines: regulation attempting to limit the so-called too-big-to-fail (TBTF) problem,[19] regulation implementing the so-called Volcker Rule,[20] and regulation imposing capital and other types of firm-specific financial requirements.[21] Some of these categories overlap.[22] However one categorizes these responses, however, the analysis below shows—and policymakers agree[23]—that they too are inadequate to control risk-taking that causes systemic externalities.

A. *Compensation*

One approach to control excessive corporate risk-taking is to better align managerial compensation with investor interests. To this end, commentators, legislators, and regulators have proposed aligning the long-term compensation of senior and secondary managers of systemically important firms with the interests of those firms' investors.[24] The U.S. Securities and Exchange Commission (SEC), for example, is authorized to enforce the recovery of bonuses paid to chief executive officers and chief financial officers of public companies that issue financial restatements due to material noncompliance "with any financial reporting requirement under the securities laws" resulting from misconduct.[25] The SEC also requires all firms whose compensation policies create risks that are "reasonably likely to have a material adverse effect" on the firm to disclose, in the form of a "narrative discourse," how those compensation policies relate to risk management and risk-taking incentives.[26]

An Overview of the Legal Theory of Finance 2 (2014) (unpublished manuscript) (on file with author).

19 *See infra* Section I.C.

20 *See infra* Section I.D.

21 *See infra* Section I.E.

22 For example, regulation imposing capital and other types of firm-specific financial requirements can overlap with TBTF regulation because both can make it less likely that a TBTF firm will fail.

23 *See* Appelbaum, *supra* note 4.

24 For a comparison of senior and secondary manager compensation, including an argument that the latter is at least as important as the former, see Steven L. Schwarcz, *Conflicts and Financial Collapse: The Problem of Secondary-Management Agency Costs*, 26 YALE J. ON REG. 457 (2009).

25 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 951–56, 971, 972, 124 Stat. 1376, 1899–906, 1915 (2010) (codified at 15 U.S.C. § 78n-1 (2012)) (adding §§ 14A, 10C, 14(i), 10D, 14(j), 14(a)(1), and 14B to the Securities Exchange Act of 1934, Pub. L. No. 111-203, 124 Stat. 1899, which extended the federal government's regulatory reach into a company's internal governance and compensation practices even further); Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 304, 116 Stat. 745, 778 (2002) (codified at 15 U.S.C. § 7243 (2012)).

26 Lisa M. Fairfax, *Government Governance and the Need to Reconcile Government Regulation with Board Fiduciary Duties*, 95 MINN. L. REV. 1692, 1704 (2011) (quoting Proxy Disclosure Enhancements, 74 Fed. Reg. 68,334 (Dec. 23, 2009) (codified at 17 C.F.R. pts. 229, 239, 240, 249, 274)).

Even greater restrictions were placed on firms receiving bailout moneys in connection with the financial crisis. For example, these firms had ceilings imposed on the compensation payable to the five highest-earning executives, in order to eliminate incentives to take "unnecessary and excessive risks that threaten the value of such" a firm.[27] These firms also were required to have an independent "Board Compensation Committee," which would meet "to discuss and evaluate employee compensation plans in light of an assessment of any risk posed to [such a firm] from such plans."[28] Additionally, they were required to recover any form of "incentive compensation paid to a senior executive officer and any of the next 20 most highly-compensated employees" if the financial statements or other criteria on which the compensation was based later is found to be "materially inaccurate."[29] The Dodd-Frank Act extends certain of these requirements to firms that are required to file periodic reports to the SEC.[30] It also requires firms to implement shareholder advisory voting on executive compensation, commonly known as "say-on-pay."[31]

Nonetheless, a misalignment remains because these compensation requirements focus exclusively on the effect of risk-taking on the firm and its investors. None of these requirements takes into account the potential for risk-taking to create systemic externalities.[32] These requirements therefore will be insufficient to control that risk-taking.[33]

---

27 American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115, 517 (adding § 111(b)(3)(A) to the Emergency Economic Stabilization Act of 2008, Pub. L. 110-343, 122 Stat. 3765 (codified as amended in scattered sections of 12 U.S.C. (2012))); *see also id.* (amending § 111 of the Emergency Economic Stabilization Act of 2008 to include § 111(b)(3)(A)) (preventing the executives with the top five highest salaries of any TARP company from receiving compensation incentivizing them to take "unnecessary and excessive risks that threaten the value" of the firm).

28 American Recovery and Reinvestment Act § 7001 (adding § 111(b)(4) to the Emergency Economic Stabilization Act).

29 *Id.* (adding § 111(b)(3)(B) to the Emergency Economic Stabilization Act).

30 *See, e.g.*, Dodd-Frank Act § 954 (requiring senior managers to return any compensation they received in the past three years based on erroneous financial reports submitted to the SEC).

31 *Id.* § 951; Press Release, U.S. Sec. & Exch. Comm'n, SEC Adopts Rules for Say-on-Pay and Golden Parachute Compensation as Required Under Dodd-Frank Act (Jan. 25, 2011), https://www.sec.gov/news/press/2011/2011-25.htm.

32 *Cf.* PETER F. DRUCKER, THE NEW SOCIETY: THE ANATOMY OF INDUSTRIAL ORDER 340–43 (1950) (arguing that board alignment with shareholder interests would weaken the desirable capacity of managers to manage in the public interest); Jesse D. Gossett, Note, *Financial Institution Executive Compensation: The Problem of Financially Motivated Excessive Risk-Taking, the Regulatory Response, and Common Sense Solutions*, 14 U.C. DAVIS BUS. L.J. 51, 63 (2013) (observing that the compensation provisions of the Dodd-Frank Act and the Sarbanes-Oxley Act "will do nothing to actually reduce the level of systemic risk at financial institutions which means [such provisions] will be largely ineffective at holding off the next financial crisis").

33 Professors Bebchuk and Spamann have partly recognized that insufficiency, arguing that compensation of a bank's "top executives" should be tied not only to common stock value but also to preferred share and bond value in order to better protect the government

B. Contingent Capital

Contingent capital regulation assumes that a firm's creditors—who would not benefit from the firm's increased profitability but could be harmed by its failure—should be good monitors against excessive risk-taking if they more clearly bear the risk of the firm failing. To assign more of that risk to creditors, such regulation requires certain debt claims to convert to equity upon specified (deteriorating) financial conditions.[34] To reduce the chance those conditions will occur, creditors impose even stricter loan covenants on their debtor-firms.[35] That aligns managerial and investor interests by contractually restricting risk-taking.

Contingent capital regulation is unlikely to be sufficient to control risk-taking that causes systemic externalities. Admittedly, it might indirectly and partially reduce systemic risk by reducing the likelihood that any given firm will fail.[36] As a practical matter, however, the firm and its shareholders will want the firm to be able to engage in risk-taking in order to make profits.[37] Firms customarily offer creditors higher interest rates to compensate for allowing looser covenants,[38] and experience shows that creditors often "go for the gold," choosing the higher rates over stronger covenants.[39] If private and public interests were perfectly aligned, the pricing theoretically should offset the risks. But in negotiating loan covenants, creditors have no incen-

as a guarantor of bank deposits. Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 254 (2010). In that context, they examine "corporate governance measures aiming to align management with shareholders" and conclude, as do I, that such measures will not fix the insufficiency and might even make it worse. *Id.* at 274–75. Unlike my Article, however, they do not consider how corporate governance measures might be reformed to help align management with societal interests.

34 Debt securities that are required to convert to equity securities upon certain conditions, such as the debtor-firm's equity capital falling below a pre-set minimum, are often called contingent convertible securities or, more simply, "CoCos." *See supra* note 17. Contingent capital regulation also serves to convert debt claims of a troubled firm into equity interests, thereby reducing the likelihood that the firm will default. *See infra* note 62.

35 *Cf.* Simone M. Sepe, *Corporate Agency Problems and Dequity Contracts*, 36 J. CORP. L. 113, 127 (2010) (footnote omitted) (observing that "although the law grants creditors no special rights against managers, creditors can acquire substantial control powers over corporate operations by bargaining for both positive and negative covenants").

36 *See supra* note 15.

37 As discussed, corporate risk-taking is economically necessary and desirable. *See supra* note 2 and accompanying text. *But cf.* John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 J. LEGAL ANALYSIS 35, 54 (2014) (arguing that because systemic risks cannot be avoided by investment diversification, shareholders can be indirectly harmed by excessive risk-taking that triggers a systemic collapse).

38 *See, e.g.*, Steven L. Schwarcz, *Rethinking a Corporation's Obligations to Creditors*, 17 CARDOZO L. REV. 647, 651 n.12 (1996).

39 Larry Light, *Bondholder Beware: Value Subject to Change Without Notice*, BLOOMBERG (Mar. 29, 1993), http://www.bloomberg.com/bw/stories/1993-03-28/bondholder-beware-value-subject-to-change-without-notice ("Bondholders can—and will—fuss all they like. But the reality is, their options are limited: Higher returns or better protection [in the form of stronger covenants]. Most investors will continue to go for the gold.").

tive to control systemic externalities. They therefore will not price in the systemic consequences of risk-taking.[40]

Also, contingent capital regulation could have unintended consequences. Because it is riskier, debt issued as contingent capital would be more expensive than non-convertible debt.[41] Capitalizing a systemically important firm with lots of contingent capital, in order to make the firm less likely to fail, might also motivate the firm's managers to take even greater corporate risks.[42]

The foregoing discussion has focused on controlling excessive corporate risk-taking by aligning managerial and investor interests, showing that existing regulatory responses are insufficient to prevent systemic externalities. This Article next examines whether regulatory responses that profess to control excessive corporate risk-taking in other ways could prevent systemic externalities.

C. *Too Big to Fail*

Another type of regulatory response to control excessive corporate risk-taking focuses on the "Too Big to Fail" problem: that systemically important firms might engage in excessive risk-taking because they would profit by a success and be bailed out by the government in case of a failure. This is a problem of moral hazard, that persons protected from the negative consequences of their risky actions will be more tempted to take risks.[43]

TBTF regulation seeks to reduce that moral hazard by limiting the government's authority to provide bailouts. In the United States, for example, it restricts the Federal Reserve's authority to act as a lender of last resort to a failing financial institution.[44]

---

40 Nor are creditor-imposed loan covenants likely to protect the financial system, as a system. *Cf.* Iman Anabtawi & Steven L. Schwarcz, *Regulating* Ex Post: *How Law Can Address the Inevitability of Financial Failure*, 92 TEX. L. REV. 75, 87 (2013) (examining how macroprudential regulation should help to protect the financial system, as a system).

41 *See, e.g.*, Eric S. Halperin, *CoCo Rising: Can the Emergence of Novel Hybrid Securities Protect from Future Liquidity Crises?*, 8 INT'L L. & MGMT. REV. 15, 21–24 (2011) (explaining why issuing CoCos to investors may be more expensive than issuing ordinary debt).

42 *Cf.* George Pennacchi, *A Structural Model of Contingent Bank Capital* 30 (Fed. Reserve Bank of Cleveland, Working Paper No. 10-04, 2011), https://business.illinois.edu/gpennacc/ConCap030211.pdf (observing that a "bank that issues contingent capital faces a moral hazard incentive to increase its assets' jump risks"). Another possible unintended consequence of contingent capital is that "by requiring banks to issue more debt, it might prompt some to reduce their ratios of equity to assets. This added leverage will leave the system more susceptible to distress in bad times." Editorial, *A Bad Way to Make Banks Safe*, BLOOMBERG VIEW (Nov. 9, 2015), https://www.bloomberg.com/view/articles/2015-11-09/a-bad-way-to-make-banks-safe.

43 *See, e.g.*, GARY H. STERN & RON J. FELDMAN, TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS (2004).

44 The Dodd-Frank Act limits the authority of the Federal Reserve to make emergency loans under § 13(3) of the Federal Reserve Act. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1101(a)(6), 124 Stat. 2113, (2010) (codified

This aspect of TBTF regulation is unlikely to be sufficient to control excessive risk-taking, and it might even increase systemic externalities. It is unlikely to be sufficient to control excessive risk-taking because the misalignment discussed in this Article results from externalized harm, not from reliance on a bailout.[45] And it might inadvertently increase systemic externalities by preventing the government from bailing out a failing systemically important firm.[46]

TBTF regulation also focuses on making systemically important firms less likely to need a government bailout if they suffer devastating losses—whether or not those losses are caused by excessive risk-taking.[47] The Dodd-Frank Act, for example, requires systemically important firms to file so-called living wills, setting forth how they could liquidate with minimal systemic impact.[48] Because this focus of TBTF regulation does not purport to control excessive corporate risk-taking, it is not central to this Article's analysis.[49]

---

at 12 U.S.C. § 343 (2012)). Dodd-Frank amended that subsection to require the Federal Reserve to consult with and receive approval from the Secretary of the Treasury to ensure that any emergency lending is designed to provide liquidity to the markets and not to aid a financially failing firm. *Id.*

45 *See supra* notes 7–12 and accompanying text.

46 *See, e.g.*, Iman Anabtawi & Steven L. Schwarcz, *Regulating Systemic Risk: Towards an Analytical Framework*, 86 NOTRE DAME L. REV. 1349, 1376 (2011); John C. Coffee, Jr., *Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight*, 111 COLUM. L. REV. 795, 825 (2011) (observing that the Dodd-Frank Act prevents federal government lender-of-last-resort assistance to nonbank financial firms that are solvent but illiquid, thereby forcing "some firms into an arguably unnecessary liquidation").

47 Yet another focus of TBTF regulation is on reducing the TBTF nature of systemically important firms, such as Senator Elizabeth Warren's proposal to break up large banks. *See* Joseph Lawler, *Warren Introduces Glass-Steagall Bill to Break Up Big Banks*, WASH. EXAMINER (July 7, 2015), http://www.washingtonexaminer.com/warren-introduces-glass-steagall-bill-to-break-up-big-banks/article/2567757.

48 *See, e.g.*, Jennifer Meyerowitz & Joseph N. Wharton, *A Dodd-Frank Living Wills Primer: What You Need to Know Now*, 31 AM. BANKR. INST. J. 34, 34 (2012) ("As part of the goal to remove the risks to the financial system posed by 'too big to fail' institutions, § 165(d) of the Dodd-Frank Act requires 'systemically important financial institutions' to create 'living wills' to facilitate 'rapid and orderly resolution, in the event of material financial distress or failure.'" (quoting Dodd-Frank Act § 165(d), 124 Stat. at 1405 (codified at 12 U.S.C. § 5325 (2012)))).

49 The living-will requirement is unlikely, in any event, to eliminate systemic externalities caused by the failure of a TBTF firm. In my years as a workout and bankruptcy lawyer, I rarely saw a firm's failure that accurately reflected, much less closely resembled, expectations about the firm when it was profitable. Furthermore, living wills do not prevent the concurrent failure of multiple otherwise-TBTF firms from, collectively, having a systemic impact. *Cf.* Victoria McGrane, *FDIC Chief: Big Failure Won't Harm the System*, WALL ST. J., May 12, 2015, at C1 (observing that some in Congress "doubt regulators could handle the failure of multiple major firms at the same time"). The financial crisis demonstrated that a concurrence of failures is likely when the causes of the failures are interconnected, such as an industry-wide overreliance on credit ratings. *See* Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 379–83, 404–05 (2008); *cf.* Janet L. Yellen, Vice Chair of Bd. of Governors of the Fed. Reserve Sys., Remarks at the Annual Meeting of the National Association for Business Economics: Macropruden-

D. *Volcker Rule*

In response to the financial crisis, former Federal Reserve Chairman Paul Volcker proposed that because bank deposits are federally guaranteed, deposit-taking banks should be restricted from making risky investments.[50] This proposal became known as the "Volcker Rule."[51] The substance of the Volcker Rule was implemented by the Dodd-Frank Act, which prohibits banks from (1) "engag[ing] in proprietary trading"[52] or (2) "acquir[ing] or retain[ing] any equity, partnership, or other ownership interest in or sponsor[ing] a hedge fund or a private equity fund."[53]

The Volcker Rule is also insufficient to control risk-taking that causes systemic externalities. Besides the Rule's limited application (to specific investments by banks), its regulatory rationale is microprudential, protecting the safety and soundness of individual firms. As with any other type of microprudential regulation, the Volcker Rule indirectly and partially reduces systemic risk by reducing the likelihood that an individual bank covered by the rule will fail; but it does not address correlations among failing firms, nor

---

tial Supervision and Monetary Policy in the Post-Crisis World 3 (Oct. 11, 2010) (transcript available at 2010 WL 3952044 (F.R.B.)) (attributing the financial crisis to concurrences of interrelated failures).

50 Paul Volcker, Op-Ed., *How to Reform Our Financial System*, N.Y. TIMES (Jan. 30, 2010), http://www.nytimes.com/2010/01/31/opinion/31volcker.html?pagewanted=all.

51 David Cho & Binyamin Appelbaum, *Obama's 'Volcker Rule' Shifts Power away from Geithner*, WASH. POST (Jan. 22, 2010), http://www.washingtonpost.com/wp-dyn/content/article/2010/01/21/AR2010012104935.html.

52 12 U.S.C. § 1851(a)(1)(A). "Proprietary trading" is defined as

> engaging as a principal for the trading account of the banking entity or [relevant] nonbank financial company . . . in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission . . . determine [by rule].

Id. § 1851(h)(4). Reference to a "trading account" is intended to primarily cover short-term trades, though federal regulators could expand that coverage. *See id.* § 1851(h)(6) (defining a trading account as "any account used for acquiring or taking positions in the securities and instruments [described in the definition of proprietary trading] principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements), and any such other accounts as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission . . . determine [by rule]").

53 *Id.* § 1851(a)(1)(B). Notwithstanding these restrictions, trading is permitted "in connection with underwriting or market-making-related activities," to the extent that either does not "exceed the . . . near term demands of clients, customers, or counterparties"; "on behalf of customers"; or by an insurance business "for the general account of the [insurance] company." *See id.* §§ 1851(d)(1)(B), (D), (F).

does it address the reasons why firms may want to engage in excessive risk-taking or how to protect the financial system as a system.[54]

E. Firm-Specific Financial Requirements

In theory, firm-specific financial requirements, such as capital and solvency requirements, could help to control excessive corporate risk-taking by systemically important firms.[55] For example, some of the largest systemically important firms are believed to have a funding advantage, "deriv[ing] from the belief of some creditors that the government might act to prevent [such a firm] from defaulting on its debts."[56] That funding advantage "creates an incentive for [those firms] to take on even more leverage and make themselves even more systemic (in order to increase the value of the [funding advantage] subsidy)."[57] Imposing a financial surcharge on those systemically important firms could, if calibrated correctly, "offset [that] subsidy and thereby cancel out these undesirable effects."[58]

In practice, however, governments have not been using firm-specific financial requirements to control excessive corporate risk-taking because that "would require more precision . . . than is now attainable."[59] Instead, firm-specific financial requirements are being imposed to try to make systemically important firms more internally robust, so (as is the goal of TBTF regulation[60]) they will be less likely to need a government bailout if they suffer

54 *See supra* note 15; *see also* Crawford, *supra* note 7, at 116 ("While prudential oversight is extremely important for addressing bank-like risks, it has never been enough on its own to prevent panics."). The Volcker Rule may also be counterproductive. Moody's has warned, for example, that it might "diminish the flexibility and profitability of banks' valuable market-making operations and place them at a competitive disadvantage to firms not constrained by the rule." Edward Wyatt, *Regulators to Set Forth Volcker Rule*, N.Y. TIMES (Oct. 10, 2011), http://www.nytimes.com/2011/10/11/business/volcker-rule-to-take-shape-this-week.html; *see also* George W. Madison et al., *Reconsidering Three Dodd-Frank Initiatives: The Volcker Rule, Limitations on Federal Reserve Section 13(3) Lending Powers, and SIFI Thresholds*, 34 BANKING & FIN. SERVS. POL'Y REP., no. 6, 2015, at 6–7 (arguing that the Volcker Rule will not mitigate systemic risk because its effect will be to move trading activity from banks, which are subject to capital and liquidity requirements, to other market participants that are not subject to the same prudential regulation; and that restricting banks from engaging in proprietary trading may actually aggravate liquidity problems). The ultimate value of the Volcker Rule will be an empirical question: whether the benefits of its limitation on proprietary trading will outweigh profits lost by losing the ability to engage in such trading.

55 *But cf.* E.J. Kane, *Hair of the Dog That Bit Us: The Insufficiency of New and Improved Capital Requirements*, *in* THE FIRST GREAT FINANCIAL CRISIS OF THE 21ST CENTURY: A RETROSPECTIVE 377, 377 (James R. Barth & George G. Kaufman eds., 2016) (arguing that forcing systemically important financial institutions (SIFIs) to show more accounting capital will do little to curb their enhanced appetite for risk-taking that could cause the firm's failure).

56 BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, *supra* note 8, at 13.

57 *Id.*

58 *Id.*

59 *Id.*

60 *See supra* note 47 and accompanying text.

losses—whether or not those losses are caused by excessive risk-taking.[61] Because this focus of firm-specific financial requirements does not purport to control excessive corporate risk-taking, it is not central to this Article's analysis.[62]

It nonetheless may be worth observing that this focus of firm-specific financial requirements is unlikely to eliminate systemic externalities. While making systemically important firms more internally robust should partially reduce systemic risk by reducing the likelihood that any given firm will fail, these requirements are effectively microprudential—regulating the safety and soundness of individual firms.[63] Firm-specific financial requirements do not purport to (macroprudentially) protect the integrity of the financial system as a system. Such financial requirements might also be counterproductive, making firms that are subject to them less competitive,[64] driving "credit

61 BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, *supra* note 8, at 2. The Federal Reserve has also characterized this use of firm-specific financial requirements as reducing a systemically important firm's "systemic footprint." *Id.* at iii.

62 This Article focuses on controlling excessive corporate risk-taking as a means of reducing systemic externalities. As discussed above, *see supra* notes 47–49 and accompanying text, other regulatory approaches to try to reduce systemic externalities are not central to this Article's analysis. Other such regulatory approaches include the use of contingent capital regulation to convert debt claims of a troubled firm into equity interests, thereby reducing the likelihood that the firm will default, and the FDIC-inspired strategy for administratively resolving a large complex financial institution. *Cf.* Mike Konczal, *Sheila Bair: Dodd-Frank Really Did End Taxpayer Bailouts*, WASH. POST (May 18, 2013), http://www.washingtonpost.com/blogs/wonkblog/wp/2013/05/18/sheila-bair-dodd-frank-really-did-end-taxpayer-bailouts/ ("[T]he FDIC has come up with a viable strategy for resolving a large complex financial institution. . . . The FDIC will take control of a holding company and put creditors and shareholders into a receivership where they, not taxpayers, will absorb any losses. This will allow the subsidiaries to remain operational, avoiding systemic disruptions, as the overall entity is unwound over time.").

63 *See supra* note 15; *cf. supra* note 36 and accompanying text (making a similar observation in the context of contingent capital regulation); Daniel Schwarcz & Steven L. Schwarcz, *Regulating Systemic Risk in Insurance*, 81 U. CHI. L. REV. 1569, 1580 (2014) (observing that although "solvency regulation . . . attempts to safeguard the financial strength of individual insurers . . . the core goal of even solvency regulation has long been understood to be protecting consumers by ensuring that insurers have the financial capacity to pay policyholder claims when they become due" (footnote omitted)).

64 *Cf.* Nabila Ahmed & Sridhar Natarajan, *Jefferies Is Poaching the Big Banks' Loan Business with Help from the Fed*, BLOOMBERG (May 29, 2015), http://www.bloomberg.com/news/articles/2015-05-29/jefferies-poaching-big-banks-loan-business-with-help-from-fed (reporting that unregulated hedge funds "step in to fill a void" when regulated banks are restricted from fulfilling market needs); Eduardo Porter, *Recession's True Cost Is Still Being Tallied*, N.Y. TIMES (Jan. 21, 2014), http://www.nytimes.com/2014/01/22/business/economy/the-cost-of-the-financial-crisis-is-still-being-tallied.html (observing that regulations that require financial institutions to increase capital cushions to buffer against risks and potential losses have been criticized for cutting into global economic output and reducing jobs). The potential for firm-specific financial requirements to make firms less competitive is a result of Congress' "mandate provided by the Dodd-Frank Act, which instructs the [Federal Reserve] Board to mitigate risks to the financial stability of the United States"

intermediation to the less-regulated shadow banking sector,"[65] misleading regulators about safety,[66] creating "perverse incentives,"[67] and inadvertently hurting the economy.[68]

II. Redesigning Regulation

For the reasons discussed above, the regulatory responses to the financial crisis that purport to mitigate excessive corporate risk-taking by systemically important firms are unlikely to be sufficient to control risk-taking that causes systemic externalities. As a result, that risk-taking is likely to continue. Indeed, those regulatory responses may be insufficient to control risk-taking that hurts the firm's interests, much less the public's interests. For example, almost half of the thirty-six banks covered in a recent Financial Stability Board survey failed to meet the "'fundamental' criteria for sound risk governance."[69] And J.P. Morgan Chase, UBS, and Barclays suffered huge losses from excessive risk-taking or lack of risk-taking oversight.[70]

Whether or not more should be done to control risk-taking that hurts the firm's interests,[71] more certainly should be done, in principle, to control

---

without consideration of costs and benefits. Board of Governors of the Federal Reserve System, *supra* note 8, at 13.

65 Board of Governors of the Federal Reserve System, *supra* note 8, at 13.

66 *Cf.* Emilios Avgouleas, *Bank Leverage Ratios and Financial Stability: A Micro- and Macroprudential Perspective* 3 (Levy Econ. Inst. of Bard Coll. Working Paper No. 849, 2015) (observing that federal regulators were misled about banking safety prior to the financial crisis because the required bank leverage ratio "totally failed to capture the perilous state of the US banks in [that] period").

67 *Id.* at 12–13. Professor Avgouleas argues "[t]here is evidence that leverage restrictions may not reduce risk" because "bank managers may be incentivized into choosing [riskier] assets with more highly correlated returns"—thereby creating "perverse incentives." *Id.* He additionally argues that even the new Basel III capital requirements create "uncertainty [that] severely undermines rather than reinforces market discipline" because "the Basel system of risk weights" is "excessively complex and highly difficult to understand [and also] susceptib[le] to gaming." *Id.* at 16–17. That uncertainty, in turn, "will lead to a near certain loss of confidence in the banking system" in the event of a crisis. *Id.* at 17.

68 *See, e.g.*, Steven L. Schwarcz, *Regulating Financial Change: A Functional Approach*, 100 Minn. L. Rev. 1441, 1466 (2016) (observing that countercyclical capital requirements may not be feasible because it is "virtually impossible to know ex ante whether a financial cycle is rational or merely a bubble"; and discussing how the misapplication of such firm-specific financial requirements led to the savings and loan (S&L) crisis of the 1980s).

69 Jim Brunsden, *Banks Must Boost Risk Oversight After Trading Scandals, FSB Says*, Bloomberg (Feb. 12, 2013), http://www.bloomberg.com/news/articles/2013-02-12/banks-must-boost-risk-oversight-after-trading-scandals-fsb-says (quoting Fin. Stability Bd., Thematic Review on Risk Governance Peer Review Report 2 (Feb. 12, 2013), http://www.fsb.org/wp-content/uploads/r_130212.pdf).

70 *Id.* In 2012, a J.P. Morgan trader, aptly nicknamed the London Whale for his big positions, caused the bank to report its biggest-ever trading loss of $6.2 billion. Also in 2012, UBS suffered the largest loss from unauthorized trading in U.K. history, $2.3 billion, when one of its traders was convicted of fraud and sentenced to prison. *Id.*

71 This Article does not focus on that question per se; it focuses instead on risk-taking that harms the public's interests.

excessive corporate risk-taking that causes systemic externalities. Section A below explains why regulation should be appropriate for that purpose, even though it is inappropriate to control most other externalities that result from corporate risk-taking. Sections B and C then examine and compare regulating-substance and regulating-governance options to control excessive corporate risk-taking that causes systemic externalities. Although financial regulation traditionally regulates substance (such as imposing capital-adequacy standards),[72] systemic risk regulation should additionally focus on regulating a firm's governance to better align private and public interests.

A. Additional Regulation Is Needed

Although in principle more should be done to control excessive corporate risk-taking that causes systemic externalities, one cannot merely assume that additional regulation is justified. Corporate risk-taking routinely causes externalities,[73] yet regulation controls few of those externalities.[74] Regulation cannot, realistically, control all corporate externalities.[75]

Nonetheless, for at least three reasons,[76] regulation should require firms to mitigate their systemic externalities. First, systemic externalities "can cause

72 *See infra* Section II.B.

73 Steven L. Schwarcz, *Collapsing Corporate Structures: Resolving the Tension Between Form and Substance*, 60 BUS. LAW. 109, 144 (2004). Most of "a corporate structure's externalities result from the limited-liability rule of corporation law." *Id.* For an analysis of whether that rule itself should be limited, see Schwarcz, *infra* note 77. Limiting that rule would regulate the shareholder principals whose agents, the managers of systemically important firms, this Article seeks to regulate.

74 *Cf.* MICHAEL J. TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT 58 (1993) ("Even if both parties to a particular exchange benefit from it, the exchange may entail the imposition of costs on non-consenting third parties. . . . The problem of third-party effects from exchange relationships is pervasive and not aberrational. Almost every transaction one can conceive of is likely to impose costs on third parties."). For arguments that corporate law should be used to control externalities, see Lawrence E. Mitchell, *The Legitimate Rights of Public Shareholders*, 66 WASH. & LEE L. REV. 1635, 1665–66 (2009) (arguing that because "creditors were providing the bulk of the risk capital," "[m]anagerial incentives can be distorted significantly by the existing regime of shareholder participation rights").

75 *Cf.* TREBILCOCK, *supra* note 74, at 58 (explaining that if externalities resulting from everyday transactions justified prohibiting the exchange process or putting constraints upon it, then "freedom of contract would largely be at an end"); *see also* R.H. COASE, THE FIRM, THE MARKET, AND THE LAW 24 (1988) (arguing that the existence of externalities does not establish a prima facie case for intervention because government regulation is also not without cost).

76 A fourth reason why regulation should require firms to mitigate their systemic externalities is that the financial crisis has established and solidified a norm that financial regulation should address and mitigate systemic risk. *See, e.g.*, Harold S. Bloomenthal & Samuel Wolff, Recent Developments in International Securities Regulation, 33 SEC. & FED. CORP. L. REP., no. 11, 2011, at 1 (commenting that the United States has led the international financial regulatory community in implementing the reforms agreed upon by the Group of Twenty, or G-20, in the aftermath of the financial crisis, and describing this regulation as "focused on the familiar crisis and postcrisis themes of systemic and macroeconomic risk, including regulation and resolution of systemically important financial institutions (SIFIs)

much more harm than non-systemic externalities."[77] Because they impact the real economy,[78] systemic externalities can, for example, lead to "widespread poverty and unemployment."[79] A prominent governor of the Federal Reserve similarly argues that "prudential regulation [should] need to involve itself with corporate governance" because "risk-taking" by systemically important financial intermediaries "carries substantial potential societal consequences."[80] Second, systemic externalities harm the public, as opposed to private stakeholders who could contract to protect themselves.[81] Third, systemic externalities can, as this Article will show, realistically, pragmatically, and efficiently be mitigated.[82]

For these reasons, systemic externalities should be distinguished from other externalities for regulatory purposes. I next examine how regulation could further control corporate risk-taking that causes systemic externalities.[83]

B. *Regulating Substance*

Regulation could control corporate risk-taking that causes systemic externalities by imposing specific regulatory requirements,[84] by making certain actions illegal or tortious, or by imposing corporate governance duties

---

and global SIFIs (G-SIFIs), bank capital requirements and supervision, derivatives regulation, investment advisers, executive compensation, and rating agencies").

77 Steven L. Schwarcz, *The Governance Structure of Shadow Banking: Rethinking Assumptions About Limited Liability*, 90 NOTRE DAME L. REV. 1, 21 (2014).

78 The "real economy" means the economic reality, such as a recession, that the public actually experiences. Schwarcz, *supra* note 7, at 206.

79 *Id.* at 207.

80 Daniel K. Tarullo, Governor, Fed. Reserve Sys., Remarks at the Association of American Law Schools Midyear Meeting: Corporate Governance and Prudential Regulation 7–8 (June 9, 2014); *cf.* Jonathan R. Macey & Maureen O'Hara, *The Corporate Governance of Banks*, 9 FED. RES. BANK N.Y. ECON. POL'Y REV. 91, 97–98 (2003) (arguing that it may be economically efficient to modify the corporate governance of FDIC-insured banks to account for systemic risk).

81 *Cf.* Ian B. Lee, *The Role of the Public Interest in Corporate Law*, *in* RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW 106, 115 (Claire A. Hill & Brett H. McDonnell eds., 2012) (arguing that corporation law should be able to impose rules to protect the public, just as law otherwise protects the public—such as a municipal park rule that protects residents of the neighborhood from excessive noise).

82 *See infra* Section III.B.

83 In a prior article, I made a related but narrower inquiry. *See* Steven L. Schwarcz, *Excessive Corporate Risk-Taking and the Decline of Personal Blame*, 65 EMORY L.J. 533 (2015). "This Article does not examine all forms of optimal regulation that could limit excessive risk-taking or its systemic consequences; its scope is limited to regulation that imposes personal liability to deter excessive risk-taking. Thus, the Article does not consider, for example, whether to break up systemically important firms." *Id.* at 540 n.26.

84 For an example of how regulatory requirements can drive contractual restrictions, see for example *supra* notes 35–40 and accompanying text (discussing how contingent capital regulation motivates contractual loan-covenant restrictions).

on the managers of systemically important firms.[85] This Article refers to imposing specific regulatory requirements and making certain actions illegal or tortious as "regulating substance," as discussed in this Section. In contrast, this Article refers to imposing corporate governance duties as "regulating governance,"[86] which is discussed in Section C below.

Financial regulation traditionally regulates substance because regulating governance is thought to "weaken[ ] the wealth-producing capacities of the firm."[87] The responses to the financial crisis discussed in Part I, for example—including those that are designed to control risk-taking by aligning managerial and investor interests—regulate substance. The capital-adequacy standards imposed on banks for decades under the Basel Accords regulate substance.[88] As this Article has shown, however, regulating substance has so far proved insufficient to control the excessive corporate risk-taking that causes systemic externalities.[89]

---

85 *See, e.g.*, Franklin A. Gevurtz, *The Role of Corporate Law in Preventing a Financial Crisis—Reflections on* In re Citigroup Inc. Shareholder Derivative Litigation, *in* CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS 163, 168–75 (P.M. Vasudev & Susan Watson eds., 2012).

86 Commentators have made a somewhat parallel distinction between external and internal regulation, the former referring to standards imposed on a firm and the latter referring to any interference with the firm's internal operations, including limiting executive compensation. *See* Lee, *supra* note 81, at 124. This Article's distinction between regulating substance and regulating governance—in which the latter refers only to regulating corporate governance *procedures* themselves—attempts to be more precise. *Cf. id.* at 124 (calling the distinction between external and internal regulation a "distinction without a difference"). For example, limiting executive compensation in prescribed ways would be regarded as regulating substance in this Article but as internal regulation under the external-internal distinction.

87 *Id.* at 124; *see also* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 425 (2002) (pointing out that negative externalities created by corporate conduct should be "constrained through general welfare legislation, tort litigation, and other forms of regulation"); Leo E. Strine, Jr. & Nicholas Walter, *Conservative Collision Course?: The Tension Between Conservative Corporate Law Theory and* Citizens United, 100 CORNELL L. REV. 335, 380–81 (2015) (also contending that the most responsible, legitimate, and effective way to control externalities is to have the "legitimate instruments of the people's will, reflective of their desire, set the boundaries for corporate conduct"); *cf.* Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES (Sept. 13, 1970), http://umich.edu/~thecore/doc/Friedman.pdf (arguing that managers lack the political legitimacy and expertise to consider social interests). In principle, I agree with these arguments, especially where the regulation concerns routine externalities or externalities as to which private parties could contract to protect themselves.

88 *See, e.g.*, Heath Price Tarbert, Note, *Are International Capital Adequacy Rules Adequate? The Basle Accord and Beyond*, 148 U. PA. L. REV. 1771, 1778–86 (2000) (stating that the "capital adequacy standards for commercial banks . . . prescribed a substantive set of risk-based capital adequacy standards").

89 *See supra* notes 54–70 and accompanying text.

Commentators have proposed other possible ways to regulate substance to help control that corporate risk-taking.[90] For example, regulation could require systemically important firms to pay into a fund that would be used to help offset systemic risks and costs.[91] This would not only help to internalize externalities; it also would motivate systemically important firms to monitor each other, in order to avoid having to pay more into the fund, thereby helping control each other's risky behavior.[92] Federal Deposit Insurance Corporation (FDIC) deposit insurance provides a precedent for this type of a fund.[93]

Although such a requirement theoretically could help to control excessive corporate risk-taking that causes systemic externalities, it may not be feasible in the near future. Politically, although such a requirement was in the bill that became the Dodd-Frank Act, it was deleted because certain members of Congress felt (incorrectly in the author's opinion) that the very creation of a systemic risk fund would itself increase moral hazard.[94] Practically, such a requirement would need further analysis of, and also would need a consensus on, how to calculate the required contributions. Such calculations would be needed both to make the size of the fund sufficiently viable for its purpose and also to allocate the required contributions among the wide range of systemically important firms.[95]

---

90 Only one country, in a limited banking context, has proposed imposing criminal illegality. The U.K.'s Financial Conduct Authority and the Bank of England's regulatory arm, the Prudential Regulation Authority, have proposed regulations that would impose personal criminal liability on bankers of a failed bank unless they could prove that they acted appropriately. Jill Treanor, *Regulators Want Reckless Bankers to be Criminally Liable Under New Plans*, GUARDIAN (July 30, 2014), http://www.theguardian.com/business/2014/jul/30/regulators-want-bankers-to-accept-criminal-liability. In protest, bank directors have been threatening to quit. *See, e.g.*, Sean Farrell, *HSBC Directors to Quit Over Threat to Jail Bosses for Banking Crises*, GUARDIAN (Oct. 7, 2014), http://www.theguardian.com/business/2014/oct/07/hsbc-directors-quit-jail-bank-crises.

91 Anabtawi & Schwarcz, *supra* note 40, at 102–03; Anabtawi & Schwarcz, *supra* note 46, at 1402. This type of regulation ideally should be global to avoid prejudicing the competitiveness of firms subject to United States regulatory requirements.

92 Anabtawi & Schwarcz, *supra* note 40, at 102–03; Anabtawi & Schwarcz, *supra* note 46, at 1402; *see also* Jeffrey N. Gordon & Christopher Muller, *Confronting Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insurance Fund*, 28 YALE J. ON REG. 151, 210 (2011) (arguing that a systemic risk fund "amounts to a mutualization of risk that should encourage more cautious firms to press regulators to rein in firms and practices that pose systemic risks").

93 Anabtawi & Schwarcz, *supra* note 40, at 102–03; Anabtawi & Schwarcz, *supra* note 46, at 1402.

94 Gordon & Muller, *supra* note 92, at 208; *see also* Steven L. Schwarcz, *Identifying and Managing Systemic Risk: An Assessment of Our Progress*, 1 HARV. BUS. L. REV. ONLINE 94, 103 (2011).

95 *Cf.* Steven L. Schwarcz, *Too Big To Fail?: Recasting the Financial Safety Net*, *in* THE PANIC OF 2008: CAUSES, CONSEQUENCES AND IMPLICATIONS FOR REFORM 94, 108 nn.40–41 (Lawrence E. Mitchell & Arthur E. Wilmarth, Jr., eds., 2010) (discussing these practical considerations, and also suggesting that—so long as each contributing firm has enough

Commentators have also suggested a so-called "Pigouvian tax" as another possible way to help control, or at least to help internalize the systemic impact of, excessive corporate risk-taking. This is a tax designed to "offset the effects of [a systemically important] bank's actions on wider society."[96] Along these lines, the Financial Stability Board (FSB) has proposed imposing a "systemic [capital] surcharge" on the largest banks.[97]

The practicality of a Pigouvian tax is unclear. At least as proposed as a capital surcharge, it could be difficult to impose on a systemically important nonbank.[98] Imposing such a surcharge on a bank would also be imperfect, economists argue, because a capital surcharge is used to achieve two (sometimes) incompatible goals—"as a buffer against unexpected loss [and to] limit risk taking."[99] To the extent it serves as a buffer against unexpected loss, a Pigouvian tax would simply be a type of firm-specific financial requirement, which would not be central to this Article's analysis.[100]

Tort law is also unlikely to control excessive corporate risk-taking that causes systemic externalities. As a form of public control through the common law system of privately enforced rights,[101] tort law has long been a fundamental tool to impose personal civil liability to remedy harm for unreasonable risk-taking.[102] Its utility is limited, however, to remedying foreseeable harm.[103] But systemic harm is rarely foreseeable.

Systemic harm instead affects a wide range of third parties in unpredictable ways. Consider, for example, an individual who is forced to close her family-owned restaurant during a systemically-caused recession. Or taking a more concrete example from the financial crisis, consider whether to impose tort liability on a manager of a financial firm who, in the expectation of a bonus, sells highly-leveraged types of risky asset-backed securities to sophisticated investors, contributing to that crisis. Tort law could not—and assum-

---

capital at risk in the fund—the government could supplement the fund to ensure that its size is sufficiently viable).

96 Gianni De Nicoló et al., *Externalities and Macroprudential Policy*, 2 J. FIN. PERSP. 95, 103 (2014); Andrew G. Haldane, *On Being the Right Size*, 2 J. FIN. PERSP. 13, 16 (2014).

97 *See, e.g.*, Haldane, *supra* note 96, at 16–17 (stating that a capital surcharge of over 7% would "remove 90% of the systemic externality").

98 Beatrice Weder di Mauro et al., *Three Birds with One Stone: The G20 and Systemic Externalities*, VoxEU (June 26, 2010), http://www.voxeu.org/article/three-birds-one-stone-g20-and-systemic-externalities.

99 *Id.*

100 *See supra* note 62 and accompanying text.

101 RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 383 (6th ed. 2003) (observing that there are "two methods of public control—the common law system of privately enforced rights and the administrative system of direct public control").

102 *See, e.g.*, Gevurtz, *supra* note 85, at 127 (observing that the concept of "[i]mposing liability to pay the damages resulting from unreasonable risks . . . is a pillar of tort law").

103 RESTATEMENT (THIRD) OF TORTS: PHYS. & EMOT. HARM § 3 (AM. LAW INST. 2016) ("To establish . . . negligence, it is not enough that there be a likelihood of harm; the likelihood must be foreseeable to the actor at the time of conduct.").

ing legally sufficient disclosure, probably should not—be used to impose personal liability on that manager for the resulting systemic harm.[104]

Regulating substance therefore is important, but it may be insufficient to control excessive corporate risk-taking that causes systemic externalities.[105] To continue to limit financial regulation to regulating substance would therefore create what Professor Ian Lee has called a "regulatory dysfunction."[106] To avoid that dysfunction, I next examine whether regulating governance could help to control that excessive risk-taking without weakening corporate wealth-producing capacity.[107]

C. *Regulating Governance*

Although regulating substance generally should be superior to government interference with corporate governance to control externalities, regulating substance has so far proved insufficient—and is unlikely to become sufficient in the near future—to control the excessive corporate risk-taking that causes systemic externalities.[108] That insufficiency may well reflect the reality that excessive corporate risk-taking primarily results from managerial judgment calls. For example, the excessive corporate risk-taking that led to the financial crisis "largely resulted from poor decisions, bad judgment, and greed."[109]

To control that risk-taking, regulation also needs to regulate governance.[110] In making corporate decisions, managers currently have a duty to

---

104 *Cf.* Armour & Gordon, *supra* note 37, at 46–47 (explaining that tort law usually does not allow recovery for indirect losses, and also observing that it is difficult to impose tort liability on a bankrupt firm).

105 *Cf. id.* at 38 (concluding that "it is unsafe to rely on regulation [that regulates substance] alone").

106 E-mail from Ian B. Lee, Assoc. Prof., Univ. of Toronto Faculty of Law, to the author (Aug. 18, 2015) (on file with author) (observing that "if existing legal obligations are an important part of the problem, then we are in the presence of a regulatory dysfunction and not a market dysfunction. A logical possibility exists that the solution is not to introduce a further intervention (new legal obligations), but rather to remove or alter the existing intervention . . . that is, to weaken the managers' existing legal duty to shareholders").

107 *Cf. supra* note 87 and accompanying text (stating the argument against regulating governance).

108 *Cf.* David T. Llewellyn, *Some Lessons for Bank Regulation from Recent Financial Crises*, *in* HANDBOOK OF INTERNATIONAL BANKING 428, 429 (Andrew W. Mullineux & Victor Murinde eds., 2003) ("While external regulation has a role in fostering a safe and sound banking system, this role is limited" and "increasingly important, are . . . corporate governance arrangements within banks.").

109 Schwarcz, *supra* note 83, at 538.

110 *Cf.* Griffith, *supra* note 6, at 1227 (recommending that derivatives clearinghouses maintain "a separate governing body with a public charge—the containment of systemic risk"); Peter O. Mülbert, *Managing Risk in the Financial System*, *in* THE OXFORD HANDBOOK OF FINANCIAL REGULATION 365, 385 (Niamh Moloney et al. eds., 2015) (suggesting that the management of financial institutions be required "to take into account the negative external effects of their decisions on other financial institutions and, thus, the contribution to increasing systemic risk and reducing financial stability"); Tarullo, *supra* note 80, at 9

the firm and its investors. To reduce systemic externalities, they should also have a duty to society (hereinafter, a "public governance duty"[111]) not to engage their firms in excessive risk-taking that leads to those externalities.[112] So long as it does not unduly weaken wealth-producing capacity, regulating governance in this way would help to align private and public interests.[113]

In the financial context, regulating governance has another advantage over regulating substance. Regulating substance often depends on regulators precisely understanding the financial "architecture"—the particular design and structure of financial firms, markets, and other related institutions—at the time the regulation is promulgated.[114] Because the financial architecture is constantly changing,[115] that type of grounded regulation has value as long as it is updated as needed to adapt to those changes.[116] But ongoing financial monitoring and regulatory updating can be costly and "is subject to political interference at each updating stage."[117] As a result, finan-

(arguing "for prudential regulation to influence the *processes* of risk-taking" to complement "capital requirements and other substantive measures").

111 This Article contemplates an actual duty on the part of a firm's managers, in contrast to mere managerial discretion, to not engage their firms in excessive risk-taking that leads to systemic externalities. *Cf.* Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733 (2005) (arguing for managerial discretion to act in the social interest).

112 An alternative to imposing a public governance duty on a firm's managers might be to designate one or more managers ("public advocates") whose primary duty would be to represent the public, preserving the other managers' traditional duties with one exception: in any decisionmaking, the other managers would have the right to take into account the public advocate's viewpoint. *Cf.* Steven L. Schwarcz, *Rethinking Corporate Governance for a Bondholder Financed, Systemically Risky World*, 58 WM. & MARY L. REV. (forthcoming 2016–17) (arguing that because bond financing now dwarfs equity financing and bond prices are tied to firm performance, corporate governance should include bondholders, and suggesting that including bondholders in corporate governance could help to reduce systemic risk because bondholders are more risk averse than shareholders).

113 There is banking precedent that purports to regulate governance to align private and public interests, but it is more precatory than real. The Basel Committee on Banking Supervision sets corporate governance guidelines for banks in order to "safeguard[ ]. . . interest in conformity with public interest on a sustainable basis." BASEL COMM. ON BANKING SUPERVISION, GUIDELINES: CORPORATE GOVERNANCE PRINCIPLES FOR BANKS 3 (2015), http://www.bis.org/bcbs/publ/d328.pdf. These guidelines, however, merely require banks to "protect the interests of depositors, meet shareholder obligations, and take into account the interests of other recognised stakeholders." *Id.* For an argument in favor of regulating governance to minimize corporate environmental externalities, see Gail E. Henderson, A Fiduciary Duty to Minimize the Corporation's Environmental Impacts (Univ. of Oslo Faculty of Law, Legal Studies Research Paper No. 2011-32, 2011).

114 Schwarcz, *supra* note 68, at 1443.

115 *Id.*

116 *Cf.* PERRY MEHRLING, THE NEW LOMBARD STREET: HOW THE FED BECAME THE DEALER OF LAST RESORT 4–5 (2011) (arguing that because economics and finance "largely ignore the sophisticated mechanism that operates to channel cash flows . . . to meet cash commitments," they have not "been particularly well suited for understanding the . . . [financial] crisis during which the crucial monetary plumbing broke down").

117 Schwarcz, *supra* note 68, at 1443.

cial regulation of substance usually lags financial innovation,[118] causing unanticipated consequences and allowing innovations to escape regulatory scrutiny.[119]

Regulating governance, in contrast, can overcome that regulatory time lag. If the firm is proposing to engage in a risky project that represents financial innovation, its managers either have or, to fulfill their governance duties, must try to obtain the most current information about the innovation and its consequences.

III. Towards Regulatory Alignment: A Public Governance Duty

To help control the excessive corporate risk-taking that leads to systemic externalities, this Article has shown that regulating governance has an advantage over, and therefore in principle should supplement, regulating substance—so long as it does not unduly weaken corporate wealth-producing capacity. Subject to that proviso, managers should have a public governance duty not to engage their firms in excessive risk-taking that leads to those externalities. Because only systemically important firms, by definition, could engage in risk-taking that leads to systemic externalities, the public governance duty should apply only to managers of those firms.

Section A below analyzes such a public governance duty under corporate governance legal theory. Thereafter, Section B shows how the duty could be feasibly and efficiently implemented, without unduly weakening corporate wealth-producing capacity. The Appendix to the Article then proposes possible model language, in the form of a Public Governance Duty Act, for regulation imposing the duty.

A. *Analyzing a Public Governance Duty Under Corporate Governance Legal Theory*

Except to the extent it intentionally limits shareholder primacy, a public governance duty that aligns a systemically important firm's interests with the public's interests should not be inconsistent with corporate governance legal theory. As explained below, it should be consistent with the stakeholder model of governance, because the public is a stakeholder whom the law should protect against systemic externalities. It should be consistent with the

118 *Id.* at 1454; *see also* Edward J. Kane, *Policy Implications of Structural Changes in Financial Markets*, 73 Am. Econ. Rev. 96 (1983) (arguing that regulatory responses lag behind innovations).

119 This occurred in 2008, for example, when the pre-crisis financial regulatory framework, which assumed the dominance of bank-intermediated funding, failed to adequately address a collapsing financial system in which the majority of funding had become non-bank-intermediated. *Cf.* Julia Black, *Restructuring Global and EU Financial Regulation: Character, Capacities, and Learning*, *in* Financial Regulation and Supervision: A Post-Crisis Analysis 3, 13 (Eddy Wymeersch et al. eds., 2012) ("[T]he system simply did not operate in the way that regulators, banks, and economists had thought it did. If you do not understand how the system works, it is very hard to build in mechanisms either for managing risk or for ensuring the system's resilience when those risks crystallize.").

more generally accepted contractarian model of governance because, even though the public is not a contracting party, systemic externalities are exactly the type of externalities that should count in limiting freedom of contract that harms non-contracting parties. And although it technically would be inconsistent with the shareholder-primacy model, even that model recognizes the need to control certain externalities—and a public governance duty may be the best way to control the excessive corporate risk-taking that causes systemic externalities.

1. The Stakeholder Model of Governance

A public governance duty should most clearly be consistent with the stakeholder model of governance. Under this model, the interests of everyone affected by a firm's actions should be considered, to avoid anyone's interest being unfairly exploited.[120] The public, of course, is affected by a firm's risk-taking.[121] This model, however, adds little explanatory value because there is fundamental disagreement on the extent to which non-investor stakeholder interests should be taken into account, valued, and balanced with shareholder interests.[122]

Judicial opinions in the United States and Canada illustrate this disagreement. In *Metropolitan Life Insurance Co. v. RJR Nabisco, Inc.*,[123] plaintiff MetLife argued that RJR's leveraged buyout caused the RJR bonds held by MetLife to lose their investment-grade rating,[124] thereby violating an implied covenant to bondholders.[125] As a consequence of the rating downgrade, the

---

120 Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 447 (2001) (explaining that stakeholders may include "employees, creditors, customers, merchants . . . or even broader interest groups such as beneficiaries of a well-preserved environment"). *But cf.* Lee, *supra* note 81, at 111 (suggesting that stakeholder theory does not necessarily imply that the firm has no bounds, i.e., that there is no distinction between the firm and the public; it need only mean that the firm's interests are not coextensive with those of the shareholders).

121 *Cf.* Zhong Xing Tan, *Stewardship in the Interests of Systemic Stakeholders: Re-conceptualizing the Means and Ends of Anglo-American Corporate Governance in the Wake of the Global Financial Crisis*, 9 J. BUS. & TECH. L. 169, 179–89 (2014) (arguing that the financial system and economy qualify as stakeholders under a risk-based model of stakeholding).

122 *Cf.* Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 578 (1998) (observing a similar type of debate in bankruptcy law, in which different parties to the debate start with very different norms).

123 716 F. Supp. 1504 (S.D.N.Y. 1989).

124 For a description of how bond ratings are structured, see Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 7 (2002) ("[T]he highest rating on long-term debt securities is AAA, with ratings descending to AA, then to A, and then to BBB and below. . . . The higher the rating, the lower the rating agency has assessed the credit risk associated with the securities in question. . . . 'Ratings below BBB- are deemed non-investment grade, and indicate that full and timely repayment on the securities may be speculative.'" (footnotes omitted) (quoting Steven L. Schwarcz, *The Universal Language of Cross-Border Finance*, 8 DUKE J. COMP. & INT'L L. 235, 253 (1998))).

125 *RJR Nabisco*, 716 F. Supp. at 1516.

resale value of the bonds plummeted.[126] MetLife argued that its damages should include this loss in market value, but the court declined to recognize that loss as legally compensable.[127] The court implicitly acknowledged the possibility that the bondholders were affected stakeholders. It refused, however, to order compensation for the resulting externalities.[128]

The authority most clearly expressing a stakeholder model is the celebrated Canadian case of *BCE, Inc. v. 1976 Debentureholders*,[129] the facts of which are virtually identical to those in *Metropolitan Life Insurance Co. v. RJR Nabisco, Inc.* Plaintiff-debentureholders argued that BCE's board of directors had acted inappropriately in agreeing to a leveraged buyout that would have caused the debentures to lose their investment-grade rating, thereby diminishing their value.[130] The court observed that the debentureholders were warned that they could not reasonably expect the investment-grade rating to be maintained, nor did they include indenture covenants to try to protect the rating.[131] Nonetheless, the court's opinion broadly articulated a stakeholder model of governance:

> Where conflicting interests arise, it falls to the directors of the corporation to resolve them in accordance with their fiduciary duty to act in the best interests of the corporation. . . . There are no absolute rules and no principle that one set of interests should prevail over another. In each case, the question is whether, in all the circumstances, the directors acted in the best interests of the corporation, having regard to all relevant considerations, including—but not confined to—the need to treat affected stakeholders in a fair manner, commensurate with the corporation's duties as a responsible corporate citizen.[132]

One prominent commentator, quoting a prior Canadian decision, observes that such a stakeholder model of governance could even take into account "the interests of, *inter alia*, shareholders, employees, creditors, consumers, governments and the environment."[133] Even in Canada, however, there remains fundamental disagreement about how to apply a stakeholder model of governance, including how to determine which stakeholders' interests should be taken into account and how managers of firms could attempt to value and balance those interests with investor interests.

---

126 *Id.* at 1506.

127 *Id.* at 1518.

128 *Id.* The court's articulated reasoning was somewhat tortured: the market-value loss did not constitute the "fruits of the agreement" under which the bonds were issued because the "substantive 'fruits' [of a bond indenture only] . . . include the periodic and regular payment of interest and the eventual repayment of principal," which were expected to continue even after RJR's leveraged buyout. *Id.* at 1518–19.

129 [2008] 3 S.C.R. 560 (Can.).

130 *Id.* at 563.

131 *Id.* at 565.

132 *Id.*

133 Robert Yalden, *Canadian Mergers and Acquisitions at the Crossroads: The Regulation of Defence Strategies After* BCE, 55 CAN. BUS. L.J. 389, 407 (2014).

The Article next argues, in the context of discussing the contractarian model of governance, that this disagreement reflects a larger uncertainty about the extent to which law should protect third parties from externalities.[134] That larger uncertainty is a fundamental inquiry of contract law. Insights from contract law can help to reveal, at least in the context of systemic externalities, how that uncertainty can be resolved.

2. The Contractarian Model of Governance

This model reflects the most widely accepted theory of corporate governance—that a firm is a "nexus of contracts" among private parties.[135] The corporate governance rules are priced as part of the contractual negotiation.[136] At first glance, a public governance duty would appear to be inconsistent with this model. After all, members of the public are not contracting parties.

Contract law, however, does not limit its application to contracting parties. Freedom of contracting is not, and should not be, absolute. Government should be able to limit it in at least three scenarios,[137] one of which is when the contracting causes externalities.[138] The critical question is which externalities should count in limiting that freedom.[139]

Even under contract law, there is no absolute answer to that question.[140] Some scholars have therefore dismissed externalities as a basis for regulation.[141] But this Article need answer only a much more limited question: Should *systemic* externalities count in limiting freedom of contract? That question has already been answered in a separate context.[142] Systemic externalities not only harm the public, who cannot contract to protect them-

134 *Cf.* TREBILCOCK, *supra* note 74, at 20 (identifying the "major conceptual" problem of "[d]etermining . . . which [externalities] are to count in constraining the ability of parties to contract with each other"). After all, the stakeholder-model debate ultimately turns on the extent to which law should require a firm's managers to protect non-investor parties who could be impacted by a corporate action.

135 Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1426 (1989).

136 *Id.* at 1430.

137 *See, e.g.*, Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515 (1999) (arguing that freedom of contract should be subject to statutory policies, paternalism, and material externalities).

138 *Id.* at 520–21.

139 TREBILCOCK, *supra* note 74, at 58–59 (raising that question).

140 *Id.* at 59–61 (explaining that different value judgments have different implications for answering that question).

141 *Cf.* Alan D. Morrison, Meta Contracting and Autonomy: A Liberal Theory of the Firm 2 (May 2015) (unpublished draft) (on file with author) (observing that "many people now argue that regulation based solely upon the correction of externalities has been proved to be inadequate").

142 That separate context was examining whether regulation should require firms to mitigate their systemic externalities. *See supra* notes 76–79 and accompanying text.

selves,[143] but also cause much more harm than non-systemic externalities, including widespread poverty and unemployment.[144] These are exactly the type of externalities that should count in limiting freedom of contract.[145]

Thus, even though the public is not a contracting party, a contractarian model of corporate governance should permit—and arguably should even require—government to limit corporate governance decisions that cause systemic externalities to the public.

3. The Shareholder-Primacy Model

A public governance duty technically would be inconsistent with the shareholder-primacy model. This model is not a corporate governance theory per se, but its widespread dominance in the United States[146] and worldwide[147] merits attention.

Proponents of shareholder primacy argue that managers of for-profit corporations should govern the firm solely for the best interests of its shareholders.[148] Although this model is sometimes discussed in a broader context of economic efficiency, it is fundamentally based on agency costs.[149] Because firms and their agents cannot enter into complete contracts to prevent the latter from shirking,[150] there should be another way to prevent that.[151] Shareholders as residual claimants have incentives to monitor the firm's agents.[152] The agents, in turn, benefit from that monitoring because they

143 *Cf.* Henry N. Butler & Jonathan R. Macey, *Externalities and the Matching Principle: The Case for Reallocating Environmental Regulatory Authority*, 14 YALE L. & POL'Y REV. 23, 29 (1996) (leaving open the possibility that government intervention might be justified to prevent externalities that cannot be internalized through Coasian bargaining); Morrison, *supra* note 141, at 21–23 (observing that firms impose costs on the public that are "not knowingly assumed").

144 *See supra* notes 76–79 and accompanying text.

145 Schwarcz, *supra* note 137, at 520–21, 534–36, 551; *see also* Butler & Macey, *supra* note 143, at 29 (arguing, in the environmental context, that government regulation may be appropriate to require a polluter to bear the full costs of its activities when the externality is significant and cannot be bargained away, and the benefits of the regulation outweigh the costs); Morrison, *supra* note 141, at 22–23 (arguing that when the public is unable to contract to avoid costs imposed by firms, the "regulatory state should minimize" those costs, representing the public as part of a "meta contract").

146 *See, e.g.*, Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) (explaining shareholder primacy's classical articulation).

147 *Cf.* Hansmann & Kraakman, *supra* note 120, at 443–48 (discussing the ideological convergence on the shareholder-primacy model around the world).

148 Strine & Walter, *supra* note 87, at 346.

149 Agency costs are an aspect of economic efficiency; efficiency increases when agency costs are minimized (because agency costs are a deadweight loss).

150 *See* Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

151 Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 566 (2003).

152 *Id.* at 567.

need focus on only one goal: maximizing shareholder value (usually in the form of stock price).[153]

A public governance duty should nonetheless be consistent with certain assumptions underlying the shareholder-primacy model. Even proponents of shareholder primacy accept that firms can cause externalities, but they believe the efficient response is for government to regulate externalities, as needed, without interfering with corporate governance.[154] This Article has shown, however, that such regulation may be insufficient to control the excessive corporate risk-taking that causes systemic externalities.[155] The alternative is to regulate corporate governance.[156]

The analysis has shown that imposing a public governance duty to align the firm's interests with the public's interests in order to control systemic externalities can be reconciled with corporate governance legal theory. I next examine how to implement such a duty without unduly weakening corporate wealth-producing capacity.

B. *Implementing a Public Governance Duty*

The discussion below shows that a public governance duty could be feasibly and efficiently implemented. Under a public governance duty, the managers of a systemically important firm[157] would not only have a private corporate governance duty to investors but also a duty not to engage in excessive risk-taking that could systemically harm the public.[158] That public duty

153 Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1200 (2002).

154 *Cf. generally supra* note 87 and accompanying text (discussing the argument that government interference with corporate governance might weaken the wealth-producing capacities of the firm).

155 *See supra* Section II.B.

156 *See supra* Section II.C. One can also make other arguments that a public governance duty should not be inconsistent with the shareholder-primacy model, including that such a duty's reduction in systemic cost would exceed any increase in agency costs resulting from the duty. Professor Morrison argues that state intervention—which implicitly would include a public governance duty—would undermine the moral value of the corporate form, which allows "choices that individuals, left to themselves, might prefer to make." Morrison, *supra* note 141, at 4. I would argue to the contrary, that individuals should have no moral right to cause systemic harm to others.

157 Recall that a public governance duty should apply only to managers of systemically important firms, which in this Article are limited to financial firms that are systemically important. *See supra* note 5 and the introduction to Section III.A.

158 *Cf.* John Carney, *Big-Bank Board Game Puts Shareholders in Second Place*, WALL ST. J. (Apr. 5, 2015), http://www.wsj.com/articles/big-bank-board-game-puts-shareholders-in-second-place-heard-on-the-street-1428255363 (noting a speech by U.S. Federal Reserve Governor Daniel Tarullo suggesting that "corporate governance would need to change to broaden the scope of boards' fiduciary duties to reflect macroprudential [i.e., systemic] regulatory objectives"). The nation of Iceland has actually enacted legislation that appears to require, at least in principle, the managers of at least certain systemically important firms to "operate[ ] [their firms] . . . in the interests of . . . shareholders . . . and the entire economy." Act on Financial Undertakings (Act No. 161/2002) (Ice.), https://eng.atvinnu

raises at least six practical questions: (1) How should a public governance duty be legally imposed? (2) How should managers assess the public costs and private benefits of a risk-taking activity? (3) How should managers balance those costs and benefits when deciding whether the firm should engage in a given risk-taking activity? (4) How should a public governance duty be enforced? (5) Weighing the goals of protecting the public against systemic externalities and encouraging the best people to serve as managers, to what extent should managers performing their public governance duty have the protection of a business judgment rule as a defense to liability? (6) To what extent should managers be protected under directors and officers (D&O) liability insurance? Consider these questions in turn.

1. Legally Imposing the Duty

A public governance duty could be legally imposed in different ways. Courts, for example, could create such a duty through judicial decisions. Or legislatures could amend their corporation laws to require such a duty.

Because this Article is primarily normative, its emphasis is on whether the duty should be imposed, not how it might be imposed. Nonetheless, the following observations may be relevant to that latter inquiry. As at least one commentator has observed, changes in corporate governance law that could have "profound public policy" implications that "ultimately shape the fabric of the form of capitalism that a society embraces" should be undertaken by "our legislatures," which are "designed to allow for a full airing of social and political currents."[159]

In the United States, this would mean that a public governance duty should be imposed either by state legislatures (especially the Delaware legislature, because most domestic firms are incorporated under Delaware law) or by the U.S. Congress ("Congress"). Because corporation law in the United States is traditionally state, not federal, states ideally should take the lead in imposing such a duty. By analogy, states are already beginning to allow corporate managers to consider non-shareholder constituencies, such as "employees, suppliers, customers and creditors of the corporation, and . . . communities."[160]

It is questionable, however, whether state legislatures are well-positioned to impose a public governance duty. They are unlikely to want to impose such a duty because it could discourage firms from incorporating in their

vegaraduneyti.is/laws-and-regulations/nr/nr/7366 (unofficial English translation provided by Icelandic government). The Dean of the University of Iceland's law faculty believes this law "puts clear constraints on the directors and managers" of those firms and "underlines the difference between" those firms "and other companies that usually have the only purpose of increasing shareholder value." E-mail from Eyvindur G. Gunnarsson, Dean, Faculty of Law, Univ. of Ice., to author (Feb. 14, 2015) (on file with author).

159 Yalden, *supra* note 133, at 410.

160 15 PA. STAT. AND CONS. STAT. ANN. § 1715(a)(1) (West 2016).

states.[161] Furthermore, systemic risk is a national and international problem, not usually a local state problem.[162] The "internalization principle" recognizes that regulatory responsibilities should generally be assigned to the unit of government that best internalizes the full costs of the underlying regulated activity.[163] For these reasons, Congress may be best situated to impose a public governance duty,[164] and indeed the Sarbanes-Oxley Act and the Dodd-Frank Act set legislative precedents for Congress limiting state corporation law.[165] A federal law public governance duty would also override inconsistent state corporation law.[166]

Congress might already implicitly have granted power to the Federal Reserve to create a public governance duty. Section 165(h) of the Dodd-Frank Act directs the Federal Reserve Board to require each publicly traded nonbank financial company supervised by the Board and each publicly traded bank holding company with total consolidated assets of $10 billion or more to establish a risk committee, which will be responsible for overseeing

161 Armour & Gordon, *supra* note 37, at 75 (observing that "systemically important firms might be expected to incorporate away from jurisdictions adopting a [director] liability rule").

162 In the corporate governance context, this disconnect is potentially even greater because firms operating anywhere in the United States can select another state's law under which to incorporate, and that law will control the firm's governance. Therefore, a state's corporate governance law need not even take that state's risks into account.

163 Robert D. Cooter & Neil S. Siegel, *Collective Action Federalism: A General Theory of Article I, Section 8*, 63 STAN. L. REV. 115, 137 (2010); *see also* Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,240, 17,249 (Mar. 14, 2014); Clayton P. Gillette, *Who Should Authorize a Commuter Tax?*, 77 U. CHI. L. REV. 223, 233 (2010). The internalization principle's rationale is that government entities will have optimal incentives to take into account the full costs and benefits of their regulatory decisions only if the impacts of those decisions are felt entirely within their jurisdictions. WALLACE E. OATES, FISCAL FEDERALISM 46–47 (1972).

164 *Cf.* Armour & Gordon, *supra* note 37, at 68 (proposing that implementing director liability for systemic harm could require "a Federal liability regime"). Professors Armour and Gordon also suggest that "the mere possibility of federal intervention could itself spur Delaware" to impose something akin to a public governance duty, because "the most powerful driver of innovation in Delaware corporate law has . . . been . . . the threat of federal pre-emption." *Id.* at 75.

165 Hillary A. Sale, *Public Governance*, 81 GEO. WASH. L. REV. 1012, 1014 (2013) (discussing those Acts as federal legislative precedents in which Congress limited how state corporation law enabled corporate private ordering). For example, Sarbanes-Oxley requires a public company's audit committee members to be independent and makes specific managers individually responsible for the accuracy of financial reports. *Id.* at 1021. Dodd-Frank requires the directors on the compensation committee to be independent and also, through its "say-on-pay" provisions, requires precatory shareholder approval of the substantive terms of executive compensation. *Id.* at 1027–29.

166 *See infra* note 170. For example, a federal law public governance duty would override a disclaimer of liability for gross negligence included in a firm's certificate of incorporation under Delaware General Corporation Law. *See* DEL. CODE. ANN. § 102(b)(7) (West 2015).

the company's risk management practices.[167] The Board's implementing regulations currently only require risk committees to focus on risks to the firm, not to the public.[168] That microprudential focus subjects risk committees to the same misalignment discussed earlier.[169] As a result, members of a risk committee who vote to favor the public over investor interests may even be violating their state law corporate governance duties. However, assuming Congress's mandate to the Board is broad enough, the Board could issue additional regulations that require risk committees to also consider systemic risks to the public.[170]

---

167 12 U.S.C. § 5365(h) (2012) (stating that the risk committee should be responsible for overseeing the firm's enterprise-wide risk management practices—i.e., overseeing the broad spectrum of risks facing the firm and the firm's affiliated group). The risk committee is also required to have independent directors (as the Federal Reserve Board deems appropriate), including at least one risk management expert having experience in identifying, assessing, and managing risk exposures of large, complex firms. *Id.* For further discussion of risk committees, see Kristin N. Johnson & Steven A. Ramirez, *New Guiding Principles: Macroprudential Solutions to Risk Management Oversight and Systemic Risk Concerns*, 11 U. ST. THOMAS L.J. 386, 416–18 (2014).

168 The Federal Reserve Board's regulations do not require risk committees to take systemic risk into account. *See* 12 C.F.R. § 252.20–22, 30–35 (2015) (at most indirectly suggesting that possibility by requiring that the level of risk management expertise possessed by the risk committee of a company should rise in accordance with a company's rising threat of systemic risk to the economy). Risk committees formed pursuant to the Board's regulations likewise do not appear to take systemic risk into account. *See, e.g.*, MAUREEN P. ERRITY & HENRY J. RISTUCCIA, DELOITTE, RISK COMMITTEE RESOURCE GUIDE FOR BOARDS app. A at 18–20 (2012) (stating in its "[s]ample board risk committee charter" that the risk committee's purpose is to identify and assess "the risks that the organization faces" and to "[p]rovide input to management regarding the enterprise's risk appetite and tolerance"); Matteo Tonello, *Should Your Board Have a Separate Risk Committee?*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 12, 2012), http://corpgov.law.harvard.edu/2012/02/12/should-your-board-have-a-separate-risk-committee/ (stating that the risk committee's function is to "develop a mutual understanding regarding the risks the company faces over time as it executes its business model for creating enterprise value").

169 *See supra* notes 8–12 and accompanying text. Although that microprudential focus reduces the likelihood that individual firms will fail, that at most partially reduces systemic risk. *See supra* note 15.

170 During an October 19, 2015, presentation on "Regulating Systemic Risk in Insurance," I suggested to the U.S. Federal Reserve Board and Reserve Bank staff that they should consider requiring risk committees to also consider systemic risks to the public. If the delegation of authority under section 165(h) of the Dodd-Frank Act is broad enough, the Board's regulations requiring a public governance duty should override contrary state law by virtue of the Supremacy Clause of the U.S. Constitution. *Cf.* Peter O. Mülbert & Alexander Wilhelm, *CRD IV Framework for Banks' Corporate Governance*, *in* EUROPEAN BANKING UNION 155, 197 (Danny Busch & Guido Ferrarini eds., 2015) (stating that the new European Capital Requirements Directive (CRD) IV "requires the decisions of . . . the management body . . . to take into account not only the interests of shareholders, but also . . . the public interest").

2. Assessing Costs and Benefits

How should managers of a systemically important firm, or members of such a firm's risk committee,[171] assess the public costs and private benefits of a risk-taking activity? Although a range of approaches is possible, this Article offers two examples of approaches: one subjective and the other more objective and ministerial. On a case-by-case basis, managers could choose which approach to follow.

When deciding how to vote on matters as to which they believe there could be significant systemic costs to the public, managers following a subjective approach would simply consider those costs and balance them against benefits—the same way they would consider any other relevant costs and benefits when making a corporate governance decision. Their assessment and balancing might, but would not necessarily, be documented or explained.[172] Managers may favor this approach because it would not change their current behavior.

This subjective approach would be subject to at least three drawbacks, however.[173] First, because the consequences of a systemic collapse can be devastating to the public, the decisionmaking process to mitigate that harm should be more transparent.[174] Second, managers following a subjective approach may be subject to peer pressure to favor investor profitability over avoiding public harm.[175] Third, although courts generally try to avoid second-guessing management decisions,[176] even managers should want to follow an approach that provides an explicit safe harbor against litigation—at least if the approach is relatively ministerial.

171 *See supra* notes 167–70 and accompanying text (discussing risk committees). Professors Armour and Gordon also advocate "board-level review of risk-taking that may give rise to systemic harms, effectuated through a risk-committee process." Armour & Gordon, *supra* note 37, at 64. Even if the cost-benefit assessment is performed by members of a firm's risk committee, the firm's senior managers (e.g., members of its board of directors) "should retain *overall* responsibility for risk oversight, mirroring [their] overall responsibility for strategy." Tonello, *supra* note 168.

172 *Cf.* JAMES D. COX & THOMAS LEE HAZEN, CORPORATIONS 191 (2d ed. 2003) (observing that "what is required for the board to act reasonably to inform itself varies with the facts").

173 The more objective approach also could have drawbacks, such as its simplifying assumption that the only way a risky project could cause systemic costs is if the project's being unsuccessful causes the firm to fail. *See infra* note 178.

174 *Cf. infra* notes 189–93 (arguing that the harmful consequences of a systemic collapse justify the application of a precautionary principle).

175 As a director of special purpose entities, I routinely experienced this peer pressure. I also saw this type of peer pressure routinely exercised against the senior manager of a banking client's internal risk committee, to greatly favor profitability over caution. To attempt to mitigate this pressure, a firm's risk committee ideally should have at least two independent members.

176 *See infra* notes 206–10 and accompanying text (discussing the business judgment rule as a defense to liability).

Consider how to craft a possible ministerial safe-harbor objective approach, using the generic example of a systemically important firm engaging in a risky project that could be profitable. The expected private benefits can be calculated as the expected value of the project to the firm's investors (usually the shareholders), which I'll call ":

" (expected value of project to investors) =

[X% chance of project being successful × $Y value to investors from that success[177]] - [(1-X% chance of project being unsuccessful) × $W loss from that failure]

The expected public costs can be calculated as the expected value of the project's systemic costs, which I'll call $:

$ (expected value of project's systemic costs) =

(1 - X% chance of project being unsuccessful) × F% chance of firm failing as a result of the project being unsuccessful × $Z resulting systemic costs.[178]

What values should management use? Most of these values would be pure business judgments about which the firm's managers should have sufficient information, or at least much more information than third parties. For example, those managers should have much more information than third parties about valuing X%, the chance of the project being successful; $Y, the value to investors from that success; $W, the loss from the project's failure; and F%, the chance of the firm failing as a result of the project's failure (i.e., effectively as a result of the $W loss).

The exception, however, is the value for $Z, the systemic costs if the firm fails. Government financial regulators are likely to know much more about valuing $Z than the firm's managers. That valuation should therefore be a public policy choice.

As a policy matter, there are several possible ways of valuing $Z. One approach would be to assume that the firm actually fails, with a systemically negative impact to the real economy. That would yield an indeterminate but

177 $Y, the value to investors from the project's success, could be measured by profit or whatever other metric the firm normally uses.

178 This equation has been simplified in two ways. First, it assumes that the only way a risky project could cause systemic costs is if the firm fails as a result of the project's being unsuccessful. Thus, managers would only need to engage in the assessment when deciding on a risky project whose failure could, either itself or in combination with other factors of which such managers are or should be aware, cause the firm to fail. This approach may miss other triggers of systemic risk, such as the negative effects of correlated portfolios. *Cf.* Schwarcz & Schwarcz, *supra* note 63, at 1595–97 (discussing the systemic impact of correlated investments by insurance companies). Second, the full equation would be [(1 - X% chance of project being unsuccessful) × F% chance of firm failing as a result of the project being unsuccessful × $Z resulting systemic costs] + [(X% chance of project being successful) × A% chance of firm failing as a result of the project being successful × $B resulting systemic costs]. However, A%, the chance of the firm failing as a result of the project being successful, is likely to be zero.

potentially huge number for $Z.[179] But that valuation approach could be misleading for at least two reasons. First, the failure of any given firm, no matter how large, would be unlikely by itself to be the sole cause of a major financial crisis; even Lehman Brothers' failure did not, by itself, cause the financial crisis.[180] Second, at least in the United States, the "living will" requirement under the Dodd-Frank Act is intended to minimize the systemic consequences of any given systemically important firm's failure.[181]

A more plausible way to value $Z would be to estimate the costs of the firm's failure to its immediate counterparties. The rationale for this approach is that first-order systemic consequences are more likely to result from a systemically important firm's failure than a full-blown financial collapse.[182] Such a cost estimate was done by analysts at J.P. Morgan for the possible failure of Long-Term Capital Management (LTCM), a large hedge fund whose losses in the Russian bond market brought it close to default; they found that LTCM's failure would have cost its larger bank-creditors $500–700 million each.[183]

Another plausible approach to valuing $Z would be to base its value on the estimated cost of a government bailout to avoid a systemic failure. Such an estimate could be required to be made by the government, for example,[184] as part of the process of designating a firm as a "systemically important financial institution" (SIFI),[185] and thereafter periodically updated by the government.

---

179 Estimates of the cost of the financial crisis are in the trillions. *See, e.g.*, Tyler Atkinson et al., *How Bad Was It? The Costs and Consequences of the 2007–09 Financial Crisis*, FED. RES. BANK DALL. STAFF PAPERS, July 20, 2013, at 1 (estimating the likely cost of the financial crisis to the United States as "greater than the value of one year's output," or greater than $15.5 trillion).

180 The shock caused by the Federal Reserve's failure to bail out Lehman Brothers was merely the final straw that triggered the collapse that led to the financial crisis. *See The Origins of the Financial Crisis: Crash Course*, *supra* note 3.

181 *See supra* note 49 and accompanying text.

182 The Dodd-Frank Act attempts to minimize systemic disruptions in the event of a failed systemically important financial institution.

183 ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT 190 (2000).

184 The process by which the government should make and periodically update such an estimate is beyond this Article's scope. One way it might do so, however, is by attempting to match the firm in question to the most "comparable company" that has received bailout money in the past, based on its tracking of data for bailout recipients in connection with the financial crisis. *See, e.g.*, *Bailout Recipients*, PROPUBLICA, http://projects.propublica.org/bailout/list/index (last updated Oct. 17, 2016) (providing a bailout list, which tracks every dollar and every recipient of federal government bailout money). Of course, no estimate would be perfect. *Cf.* ASWATH DAMODARAN, APPLIED CORPORATE FINANCE 565 (4th ed. 2015) (observing that a comparable companies approach is never based on exactly comparable companies).

185 Such an estimate should, ideally, take into account both domestic and foreign bailout costs. If the United States is designating a global firm as a SIFI, the bailout cost would include not only the United States bailout cost but also the costs of any necessary foreign bailouts.

3. Balancing Costs and Benefits

Next consider how managers should balance public costs and private benefits when deciding whether their firm should engage in a given risk-taking activity. Managers following a subjective approach would simply balance those costs and benefits the same way they would balance any other relevant costs and benefits when making a corporate governance decision.[186] But that subjective approach would again be subject to the drawbacks that the balancing process should be more transparent, that managers engaging in subjective balancing may be subject to peer pressure to assign more weight to investor profitability than to avoiding public harm, and that subjective balancing does not provide a clear safe harbor against litigation.

Managers following the ministerial safe harbor objective approach to assessing public costs and private benefits could also use that approach to balance those costs and benefits. Using the earlier terminology, they would be balancing ″ (the expected value of the project to the firm's investors) against $ (the expected value of the project's systemic costs), recognizing that a firm's wealth production to society should be assessed net of potential systemic costs. Such a balancing would be needed only when deciding on a risky project whose failure could, either itself or in combination with other factors of which such managers are or should be aware, cause the firm to fail.[187] Managers should be aware of such projects.[188]

To ensure that the balancing does not unduly weaken corporate wealth-producing capacity, it should be designed to yield an economically efficient result. From a strict economic efficiency standpoint, the project would be Kaldor-Hicks efficient if ″ exceeds $.[189] As a public policy matter, however, simple Kaldor-Hicks efficiency may be insufficient because the magnitude and harmful consequences of a systemic collapse, if it occurs, could be devastating. When balancing the costs and benefits of activities that might pose

---

186 *See supra* note 172 and accompanying text.

187 *See supra* note 178 and accompanying text. Managers making this determination and the other determinations contemplated by a public governance duty would be protected, of course, by the business judgment rule. *See infra* notes 206–25 and accompanying text.

188 Armour & Gordon, *supra* note 37, at 69 (observing that "it is surely the board's responsibility to identify those risks which are of a magnitude and kind as to threaten the firm's stability").

189 Kaldor-Hicks efficiency is the practical standard used by economists. ROBIN PAUL MALLOY, LAW IN A MARKET CONTEXT: AN INTRODUCTION TO MARKET CONCEPTS IN LEGAL REASONING 190 (2004). A project is Kaldor-Hicks efficient if its overall benefits exceed its overall costs, regardless of who bears the costs and who gets the benefits. *Id.* Kaldor-Hicks efficiency implicitly assumes that the distribution of benefits and costs is not controlled by the party—in our case, a firm's managers—also controlling the decision whether to engage in the project. *Id.* at 190–91. But those managers do not completely control the distribution of benefits; the public usually benefits, at least indirectly, from corporate risk-taking that benefits investors.

great harm, policymakers normally apply a precautionary principle.[190] "The strongest form of the precautionary principle"—under which "the potential for great harm justifies *any* regulatory intervention, and/or that the proponent of an activity must conclusively demonstrate that the activity is safe before it is allowed"[191]—should not, however, apply to corporate decision-making because it could stymie much reasonable risk-taking, thereby weakening corporate wealth-producing capacity.

It may be more appropriate to apply a weaker form of the precautionary principle, which would merely require "a margin of safety" to demonstrate that a given risk-taking activity is justified.[192] Under this weaker form of the precautionary principle, engaging in a project for which " considerably exceeds $ should not constitute excessive risk-taking.[193] This formulation would not completely prevent risk-taking that causes systemic externalities. It should, however, reduce that risk-taking by including systemic externalities in the corporate governance balancing, thereby also shaping corporate governance norms to begin to take the public into account.[194]

In examining how to apply this approach, assume for illustrative purposes[195] that a systemically important firm's bailout cost ($Z) would be $500 million and that the firm's managers estimate the other values as follows:

X% (the chance of the project being successful) = 80%.

$Y (the value to investors from that success) = $50 million.

190 Hilary J. Allen, *A New Philosophy for Financial Stability Regulation*, 45 LOY. U. CHI. L.J. 173, 191 (2013) (observing that precautionary principles generally direct "regulators to err on the side of regulating an activity when the outcome of that activity is uncertain, but potentially irreversible and catastrophic"). Although precautionary principles have been mostly applied in assessing environmental regulation, they also can have application to financial regulation. *Id.* at 191–92; *see also* JAMES SALZMAN & BARTON H. THOMPSON, JR., ENVIRONMENTAL LAW AND POLICY 16 (2d ed. 2007); Saule T. Omarova, *License to Deal: Mandatory Approval of Complex Financial Products*, 90 WASH. U. L. REV. 63, 84 (2012) ("[A]dopting and operationalizing the general *concept of precaution* in the context of post-crisis financial systemic risk regulation may be a worthwhile, and even necessary, exercise."); Schwarcz, *supra* note 7, at 234–35 (applying a precautionary principle to cost-benefit balancing involving systemic risk).

191 Allen, *supra* note 190, at 195.

192 *See* Cass R. Sunstein, *Beyond the Precautionary Principle*, 151 U. PA. L. REV. 1003, 1014 (2003) (discussing this form of the precautionary principle, under which "[r]egulation should include a margin of safety, limiting activities below the level at which adverse effects have not been found or predicted").

193 The margin of safety, in other words, is that " does not merely exceed but *considerably exceeds* $. To provide more of a safe harbor for managers, the regulatory language of the public governance duty could specify a percentage that is deemed to provide that margin.

194 *Cf.* Lee, *supra* note 81, at 124 (observing that "provisions embedded within corporate [governance] law might influence the managers' conception of their role, with the result that the norms underlying such provisions are capable of guiding managers even within the gaps left by legal enforcement mechanisms").

195 These values are solely illustrative. They rely on no hard empirical data, and a quantitative analysis is no better than its assumptions.

$W (the loss from the project's failure) = $20 million.

F% (the chance of the firm failing as a result of the project's failure) = 10%.

Applying these values yields the following:

" (expected value of the project to the firm's investors)

= [(80% chance of project being successful) × $50 million value to investors from that success] - [(20% chance of project being unsuccessful) × $20 million loss from that failure]

= $36 million

$ (expected value of the project's systemic costs)

= (20% chance of project being unsuccessful) × 10% chance of firm failing as a result of the project being unsuccessful × $500 million resulting systemic costs

= $10 million

If these values are realistic, " ($36 million) would considerably outweigh $ ($10 million). Managers of a systemically important firm that undertake this project would not be engaging in excessive risk-taking.

Much will depend on valuing $Z, the systemic costs if the firm fails. If $Z were $1.5 billion, rather than $500 million, the expected value of the project's systemic costs would equal $30 million. Managers of a systemically important firm that undertake the project might then be engaging in excessive risk-taking because " ($36 million) would not considerably outweigh $ ($30 million).

Because this balancing includes a margin of safety against systemic risk, it could reduce a firm's wealth production from a given project that is not undertaken. Nonetheless, the net overall wealth production to society, after subtracting systemic costs, should be increased.[196]

4. Enforcing a Public Governance Duty

Who should enforce a public governance duty? Under existing corporate governance law, shareholder derivative suits are the primary enforce-

196 The balancing also should satisfy what at least one leading civil law scholar characterizes as the burden that should be met in order for financial regulation to favor general welfare over corporate governance autonomy. *See* Matthias Haentjens, *Party Autonomy, Public Policy and European Bank Insolvency Law*, (Hazelhoff Centre for Fin. Law, Research Paper Series No. 7, 2015). In connection with examining bank crisis management measures under the Dutch Intervention Act, Professor Haentjens observes that private autonomy is a "fundamental principle" of European Union law. *Id.* at 9. Nonetheless, he argues that "public welfare may take priority over party autonomy" if the regulation protecting public welfare (1) unequivocally serves the public welfare, (2) proportionately and optimally balances public welfare against party autonomy, and (3) explicitly states that it is applying the balancing. *Id.* at 11–12. This Article's public governance duty should meet all of these conditions.

ment mechanism. Shareholders would have no interest, however, in suing managers of their firm for externalizing systemic harm. Therefore, the government, by default, at least should have the right to enforce the public duty.

The government, however, may be unable to effectively monitor a firm's internal compliance with the public governance duty until the firm fails, when systemic consequences may be irremediable. To facilitate better monitoring, regulation implementing a public governance duty should include whistleblower incentives,[197] including anti-retaliation protection for managers or others involved in the risk assessment who inform government officials of their firm's noncompliance[198] and possibly also monetary rewards.[199] Regulation implementing a public governance duty might even impose an obligation on managers involved in the risk assessment to inform government officials of their firm's noncompliance.[200]

Another way to facilitate better monitoring, and more specifically enforcement, of the public governance duty would be to incentivize members of the public themselves. Qui tam suits under the False Claims Act,[201] the primary litigation tool for combating fraud against the United States government, constitute a strong precedent for this. That Act permits private citizens to sue alleged defrauders in the name of the government.[202] If the

---

197 The Sarbanes-Oxley Act (SOX) and the Dodd-Frank Act already protect whistleblowers in the financial industry to some extent, including providing for anti-retaliation provisions.

198 Informing government officials of one's firm's noncompliance is called external reporting. In principle, whistleblowers who engage in internal reporting—informing someone within the firm, such as an employment supervisor—should also be protected. *Cf.* Orly Lobel, *Linking Prevention, Detection, and Whistleblowing: Principles for Designing Effective Reporting Systems*, 54 S. TEX. L. REV. 37, 41 (2012) ("[A]n important principle for designing reporting systems is that, under most circumstances, attempts to resolve compliance issues should first be made internally. Only if internal reporting fails or is deemed impractical should external reporting to an administrative agency or another outside authority be encouraged."). Managers involved in the risk assessment associated with the public governance duty, however, will already be the most senior managers. *See supra* text accompanying note 8.

199 The Dodd-Frank Act, for example, offers monetary incentives to whistleblowers and allows them to commence actions in federal court without first seeking administrative relief. *See* 15 U.S.C. § 78u-6(b) (2012); *id.* § 78u-6(h)(1)(B). A whistleblower who prevails in court may receive up to twice the amount of wages lost due to retaliation, as well as attorneys' fees and ten percent to thirty percent of any cash recovered by the SEC based on the whistleblower report. *See id.* § 78u-6(b).

200 Managers complying with this obligation should logically receive anti-retaliation protection. However, in some statutes, such as the Whistleblower Protection Act, a manager who reports wrongdoing as part of his "duty" may be excluded from anti-retaliation protections if the reporting is made in the ordinary course of the manager's duties. *See* Yuval Feldman & Orly Lobel, *The Incentives Matrix: The Comparative Effectiveness of Rewards, Liabilities, Duties, and Protections for Reporting Illegality*, 88 TEX. L. REV. 1151, 1167 (2010).

201 31 U.S.C. §§ 3729–33 (2012).

202 *Id.* § 3730(c)(3).

suit is successful or settled, the citizen-plaintiff is entitled to thirty percent of the award or settlement, plus costs and attorneys' fees.[203]

Qui tam lawsuits raise a standing question; the citizen-plaintiff "suffers no injury" and thus would appear to "lack the 'injury in fact' required to create Article III standing" under the United States Constitution.[204] Nonetheless, the Supreme Court has found standing through a somewhat circular argument—that the Act's partial assignment of the government's claim to the citizen-plaintiff provides a sufficient stake in the outcome to create Article III standing.[205]

That same circular argument could justify citizen standing to sue to impose personal liability on managers who breach their public governance duty, if those citizen-plaintiffs were entitled to a percentage of the award or settlement. Moreover, those citizen-plaintiffs would have an additional standing claim: as members of the public, they would be directly harmed by a systemically important firm's collapse.

Assuming that regulation implementing a public governance duty allows qui tam lawsuits, regulators should provide for an ongoing study of those lawsuits to ensure they do not overwhelm the courts or discourage good people from serving as managers.

5. Business Judgment Rule as a Defense

A critical question concerns the business judgment rule as a defense to liability. In the traditional corporate governance context, managerial decisions—including risk-taking decisions—are protected to some extent by this rule, which presumes that managers should not be personally liable for harm caused by negligent decisions made in good faith and without conflicts of interest—and in some articulations of the business judgment rule, also without gross negligence.[206] Weighing the goals of protecting the public against systemic externalities and encouraging the best people to serve as managers, to what extent should managers performing their public governance duty have the protection of that rule?

One of the business judgment rule's primary justifications[207] is an attempt to balance somewhat similar goals: protecting investors against

203 David Freeman Engstrom, *Private Enforcement's Pathways: Lessons from Qui Tam Litigation*, 114 COLUM. L. REV. 1913, 1944 (2014).

204 Richard A. Bales, *A Constitutional Defense of* Qui Tam, 2001 WIS. L. REV. 381, 384 (footnote omitted).

205 *Id.* (citing Vt. Agency of Nat. Res. v. United States *ex rel.* Stevens, 529 U.S. 765, 777–78 (2000)).

206 Christine Hurt, *The Duty to Manage Risk*, 39 J. CORP. L. 253, 258 (2014). *But cf. In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 65 (Del. 2006) (stating that "grossly negligent conduct, without more, does not and cannot constitute a breach of the fiduciary duty to act in good faith").

207 The business judgment rule's other primary justification is that the exercise of managerial business judgment is inappropriate for court review. Hurt, *supra* note 206, at

losses, and encouraging the best managers to serve.[208] Even though the business judgment rule can reduce investor protection, that reduction is seen as a necessary cost. Because managers cannot always precisely predict the consequences of their corporate governance decisions, some decisions that appear correct when made can result in investor harm. Without the business judgment rule's protection, competent managers would be exposed to liability,[209] discouraging the quality of people who will consider serving as managers.[210]

In a public-governance-duty context, consider how to balance the parallel goals of protecting the public against systemic externalities and encouraging the best managers to serve. The first goal, protecting the public against systemic externalities, should be more important than protecting investors against losses because systemic harm can be widespread and devastating.[211] The second goal, encouraging the best managers to serve, should also be more important; managers may find it even more difficult to precisely predict the public governance consequences of their decisions because it is harder to predict systemic than ordinary consequences[212] and also harder to predict consequences to the public than to the firm and its investors.[213] Managers therefore may need more encouragement to serve.

Because there would be increased importance for each of these competing goals in a public-governance-duty context, the business judgment rule

---

259–60. This justification should be as applicable in a public-governance-duty context as in a traditional corporate governance context.

208 *See, e.g.*, Ryan Scarborough & Richard Olderman, *Why Does the FDIC Sue Bank Officers? Exploring the Boundaries of the Business Judgment Rule in the Wake of the Great Recession*, 20 FORDHAM J. CORP. & FIN. L. 367, 377 (2015) (explaining that a typical justification for business judgment rule protection is fear that qualified individuals will refrain from serving as managers due to the significant liability exposure).

209 *Cf.* MELVIN ARON EISENBERG & JAMES D. COX, BUSINESS ORGANIZATIONS: CASES AND MATERIALS, 625–26 (unabr. 11th ed. 2014) (explaining that due to hindsight bias, people often erroneously treat decisions that have bad results as bad decisions).

210 *Cf.* William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of* Van Gorkom *and Its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV. 449, 455 (2002) (explaining the highly disproportionate incentives: liability for an imprudent decision could be in the millions, whereas outside directors rarely receive fees commensurate with that level of risk); Scarborough & Olderman, *supra* note 208, at 377 (arguing that even management salaries pale compared to the huge potential liability managers face after a crisis). A related justification is that the business judgment rule encourages appropriate levels of risk-taking. *Id.* at 378–79. Without that rule's protections, managers may be unduly risk-averse, thereby avoiding risky but socially desirable economic projects. Allen, Jacobs & Strine, *supra*, at 455.

211 *See supra* note 15 and accompanying text (observing that systemic externalities damage the economy and harm the public); *supra* note 179 (estimating the likely cost of the financial crisis in the trillions). Also, members of the public, unlike investors, cannot mitigate their harm by voting to replace managers or selling securities.

212 *Cf.* Anabtawi & Schwarcz, *supra* note 40, at 93–96 (observing, among other things, that we do not yet know enough about systemic shocks to prevent their transmission).

213 *Cf.* Friedman, *supra* note 87 (arguing that managers are experts in running the company, not experts in improving social welfare).

should still be needed to help balance those goals.[214] The next question is whether the business judgment rule should therefore apply to performance of a public governance duty the same way it applies to performance of traditional corporate governance duties.

At least in a traditional corporate governance context—in which the first competing goal is protecting investors against losses, not protecting the public against systemic harm—scholars have rejected arguments to weaken the business judgment rule for managers who engage their firms in excessive risk-taking. A weaker rule, they argue, would require courts to exercise inappropriate discretion, and it should be up to shareholders to evaluate corporate risk through their investment decisions, not through litigation.[215] In a public-governance-duty context, courts likewise should not be required to exercise inappropriate discretion. However, the argument that it should be up to shareholders to evaluate corporate risk through their investment decisions would be inapplicable because systemic externalities primarily affect the public, not shareholders.[216]

Applying these scholars' arguments to a public-governance-duty context, it should be acceptable to weaken the business judgment rule for managers who engage their firms in excessive systemic risk-taking if that weakening would not require courts to exercise inappropriate discretion or discourage the best people from serving. Scholars who have examined corporate governance from the standpoint of systemic harm likewise argue that "the case for business judgment protection" is weaker.[217] This Article next argues that the public interest should in principle require a modest weakening of the business judgment rule, if such weakening would not require courts to exercise inappropriate discretion or discourage the best people from serving. It then proposes how, consistent with those goals, the business judgment rule should be weakened, and also shows why the proposed weakening would be consistent with the business judgment rule's actual application in at least some states, including Delaware.

The public interest should require a modest weakening of the business judgment rule because public harm breaches one of the basic assumptions of that rule's application—that there be no conflict of interest.[218] The interest of a manager who holds significant shares or interests in shares, or whose compensation or retention is dependent on share price, is aligned with the

214 Recall that the business judgment rule's other primary justification should be as applicable in a public-governance-duty context as in a traditional corporate governance context. *See supra* note 207.

215 *See* Hurt, *supra* note 206, at 259–60; Robert T. Miller, *Oversight Liability for Risk-Management Failures at Financial Firms*, 84 S. CAL. L. REV. 47, 120–21 (2010).

216 Recall that shareholders generally want their firms to take potentially profitable risks, regardless of the possible systemic impact. *See supra* note 6 and accompanying text.

217 Armour & Gordon, *supra* note 37, at 39. They make this argument on the basis that "diversified shareholders [then] want managers to take *less* risk." *Id.* Professors Armour and Gordon also observe that "[d]irector liability is not an innovation in the control of risk-taking by financial institutions." *Id.* at 62.

218 *See supra* note 206 and accompanying text.

firm's shareholders, not with that of the public. To that extent, the manager would have a conflict of interest.[219] Most managers are conflicted in that way; they should not be given quite the same absolute deference that the business judgment rule gives non-conflicted managers.

So how should the business judgment rule be weakened without requiring courts to exercise inappropriate discretion or discouraging the best people from serving as managers? One solution would be to prevent conflicted managers who are grossly negligent—that is, who fail to use even slight care in assessing systemic harm to the public—from using the rule as a defense. Technically, this solution does not even change the business judgment rule; it merely applies the gross negligence standard that is articulated as part of that rule, though rarely utilized with any rigor.[220] Moreover, because courts routinely review whether other types of actions are grossly negligent, they should not find it "inappropriate" or impractical to review corporate risk-taking actions under a gross negligence standard. As a practical matter, furthermore, managers who follow a reasonable procedure to balance public costs and private benefits—such as the procedure discussed in this Article[221]—should be protected.[222] That would effectively conform the business judgment rule's public-governance-duty application to a duty of process care, the standard commonly used in the United States.[223]

The requirement that managers use at least slight care in assessing systemic harm to the public would also be consistent with the business judgment rule's actual application in at least some jurisdictions, including

219 *Cf.* Avgouleas, *supra* note 66, at 19 (arguing that "where managerial rewards are contingent on shareholder returns, this naturally places limits on analyzing shareholders and managers as distinct stakeholder groups within banks"). I recognize that courts applying the business judgment rule usually look for conflicts of interest between managers, on the one hand, and the firm and its shareholders, on the other hand. Logically, however, if—as this Article argues—the managers should also have a duty to the public, then the notion of conflicts should be broadened to include conflicts between managers, on the one hand, and the public, on the other hand.

220 Although gross negligence is articulated as part of the business judgment rule, directors usually are not subjected to monetary damages for violating their duty of care, even when they are grossly negligent. *See, e.g.*, Carter G. Bishop, *Directorial Abdication and the Taxonomic Role of Good Faith in Delaware Corporate Law*, 2007 MICH. ST. L. REV. 905, 911; Jesse W. Markham, Jr., *The Failure of Corporate Governance Standards and Antitrust Compliance*, 58 S.D. L. REV. 499, 502 (2013) (observing that although it is included in the duty of care, gross negligence "has almost no place in the life of a board member of a public company because every state of the Union has enacted so-called 'exculpation' enabling laws that permit corporations to excuse their boards of any duty of care").

221 *See supra* subsections III.B.1, III.B.2.

222 *See infra* Appendix, § 5(a) of the proposed Public Governance Duty Act, which provides this safe harbor.

223 *See, e.g.*, Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000) (stating that due care in the corporate decisionmaking context is process due care only, not substantive due care); *In re* Caremark Int'l, Inc. Derivative Litig., 698 A.2d 959, 967–68 (Del. Ch. 1996) (explaining that the business judgment rule is process oriented and informed by a deep respect for all good faith board decisions).

Delaware, that do not formally articulate a gross negligence standard as part of the rule. Delaware, for example, disallows business-judgment-rule protection for managers who act in "bad faith,"[224] which is broadly defined as including conduct that "is *known to constitute* a violation of applicable positive law,"[225] which in turn is interpreted to include a manager failing to take "steps in a good faith effort to prevent or remedy" such a violation.[226] A manager's failure to use even slight care when assessing systemic harm to the public under a legally mandated public governance duty would appear to be bad faith under those interpretations.

6. Protecting Managers Under D&O Liability Insurance

The final question is the extent to which managers who become subject to liability for breaching the public governance duty should be protected under D&O liability insurance, which indemnifies managers against personal liability. Although D&O liability insurance will be needed to incentivize good managers and also to help ensure that sufficient funds are available to properly incentivize private-action lawsuits, it might compromise the deterrent effect of imposing personal liability.[227] Furthermore, because the harm resulting from systemic harm is open-ended,[228] insurers may be reluctant to offer D&O insurance covering breaches of the public governance duty. At least one possible solution to these concerns would be to specify a limit on the amount of the claim that could be imposed for breaching the public governance duty and, like a deductible, to require managers to be personally liable for some percentage of that amount.[229]

The discussion above is normative, attempting to neutrally balance competing goals. Under United States law, however, regulators are technically required "to mitigate risks to the financial stability of the United States" without consideration of costs and benefits.[230] That law could be interpreted to

224 *See In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 755 (Del. Ch. 2005) (explaining that "[t]he presumption of the business judgment rule creates a presumption that a director acted in good faith" and that "[t]he good faith required of a corporate fiduciary includes . . . duties of care and loyalty").

225 Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1051 n.2 (Del. Ch. 1996).

226 *Caremark*, 698 A.2d at 971.

227 *Cf.* Richard MacMinn et al., *Directors, Directors and Officers Insurance, and Corporate Governance*, 35 J. INS. ISSUES 159, 165 (2012) (observing that "[t]he major criticism of corporate purchase of D&O insurance is that it creates moral hazard problems for" the managers covered by such insurance).

228 Armour & Gordon, *supra* note 37, at 69 (indicating that systemic losses raise open-ended director liability because they "cannot readily be quantified").

229 The Appendix's proposed Public Governance Duty Act accomplishes this in §§ 4(a) and 5(b) thereof. *Cf.* Armour & Gordon, *supra* note 37, at 69 (arguing that capping director liability by reference to income "will in most cases strike a balance between the desire to enhance deterrence while avoiding strong disincentives to director service by the most qualified").

230 BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, *supra* note 8, at 13; *see supra* note 64.

favor the first competing goal (protecting the public against systemic externalities) over the second (encouraging the best managers to serve).[231]

Conclusion

Although corporate risk-taking is economically necessary and even desirable, it can sometimes be harmful. There is widespread agreement that excessive corporate risk-taking was one of the primary causes of the systemic economic collapse that became the 2008–2009 financial crisis. Most financial regulation since the crisis is therefore directed at reducing excessive risk-taking by systemically important firms. That regulation usually focuses on aligning managerial and investor interests, on the assumption that investors generally would oppose excessively risky business ventures.

This Article argues that assumption is flawed. What constitutes "excessive" risk-taking depends on the observer; risk-taking is excessive from a given observer's standpoint if, on balance, it is expected to harm that observer. As a result, the law inadvertently allows systemically important firms to engage in risk-taking ventures that are expected to benefit the firm and its investors but, because much of the systemic harm from the firm's failure would be externalized onto other market participants as well as onto ordinary citizens impacted by an economic collapse, harm the public.

Pragmatically, regulators cannot control the myriad harmful externalities that result from corporate risk-taking. But excessive risk-taking that causes the failure of a systemically important firm could trigger a domino-like systemic collapse of other firms or markets, leading to widespread unemployment and poverty.[232] Regulation should try to control that risk-taking. Post-financial-crisis regulation attempts to control that risk-taking without interfering with corporate governance because financial regulation of corporate governance is thought to weaken the wealth-producing capacities of the firm. That sort of substantive financial regulation is certainly important. The Article shows, however, that it is, and inevitably will be, insufficient to control the excessive corporate risk-taking that causes systemic externalities.

The Article then examines whether regulating corporate governance could help to control that risk-taking, without unduly weakening corporate wealth-producing capacity. It concludes that managers of systemically important firms should not only have their traditional corporate governance duty to investors but also a duty—which the Article calls a "public governance duty"—not to engage in excessive risk-taking that could systemically harm the public. Such a duty would help to align private and public interests. It also would help to correct another critical regulatory failure—that substantive financial regulation usually lags financial innovation. That regulatory lag occurs because substantive financial regulation often depends on regulators

231 That law should not fully trump the first competing goal over the second because protecting the public against systemic externalities requires at least reasonably competent managers.

232 *See supra* note 12 and accompanying text.

precisely understanding the particular design and structure of financial firms, markets, and other related institutions at the time the regulation is promulgated. The problem, though, is that the design and structure are constantly changing. The public governance duty, in contrast, would overcome that time lag. If the firm is proposing to engage in a risky project that represents financial innovation, its managers either have—or to fulfill their governance duties, should try to obtain—the most current information about the innovation and its consequences.

The proposed public governance duty is designed to avoid weakening corporate wealth-producing capacity.[233] The duty merely requires managers of systemically important firms to price in potential systemic costs when deciding on risky projects whose failure could cause the firm to fail. This recognizes that a firm's wealth production to society should be assessed net of systemic public harm. The Article's analysis of the public governance duty also informs the larger debate over corporate governance models. The analysis shows how such a duty would fit within corporate governance legal theory. It also explains why systemic externalities should count in limiting corporate governance autonomy (and freedom of contract).

Because the public governance duty is intended to have minimal impact on existing corporate governance, this Article also examines such practical concerns as how the duty should be legally imposed, how managers should assess and balance the public costs and private benefits of a risk-taking activity, how the duty should be enforced, and to what extent managers performing the duty should have the traditional protection of a business judgment rule as a defense to liability. The last issue is especially significant because qualified managers are unlikely to want to serve without that protection.

The Appendix below proposes a Public Governance Duty Act designed to implement the goals set forth in the Article.[234] Such a public governance duty should significantly reduce, but it could not completely prevent,[235] the excessive risk-taking that causes systemic externalities. Even if imperfect, however, that duty should constitute an important first step[236] towards

---

233 Read literally, however, the Dodd-Frank Act imposes a mandate on United States regulators to reduce systemic externalities regardless of the costs of doing so. *See supra* notes 230–33 and accompanying text. This Article—and regulators generally—eschew such an austere and unrealistic approach.

234 In the United States, certain of those goals might be able to be implemented without the need for new legislation. *See supra* notes 167–70 and accompanying text (explaining that the Federal Reserve Board requires risk committees of systemically important financial firms to consider risks to the firm, not to the public; but noting § 165(h) of the Dodd-Frank Act might already provide the Federal Reserve Board with a broad enough mandate to require those committees to also consider systemic risks to the public).

235 *See, e.g.*, *supra* note 178 and accompanying text (discussing simplifying assumptions); *supra* notes 179–85 and accompanying text (discussing the difficulty of valuing $Z, the systemic costs if the firm fails); and *supra* note 184 (explaining why "no estimate [of $Z] would be perfect").

236 There could be even weaker first steps. For example, rather than imposing a public governance "duty," government could simply legislate a public governance "right" that

shaping corporate governance norms to begin to take the public into account.[237]

would permit, but not require, managers to take into account potential systemic harm. State constituency statutes sometimes take that approach. *See supra* note 160 and accompanying text (discussing the Pennsylvania constituency statute). Managers who then vote to favor public over investor interests would not necessarily be violating their state law corporate governance duties.

237 This Article does not directly engage the broader questions of whether corporate governance law should take into account other public interests, such as climate change and environmental harm or non-systemic economic harm, when traditional forms of regulation are insufficient. In separate articles, I use this Article's conceptual analysis as a stepping-stone to address these broader questions. I also address the possibility of designating certain managers specifically to act in the public interest in lieu of modifying the corporate governance duties of regular managers. *Cf. supra* note 112 (observing that an alternative to imposing a public governance duty on a firm's managers might be to designate a public-advocate manager whose primary duty would be to represent the public, preserving the other managers' traditional duties with one exception: in any decisionmaking, the other managers would have the right to take into account the public advocate's viewpoint).

APPENDIX: MODEL REGULATORY LANGUAGE FOR A PUBLIC GOVERNANCE DUTY[238]

Public Governance Duty Act

SECTION 1. TITLE

(a) This Act may be cited as the "Public Governance Duty Act."

SECTION 2. DEFINITIONS

Except as otherwise specifically provided in this Act, the following definitions shall apply:

(1) The term "business judgment rule" means the legal presumption that a firm's managers should not be personally liable for harm caused by negligent decisions made in good faith and without conflicts of interest.

(2) The term "director" means a member of a systemically important firm's board of directors or such other senior manager who shares or otherwise has ultimate responsibility to manage the firm.

(3) The term "fail" means that a firm admits in writing its inability to pay its debts; or makes a general assignment for the benefit of creditors; or becomes subject to a bankruptcy, insolvency, winding-up, liquidation, or other similar case or proceeding; or otherwise ceases normal business operations due to financial distress.

(4) The term "public governance duty" has the meaning set forth in Section 3(a) of this Act.

(5) The term "systemically important firm" means a firm that has been designated as systemically important by [name of applicable governmental body that is authorized to make that designation].

SECTION 3. PUBLIC GOVERNANCE DUTY

(a) THE PUBLIC GOVERNANCE DUTY. In addition to the duties a director may have to shareholders or other stakeholders, each director of a systemically important firm has a duty ("public governance duty") not to engage the firm in risk-taking that, viewed at the time of such risk-taking and either itself or in combination with other factors of which such director is or should be aware, could reasonably cause the firm to fail[239] unless such director (1) first performs one of the processes set forth in subsection (b) of this

238 For an analysis of the process by which this proposed Public Governance Duty Act or alternative language stating a public governance duty could be implemented into law, see *supra* notes 159–70 and accompanying text.

239 *Cf. supra* notes 178, 187–88 and accompanying text (discussing the risk-taking for which managers should assess the public governance duty). Directors making this determination would be protected by the business judgment rule.

Section and (2) based thereon, determines that the firm should engage in that risk-taking.

(b) PROCESS. For each risk-taking described in subsection (a) of this Section, a director shall perform the process described in either subsection (b)(1) or subsection (b)(2) of this Section.

(1) The director shall assess and balance the benefits and costs of such risk-taking, including potential systemic harm to the public, in the manner such director would lawfully assess and balance any other relevant benefits and costs when making a corporate governance decision;[240]

(2) The director shall assess and balance the benefits and costs of such risk-taking, including potential systemic harm to the public, according to the following methodology: [the Act could insert here, for example, methodology extracted from this Article's text].[241]

SECTION 4. LIABILITY AND ENFORCEMENT

(a) LIABILITY. A director who violates the public governance duty shall be liable for up to [$250,000][242] per risk-taking.

(b) PUBLIC ENFORCEMENT. [Name of applicable governmental agency that is authorized to enforce this Act] (the "Agency") may enforce this Act by [insert appropriate administrative and/or judicial legal actions that may be taken to impose liability or to restrain a risk-taking for which a director has violated the public governance duty].[243]

(c) PRIVATE ENFORCEMENT. A person may bring a civil action to enforce this Act on behalf of and in the name of the Agency.[244]

(1) A copy of the complaint and written disclosure of substantially all material evidence and information the person possesses shall be served on the Agency. The complaint shall be filed in camera, shall remain under seal, and shall not be served on the defendant until the Agency elects whether to intervene and proceed with the action.

(2) The Agency shall elect whether to intervene and proceed with the action within sixty days after it receives both the complaint and the material evidence and information referenced in subsection (c)(1) of this Section. Before the expiration of that sixty-day period, the Agency shall (A) proceed with the action, in which case the action shall be conducted by the Agency, or (B) notify the court that it declines to take over the action, in which case the person initiating the action shall have the right to conduct the action.

---

240 *See supra* notes 170–72 and accompanying text.

241 *See supra* text accompanying notes 171–99.

242 This number is merely suggested. *Compare* text accompanying *supra* notes 201–03 (discussing how to incentivize qui tam actions) *with* section 5(b) of the Public Governance Duty Act (limiting director insurance coverage).

243 *See supra* notes 196–99 and accompanying text.

244 *See supra* notes 201–05 and accompanying text (discussing qui tam actions).

(3) If the Agency proceeds with the action, it shall have full responsibility for prosecuting the action, and shall not be bound by any act of the person bringing the action. Such person, however, shall receive at least [fifteen percent but not more than thirty percent][245] of the proceeds of the action or settlement thereof, depending upon the extent to which the Agency determines such person substantially contributed to the prosecution of the action.

(4) If the initiating person conducts the action because the Agency declined to take it over, such person shall have the right to the proceeds of the action or settlement thereof.[246] However, if the action is dismissed or the defendant otherwise prevails, the court may require such person to pay the defendant's reasonable attorneys' fees and expenses if the court finds that the action was clearly frivolous, clearly vexatious, or brought primarily for purposes of harassment.

SECTION 5. DEFENSES AND INSURANCE

(a) DEFENSES. This Act shall not restrict the availability of the business judgment rule as a defense to liability, provided a director claiming that defense either (A) uses at least slight care when performing the public governance duty or (B) in good faith performs the process set forth in subsection 3(b)(2) of this Act.[247]

(b) INSURANCE. A director who violates the public governance duty shall be personally liable for at least [ten][248] percent of any liability award or settlement against such director. Such personal liability may not be reimbursed, indemnified, or otherwise directly or indirectly paid or hedged by insurance (including directors and officers liability insurance) or any other means.[249]

SECTION 6. WHISTLEBLOWING RIGHTS AND OBLIGATIONS

(a) Each employee of a systemically important firm shall have the right, and each director of such a firm shall have the obligation, to report to the Agency any violation or potential violation of the public governance duty of which such employee or director has knowledge and to assist the Agency in an investigation of such violation.[250]

---

245 *Cf. supra* text accompanying note 203 (discussing citizen-plaintiff recovery in qui tam actions).

246 *See id.*

247 *See supra* notes 206–26 and accompanying text (discussing the requirement to use at least slight care as part of a business judgment rule defense).

248 This number is merely suggested. *Compare* text accompanying *supra* note 229 (discussing how much personal liability is needed to discourage violations of the public governance duty), *with* section 4(a) of the Public Governance Duty Act.

249 *See supra* notes 227–29 and accompanying text (discussing D&O insurance).

250 *See supra* notes 197–200 and accompanying text (discussing whistleblowing).

(b) An employee or director who acts in accordance with subsection (a) of this Section, (1) shall not, on account of such action, be liable to any person under any law, rule, or regulation or under any contract or other agreement, and (2) may not, on account of such action, be discharged, demoted, suspended, threatened, or harassed, directly or indirectly, or in any other manner discriminated against, by such employee's or director's firm or by any other person.[251]

(c) If the Agency finds, after notice and a hearing, that a director has willfully violated such director's obligation under subsection (a) of this Section, it may impose a civil penalty against such director of up to [$20,000].[252]

---

251 Section 4(b) of the Public Governance Duty Act might also offer monetary incentives to non-director employee whistleblowers, such as allowed under 15 U.S.C. § 78u-6(b) (2012) in a different context.

252 This number is merely suggested.

NATIONAL CONFERNCE OF BANKRUPTCY JUDGES

October, 2018

International Venue and Forum Shopping

Global Insolvency Proceedings for a Global Market: The Universalist System and the Choice of a Central Court

Jay L. Westbrook*

In this time of relative prosperity, large multinational companies are filing insolvency proceedings all over the world.[1] Restructuring is now part of the daily routine of global business—back then a bit more, at the moment a bit less, but always a stream of needed repairs. The overall challenge is to manage damaged enterprises across borders in a world governed by nation-states. In this Article, I suggest that we should enlarge our perspective to embrace not only the Model Law on Cross-Border Insolvency (Model Law),[2] but also the larger system of modified universalism that it both presupposes and anticipates.

---

* Benno C. Schmidt Chair of Business Law, The University of Texas School of Law. I am grateful to David Stevenson and Yanan Zhao, both Texas Law '18, for excellent research for this Article. It is based on a lecture given at the National University of Singapore, August 17, 2017, Distinguished Visitor Lecture Series, the Centre for Banking & Finance Law (CBFL). I am especially grateful to Professor Hans Tjio, Co-Director of the CBFL, for the opportunity to learn so much about developments in insolvency law in Singapore. Some of the same themes were part of a keynote address I gave at a Chicago-Kent College of Law conference, *Comparative and Cross-Border Issues in Insolvency Law*, November 30, 2017, admirably organized by Professor Adrian Walters.

1. At the time of writing, recent filings have included *In re* Premium Point Master Mortg. Credit Fund, Ltd., No. 1:18-BK-10586 (Bankr. S.D.N.Y. filed Mar. 1, 2018); *In re* PT Bakrie Telecom Tbk, No. 1:18-BK-10200 (Bankr. S.D.N.Y. filed Jan. 29, 2018); *In re* RCR Int'l Inc. and RCR Int'l Inc., No. 1:18-BK-10112 (Bankr. D. Del. filed Jan. 18, 2018); *In re* Bibby Offshore Servs. Plc, No. 1:17-BK-13588 (Bankr. S.D.N.Y. filed Dec. 20, 2017); *In re* CGG Holding (U.S.) Inc., No. 1:17-BK-11637 (Bankr. S.D.N.Y. filed June 14, 2017); *In re* Toys "R" Us, Inc., No. 3:17-BK-34665 (Bankr. E.D. Va. filed Sept. 19, 2017); *In re* Zetta Jet USA, Inc., No. 2:17-BK-21386-SK (Bankr. C.D. Cal. filed Sept. 15, 2017); *In re* Seadrill Ltd., No. 6:17-BK-60079 (Bankr. S.D. Tex. filed Sept. 12, 2017); *In re* Takata Americas, No. 1:17-BK-11372 (Bankr. D. Del. filed June 25, 2017) (seeking chapter 15 relief in aid of a Japanese proceeding); *In re* Ultra Petroleum Corp., 575 B.R. 361 (Bankr. S.D. Tex. 2017); *see also* Michael O'Boyle & Michael Perry, *Mexico's ICA Says Filed Pre-packaged Bankruptcy Plan*, REUTERS (Aug. 26, 2017), https://www.reuters.com/article/us-mexico-ica/mexicos-ica-says-filed-pre-packaged-bankruptcy-plan-idUSKCN1B604S [https://perma.cc/8NDV-VLLU].

2. U.N. COMM'N ON INT'L TRADE LAW (UNCITRAL), UNCITRAL MODEL LAW ON CROSS-BORDER INSOLVENCY WITH GUIDE TO ENACTMENT AND INTERPRETATION, U.N. Sales No. E.14.V.2 (2014) [hereinafter UNCITRAL MODEL LAW].

I. Background

As explained just below, I have argued that the text of the Model Law should be interpreted as a "systems" text consistent with its intended purpose as a major part of that international system. I expand the argument here to say that the needs of the system of modified universalism embodied in the Model Law should govern judicial action over an expanding pool of issues touching international insolvency. Those jurisdictions that have adopted texts or judicial principles similar to the Model Law should embrace a similar understanding, even if they do not adopt the Model Law itself.[3]

This Article discusses these key elements of the Model Law system:

1. At the heart of the system of modified universalism is the choice of a central court to coordinate a multinational case, so the discussion includes an analysis of the general rule for choosing the central court and important exceptions to that rule;
2. The "center of the debtor's main interests" (COMI) test best identifies the central court because the court's relationship to the debtor legitimates its actions as the jurisdiction with the strongest interest in the case;
3. Certain situations create exceptions to the COMI test or require supplementation of that test; and
4. Every multinational case requires real-time coordination and cooperation among jurisdictions, which in turn require an active judicial role in guiding professionals toward international communication and cooperation.

A. *"Systems" Texts*

When a binding legal text is adopted that has a purpose or rationale only if applied as part of a system, the courts should be active to resolve issues it does not squarely cover in a way that facilitates that system. To retain old doctrines or refuse to consider new issues may amount to obstruction of the system that the lawgiver meant to adopt.[4] In this Article, my central objective

---

3. A number of countries that have not adopted the Model Law nonetheless follow similar principles under the doctrine of "comity" or international cooperation. *See, e.g.*, Jay Lawrence Westbrook, *Chapter 15 at Last*, 79 AM. BANKR. L.J. 713, 721 & nn.50–53 (2005) (discussing German and Spanish bankruptcy law).

4. This Article is not the place to launch an extensive discussion of textualism, so I will merely note my disagreement with any doctrine that permits the courts to announce they will not move an inch beyond what a legal text requires even to further the policy that is reflected in the text. I must observe, however, that allegiance to such doctrines seems often to turn on judicial views about the underlying policy. For a juxtaposition of the ever-narrowing scope of "extraterritorial" effects of Congressional enactments with the constantly expanding boundaries of the Federal Arbitration Act in the United States, compare *In re* Ampal-Am. Isr. Corp., 562 B.R. 601 (Bankr. S.D.N.Y. 2017) (refusing to apply provisions of the Bankruptcy Code extraterritorially absent clear statutory intent), *with* Am. Express Co. v. Italian Colors Rest., 570 U.S. 228 (2013) (holding that the FAA does not

is to describe the needs of the global insolvency system as represented by the Model Law. As one consequence, I hope to advance our understanding of the Model Law as a systems law that should be interpreted in ways that advance the needs of the system. In a recent article, I outlined the systems analysis:

> One useful distinction that I have not found in the literature is the difference between a standards text and a system text. It seems plausible to divide international instruments into two broad categories: those that seek to establish international (or universal) standards and those that seek to establish an international system. . . .
>
> As a general proposition, it would seem that the international rule for the standards texts would usually be focused almost entirely on uniformity, so that states and individual actors could conform their conduct . . . to those international norms, and nations could be consistent in applying those norms. By contrast, uniformity would be an important but subsidiary goal for a system text. There the overriding need is for decisions that enable the international system to function as designed. Uniformity would certainly contribute to that goal, but would hardly be enough by itself.[5]

I concluded by proposing that "courts should determine if an international text establishes a system rather than standards; if so, it should adopt whatever [rule] best enables that system to achieve its intended ends."[6] In that analysis, the Model Law is a systems (institutional) text, while a text devoted to international rules (for example, about priority in insolvency distributions) would be a "standards" text. While any legal text must be applied as written, most texts require interpretation and occasionally the filling of an unintended gap that impedes the text's intended function. Understanding the needs of the global insolvency system helps both in applying the Model Law and in achieving the demands of modified universalism where the Model Law does not apply.[7] This Article starts with that understanding and proceeds from there.

B. *Goals of Global Insolvency Law*

In that context, we begin with the fundamental goals of insolvency law that are common to all of us: maximizing value for all stakeholders and

---

permit courts to invalidate a contractual waiver of class arbitration on the ground that the plaintiff's cost of individually arbitrating a federal statutory claim exceeds the potential recovery), and AT&T Mobility v. Concepcion, 563 U.S. 333 (2011) (invalidating a law that conditioned the enforcement of arbitration on the availability of class procedures because that law interfered with fundamental attributes of arbitration).

5. Jay Lawrence Westbrook, *Interpretation Internationale*, 87 TEMP. L. REV. 739, 750–53 (2015).

6. *Id.* at 750–51.

7. *See supra* notes 2–3 and accompanying text.

satisfying public policy in a fair allocation of that value.[8] Nations still differ substantially in defining the classes of stakeholders in an insolvency proceeding and in the allocation of value to each class,[9] but we are united in seeking to obtain as much value as possible and to achieve socially desirable ends in a fair and orderly process.

Neither of these goals can be fully realized unless a single collective insolvency proceeding extends over an entire market. Only in a single proceeding can all assets be assembled to be sold or recapitalized free of prior claims and value allocated fairly to all stakeholders.[10] Only a unified approach can produce predictable results that enhance the efficiency of market transactions based on a common understanding of the effects of insolvency.[11] For that very reason, the founders of the United States, in

---

8. *See* Jay Lawrence Westbrook, *Systemic Corporate Distress: A Legal Perspective*, *in* RESOLUTION OF FINANCIAL DISTRESS: AN INTERNATIONAL PERSPECTIVE ON THE DESIGN OF BANKRUPTCY LAWS 47, 55 (Stijn Claessens et al. eds., 2001) ("General agreement exists on the central purposes of insolvency law: maximizing asset values, providing equality of treatment for creditors and other parties with similar legal rights, preventing and undoing fraud, and providing commercially predictable results and transparent legal procedures.").

9. *See, e.g.*, JANIS P. SARRA, EMPLOYEE AND PENSION CLAIMS DURING COMPANY INSOLVENCY: A COMPARATIVE STUDY OF SIXTY-TWO JURISDICTIONS 9, 13 (2008) (finding that some nations use a priority system for employees, who are viewed as "particularly vulnerable claimants," and that many of those countries institute caps on the amounts of claims that are given priority).

10. *See* Jay Lawrence Westbrook, *A Global Solution to Multinational Default*, 98 MICH. L. REV. 2276, 2292–93 (2000) (explaining that a single bankruptcy proceeding can provide a unified approach to assembly and sales of assets, increase the possibility of reorganization, and ensure equality for stakeholders with similar legal rights around the world).

11. *Id.* at 2293 ("A single court would maximize asset values . . . by providing a unified approach to assembly and sale of assets as a whole. If it commanded a worldwide stay, it could most effectively protect those assets prior to sale."). *See also* Cambridge Gas Transp. Co. v. Official Comm. of Unsecured Creditors [2006] UKPC 26, [2007] 1 AC 508 (appeal taken from the Isle of Man) (reaffirming the universalist tradition of the English common law and recognizing pragmatism and realism that are integral features of the notion of "modified universalism"); McGrath v. Riddell (*in re* HIH Cas. & Gen. Ins. Ltd.) [2008] UKHL 21, [2008] 1WLR 852, [6]–[7], [30], [36] (appeal taken from Eng.) (advocating for the principle of universalism); World Bank Group [WBG], *Principles for Effective Insolvency and Creditor/Debtor Regimes*, at 20 (2016), http://documents.worldbank.org/curated/en/518861467086038847/pdf/106399-WP-REVISED-PUBLIC-ICR-Principle-Final-Hyperlinks-revised-Latest.pdf [https://perma.cc/4WWQ-GDZW] (discussing the objectives of effective insolvency systems); TRANSNATIONAL INSOLVENCY: GLOBAL PRINCIPLES FOR COOPERATION IN INTERNATIONAL INSOLVENCY CASES princ. 1–2 (AM. LAW INST. & INT'L INSOLVENCY INST. 2012) (outlining the objectives and aim of the Global Principles) [https://perma.cc/T7MS-CJV7] [hereinafter ALI–III GLOBAL PRINCIPLES]; Todd Kraft & Allison Aranson, *Transnational Bankruptcies: Section 304 and Beyond*, 1993 COLUM. BUS. L. REV. 329, 364 (1993) ("A system that brings together all the creditors, and all the debtors' property, for a single distribution is the most efficient and equitable system possible."); John Lowell, *Conflict of Laws as Applied to Assignments for Creditors*, 1 HARV. L. REV. 259, 264 (1888) ("[I]t would be better in nine cases out of ten that all settlements of insolvent debtors with their creditors should be made in a single proceeding, and generally at a single place[.]"); Jay Lawrence Westbrook, *Multinational Financial Distress: The Last Hurrah of Territorialism*, 41 TEX. INT'L L.J. 321, 324–25 (2006) ("To function effectively, bankruptcy law must have a reach co-extensive with the market

seeking to create a single national market, realized that one of the few specific powers that must be given to the new national government was the authority to make uniform national laws on the subject of bankruptcy.[12] Similarly, older writers asserted the "universalism" of insolvency law.[13]

It follows that the globalized marketplace of the twenty-first century requires a global insolvency proceeding. That should be our goal. However, because insolvency laws differ considerably around the world, and it is a technical and difficult area of law, that ideal will not be achieved for some time.[14] In light of that, an increasing number of courts and academics have come to accept a standard that I have suggested—"modified universalism"—which is universalism adapted to the political realities of differing laws in a world in which law is administered by nation-states.[15] The objective is to

in which it operates. It is for that reason that most bankruptcy laws are national in scope, even in countries like the United States where much commercial and property law is regional.").

12. U.S. CONST. art. I, § 8. *See* Dan J. Schulman, *The Constitution, Interest Groups, and the Requirements of Uniformity: The United States Trustee and the Bankruptcy Administrator Programs*, 74 NEB. L. REV. 91, 99–105 (1995) (discussing the original intent behind the bankruptcy power); Westbrook, *supra* note 10, at 2286–87 (noting that the Founders gave the national government the power to govern general defaults while reserving the commercial law-making power to states).

13. *See, e.g.*, J.H. DALHUISEN, 1 DALHUISEN ON INTERNATIONAL INSOLVENCY AND BANKRUPTCY 3-3, 3-11 (7th ed. 1986) (indicating that the need for coordination was becoming more widely recognized among nations and asserting that "full faith and credit" treaties have forwarded coordination in bankruptcy); JOSEPH STORY, COMMENTARIES ON THE CONFLICT OF LAWS 7–8 (Morton J. Horwitz et al., eds., Arno Press Inc. 1972) (1834) (proposing that the public welfare may necessitate exceptions to the general rule that the laws of one country are limited to that country); Lowell, *supra* note 11, at 264; Kurt Nadelmann, *Legal Treatment of Foreign and Domestic Creditors*, 11 LAW & CONTEMP. PROBS. 696, 709–10 (1946); Jay Lawrence Westbrook, *Theory and Pragmatism in Global Insolvencies: Choice of Law and Choice of Forum*, 65 AM. BANKR. L.J. 457, 458 (1991); *see also* FRIEDRICH CARL VON SAVIGNY, PRIVATE INTERNATIONAL LAW AND THE RETROSPECTIVE OPERATION OF STATUTES: A TREATISE ON THE CONFLICTS OF LAWS 257–64 (William Guthrie trans., 2d ed. 1880) (discussing the peculiar nature of bankruptcy and its implications on the conflict of laws); John D. Honsberger, *Conflict of Laws and the Bankruptcy Reform Act of 1978*, 30 CASE W. RES. L. REV. 631, 675 (1980) (discussing the trend toward harmonization between the bankruptcy systems of the United States and Canada); Stefan A. Riesenfeld, *The Evolution of Modern Bankruptcy Law*, 31 MINN. L. REV. 401, 415 & nn.95–97 (1947) (surveying classic leading scholarships in international insolvency law and theory of universality); Barbara K. Unger, *United States Recognition of Foreign Bankruptcies*, 19 INT'L L. 1153, 1183 (1985) (observing the U.S. courts' increasing recognition of foreign proceedings, which demonstrates a more cooperative universality view).

14. *See* JAY LAWRENCE WESTBROOK, CHARLES D. BOOTH, CHRISTOPH G. PAULUS & HARRY RAJAK, A GLOBAL VIEW OF BUSINESS INSOLVENCY SYSTEMS 232 & n.19 (2010) (discussing the practical obstacles faced by a unitary approach as a result of the disparities in the laws of various countries) [hereinafter WESTBROOK ET AL., A GLOBAL VIEW]; Westbrook, *supra* note 10, at 2299 (recognizing that to realize a universalist approach requires international consensus and would take a long time).

15. *See* Cambridge Gas [2006] UKPC 26 [16]–[20] (appeal taken from Isle of Man) (recognizing that English common law has traditionally believed the importance of universality in international insolvency proceedings and that the underlying principle of universality requires foreign courts' recognition and assistance); Rubin v. Eurofinance SA [2012] UKSC 46 [51] (appeal

produce results as close as possible to those that would emerge from a single global proceeding.

Modified universalism lies at the heart of the Model Law.[16] The traditional concept of "territorialism," or the "grab rule," has been largely abandoned.[17] Unlike territorialism, modified universalism requires a "central" proceeding that serves a coordinating role, as well as a sophisticated, policy-sensitive approach for choice of law.[18] The most important task of a system of modified universalism is to identify the jurisdiction that should host the central proceeding.

Under the Model Law, the "main" insolvency proceeding is the one opened at the debtor's center of main interests, or COMI.[19] The preferred result under the Model Law is that the main proceeding should be the central one that coordinates the global insolvency process. This Article discusses circumstances in which that might not be true or might not be entirely true.

II. A Moratorium with Global Effect

The purposes of insolvency law cannot be vindicated without court control of the affairs of a debtor.[20] To apply insolvency law properly to a

---

taken from Eng.) (accepting the "general principle of private international law . . . that bankruptcy (whether personal or corporate) should be unitary and universal." (quoting *In re* HIH [2008] UKHL 21, [6]–[7] (appeal taken from Austl.))); ALI–ILL GLOBAL PRINCIPLES, *supra* note 11, princ. 10; Jay Lawrence Westbrook, *Choice of Avoidance Law in Global Insolvencies*, 17 BROOK. J. INT'L L. 499, 517 (1991) ("[Modified universalism] accepts the central premise of universalism, that assets should be collected and distributed on a worldwide basis, but reserves to local courts discretion to evaluate the fairness of the home-country procedures and to protect the interests of local creditors.").

16. *See, e.g.*, Lynn M. LoPucki, *Global and Out of Control?*, 79 AM. BANKR. L.J. 79, 82–83, 86 (2005) (summarizing the history behind the promulgation of the UNCITRAL Model Law, which incorporated the universalists' "home country" concept); *see generally* UNCITRAL MODEL LAW, *supra* note 2.

17. *See* Jay Lawrence Westbrook, *Universalism and Choice of Law*, 23 PA. ST. INT'L L. REV. 625, 625 (2005) (noting that these traditional approaches have been replaced by modified universalism).

18. *See id.* at 631–32 (explaining that, under the modified universalism approach, courts should consider the usual choice of law factors like place of contracting, the parties' choice of law, principal place of business, principal location of assets, location of most creditors, and the like); *see also* WESTBROOK ET AL., A GLOBAL VIEW, *supra* note 14, at 238 (discussing how the degree of adaptability of insolvency laws in different jurisdictions affects modern universalism and choice of law).

19. UNCITRAL MODEL LAW, *supra* note 2, art. 17(2)(a); *see also* WESTBROOK ET AL., A GLOBAL VIEW, *supra* note 14, at 236 ("Under the lead of the European Union Regulation and the UNCITRAL Model Law it becomes nowadays increasingly accepted that the correct place for opening the main proceeding should be the center of the debtor's main interests.") (internal citations omitted); Susan Block-Lieb, *The UK and EU Cross-Border Insolvency Recognition: From Empire to Europe to "Going It Alone"*, 40 FORDHAM INT'L L.J. 1373, 1395–1400 (2017) (explaining the application of the COMI test to British and European laws); Lynn M. LoPucki, *Universalism Unravels*, 79 AM. BANKR. L.J. 143, 143 (2005) (describing the universalism approach under the Model Law as applying the COMI country's law to control a company's worldwide bankruptcy).

20. *See, e.g.*, Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEXAS L.

global market requires the power to halt collection efforts all over the world as quickly as possible to prevent the great loss of value that would result from a mad scramble for assets by creditors. Control is also necessary to ensure the allocation of that value in an orderly and fair way. The Model Law provides for an automatic moratorium or injunction upon recognition of a main proceeding by another jurisdiction.[21] The injunction provides the necessary cooperation by enjoining seizures by creditors, thus giving the courts control of the relevant assets in both the main and recognizing jurisdictions. The Model Law also permits interim injunctive relief prior to recognition.[22] However, the scope of this recognition injunction is not explicitly global and is subject to the constraints and limitations imposed under the law of the recognizing state,[23] so it is not a complete protection against creditor or debtor activity inconsistent with the necessary court control. That protection is also limited insofar as it may require some time to obtain relief in other jurisdictions after the filing of the main proceeding.

A better solution would be a worldwide injunction, or "stay" (in some countries a "moratorium"). No country in the world claims the power to impose a stay everywhere on the planet. But its closest approximation is what I would call an "indirect global stay," which is a stay that applies to any person (or legal entity) subject to the personal jurisdiction of a court and forbids that person from acting anywhere in the world in a way inconsistent with the court's insolvency moratorium.[24] Such a stay is limited because it applies only to persons subject to the court's personal jurisdiction, but it is global insofar as it restricts such persons' activities everywhere in the world.[25] While such a stay does not bind an actor not subject to personal jurisdiction in the country issuing the stay, it can block a large amount of debtor and creditor activity globally if the issuing court has personal

REV. 795, 823 (2004) (discussing the importance of control in enforcing the collective process of bankruptcy); Oscar Couwenberg & Stephen J. Lubben, *Corporate Bankruptcy Tourists*, 70 BUS. LAW. 719, 742 (2015) (noting that the global stay available in U.S. bankruptcy proceedings provides better protection of debtors' assets and therefore was one of the reasons foreign corporations were attracted to the idea of filing bankruptcy in the United States).

21. UNCITRAL MODEL LAW, *supra* note 2, art. 20(1)(a).

22. *See id.* art. 19(1) (allowing courts to grant urgent relief upon application for recognition of a foreign proceeding).

23. *See id.* art. 29 (noting that the Model Law does not necessarily import the consequences of the foreign law into the insolvency system of the enacting state but that the relief granted may be aligned with a comparable proceeding commenced under the law of the enacting state).

24. I offer this phrase because I have not seen a term used to describe this sort of effect that a national court may give to an insolvency moratorium.

25. *See* Jay Lawrence Westbrook, *Multinational Insolvency: A First Analysis of Unilateral Jurisdiction*, *in* NORTON ANNUAL REVIEW OF INTERNATIONAL INSOLVENCY 11, 17–18 (2009) (explaining the personal jurisdiction requirement for the U.S. Bankruptcy Court to exercise control over bankruptcy proceedings, and the court's power to have effects on debtors' assets and actions outside of the United States).

jurisdiction over major creditors of a given debtor. For example, such a stay issued in Manhattan as to Debtor Corporation would bind JPMorgan Chase, which is undoubtedly subject to the orders of the bankruptcy court in that place. Because U.S. law says the order constrains that bank everywhere in the world,[26] the stay may prevent a large amount of activity against Debtor Corporation's assets in which that very large lender might otherwise engage.

III. Control Countries

Because it depends on personal jurisdiction, a stay has its greatest effect when the issuing court is located in a country in which a number of major international creditors do substantial business and therefore are subject to the personal jurisdiction of that court.[27] A court in a country that is an economic backwater might not have personal jurisdiction over many important creditors in a given case, but a country located in a financial center may have great indirect power to constrain creditor activity everywhere.[28] The bankruptcy courts in Manhattan are a good example, given that a substantial percentage of the world's financial institutions do business there. I will call countries whose courts are in that position "control countries." Three of the

26. *See, e.g.*, U.S. Lines, Inc. v. GAC Marine Fuels Ltd. (*In re* McLean Indus.), 76 B.R. 291, 295–96 (Bankr. S.D.N.Y. 1987) (finding creditors subject to the U.S. court's jurisdiction and enforcing as to property in Hong Kong and Singapore a worldwide automatic stay). Bankruptcy is not the only area in which the United States sometimes issues injunctions that include conduct outside its borders. *See, e.g.*, United States v. First Nat'l City Bank, 379 U.S. 378, 410 (1965) (affirming the imposition of a temporary injunction in an action by the United States for foreclosure of a tax lien as against a Uruguayan corporation); *see also* Richmark Corp. v. Timber Falling Consultants, 959 F.2d 1468, 1482 (9th Cir. 1992) (contempt sanctions issued against a Chinese party for non-compliance with discovery order); *In re* Grand Jury Proceedings Bank of Nova Scotia, 740 F.2d 817, 829 (11th Cir. 1984) (contempt sanction issued against a Cayman Island party for non-compliance with discovery order); Rogers v. Webster, No. 84-1096, 1985 U.S. App. LEXIS 13968, at *9–10 (6th Cir. Oct. 22, 1985) (ordering delivery of stock certificates located in Canada to Michigan); *In re* Gaming Lottery Sec. Litig., 96 Civ. 5567 (RPP), 2001 U.S. Dist. LEXIS 1204, at *18–19 (S.D.N.Y. Feb. 13, 2001) (ordering delivery of bank accounts in Scotland to New York); Koehler v. Bank of Bermuda Ltd., 12 N.Y.3d 533, 541 (2009) (ordering delivery of stock certificates located in Bermuda to New York). Many other countries do the same. *See, e.g.*, David Capper, *Worldwide Mareva Injunctions*, 54 MOD. L. REV. 328, 329–30 (1991) (U.K. Mareva injunctions).

27. *See, e.g.*, Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, 474 B.R. 76, 81 (S.D.N.Y. 2012) (upholding bankruptcy court's extraterritorial application of the automatic stay, rendering a creditor's action in the Cayman courts void); *In re* Nortel Networks Inc., No. 09–10138–KG, 2011 WL 1154225, at *1 (D. Del. Mar. 29, 2011) (affirming bankruptcy court's order enjoining administrative proceedings against the debtor in the United Kingdom in a multinational company's bankruptcy proceeding); *In re* McLean Indus., Inc., 76 B.R. at 295–96. For a current sweeping example, see Order Restating and Enforcing the Worldwide Automatic Stay, *In re* Seadrill Ltd., No. 6:17-BK-60079 (Bankr. S.D. Tex. Sept. 13, 2017), ECF No. 91.

28. *See* Westbrook, *supra* note 25, at 17–18 ("[T]he effect of the automatic stay may be to block collection efforts anywhere in the world by any creditor that does business in the U.S., including most of the major international lenders, underwriters, and investors.").

countries that will often be in that position are the United Kingdom, the United States,[29] and now Singapore.[30]

While control countries may well serve as home to central proceedings for multinational insolvencies—that is, might host the central proceeding for a given case—their final insolvency judgments may be of limited value unless they are recognized and enforced in countries that have territorial control of the debtor's assets. The specific requirements for market-wide recognition are discharge (or nonenforcement) of prior debts and recognition of changes in title to property.[31] After a reorganization plan has been approved by a court with proper jurisdiction, only the debts recognized in the plan should be enforceable in any country.[32] Following either a reorganization or a liquidation, there must also be global acceptance of the effect of the proceeding on title to property, especially as to the results of sales.[33] If an insolvency-court judgment encounters substantial local

29. There may be some question about the extent of personal jurisdiction in such matters. *See* Daimler AG v. Bauman, 134 S. Ct. 746 (2014) (sharp limitation on general jurisdiction); Walden v. Fiore, 134 S. Ct. 1115 (2014) (limiting specific jurisdiction). This line of cases may suggest difficulty in obtaining jurisdiction over foreign entities in bankruptcy proceedings, but the Supreme Court has told us repeatedly that bankruptcy is an exceptional sort of legal procedure with special rules. In the area of the Tenth Amendment, for example, the Court has found that states may be subject to federal judgments in a way not possible in other sorts of federal lawsuits. *See* Cent. Va. Cmty. Coll. v. Katz, 546 U.S. 356, 362 (2006) ("Bankruptcy jurisdiction, at its core, is in rem."); Tenn. Student Assistance Corp. v. Hood, 541 U.S. 440, 447 (2004) ("The discharge of a debt by a bankruptcy court is similarly an in rem proceeding."). *See also* Jay Lawrence Westbrook, *Interpretation Internationale*, 87 Temple L. R. 739 at nn.37–39 (2015). The "in rem" analysis of those cases is especially applicable to the automatic stay.

30. *See* Companies (Amendment) Act 2017, § 211B(1)(d) (Sing.) (allowing Singapore courts to issue an order "restraining the commencement, continuation or levying of any execution, distress or other legal process against any property of the company"). This provision was added in the recent reform in which the Model Law was adopted. NAT'L ARCHIVES OF SINGAPORE, FACT SHEET ON THE COMPANIES (AMENDMENT) BILL 2017 AND LIMITED LIABILITY PARTNERSHIPS (AMENDMENT) BILL 2017, http://www.nas.gov.sg/archivesonline/data/pdfdoc/20170310004/Factsheet%20on%20CA%20and%20LLP%20Act%20amendments_media.pdf [https://perma.cc/3F23-HXHG].

31. *See* ALI-III GLOBAL PRINCIPLES, *supra* note 11, princ. 27.1 (requiring each administrator in parallel international insolvency proceedings to obtain court approval of any action affecting assets or operations in a particular jurisdiction if approval is required under the laws of that jurisdiction). As to discharge, a control country would be able to bind a number of creditors by a discharge injunction like that arising from a chapter 11 plan in the United States, but there would likely be many smaller local creditors and property owners who would not be bound. The result would be highly inefficient and litigious. The same thing would be true of property-rights rulings including the validity of sales. Of course, it may be possible in a given case to buy out all such creditors and owners at a reasonable cost. There might remain problems of public policy and judicial conflict, especially at the COMI.

32. *See, e.g., id.* princ. 37 & cmt. (recognizing a plan of reorganization adopted by a main proceeding under stated conditions, including notice).

33. *See id.* princ. 29, 36, 37 & comts. (demanding that each state assist and recognize the sales that generate maximum value for debtor's assets, and designating the reorganization plan adopted by a main proceeding as final and binding upon the debtor and every creditor when the issuing state

resistance to recognition and enforcement, the reorganization or sale may be a fiasco.

The need for a consensus on the standard for choosing a central court is actually increased as countries adopt an indirect global stay because its adoption will itself create a greater possibility of conflict among jurisdictions, especially control countries. Thus, a court who claims the role of the central court as to a debtor should seek to adopt standards that will encourage other courts to accept that court's jurisdiction as legitimate and to enforce the results obtained in the central court. Where that is true, efficient and effective coordination of international insolvency proceedings can be achieved.

IV. Choice of Central Court

A. Incorporation versus COMI

Some courts continue to look to the traditional notion that the central court should be the one presiding where a debtor company is incorporated.[34] A recent Scottish decision has strikingly highlighted the anomalies in the registration approach as applied in a globalizing world.[35] It adopted the common law idea that the law of the jurisdiction of incorporation controls the affairs of the corporation to apply Scotland's law to a thoroughly Indian company. In so doing, it stated that it was following the Privy Council in the *Singularis* case but ignored the Model Law, which applied in Scotland as it did not in *Singularis*.[36]

The Pacific Andes bankruptcy, discussed below, further illustrates the defects of the incorporation approach: diffusing control of a multinational insolvency and adding to expense and difficulty. It increases the likelihood of wasteful expense and inefficient results. It is noteworthy that in the recent

court has international jurisdiction over the debtor and there is no pending parallel proceeding).

34. *See, e.g.*, Singularis Holdings Ltd. v. PricewaterhouseCoopers [2014] UKPC 36, [12] (appeal taken from Berm.) (elaborating on the common law rule of comity that recognizes the vesting of a company's assets under the law of its incorporation); Case C-341/04, Eurofood IFCS Ltd. v. Bank of Am. (*in re* Eurofood IFCS), N.A., 2006 E.C.R. I-3813, I-3844–45 (finding the center of the debtor's main interests in the country of its incorporation instead of the country of its administration). Some courts have reached that result only because they did not proceed beyond the presumption in the Model Law. *Cf. infra* note 40. For more detailed discussion, see Jay Lawrence Westbrook, *Locating the Eye of the Financial Storm*, 32 BROOK. J. INT'L L. 1019, 1028–30 (2007).

35. *In re* Hooley Ltd. [2016] CSOH 141 (Scot.).

36. *See In re* Hooley Ltd. [2016] CSOH 141 [33]–[36] (Scot.) (finding foreign proceedings in India as ancillary to insolvency proceedings in Scotland because Scotland is the debtor's place of incorporation). In reaching its decision, the court cited *Singularis*, a case involving countries that had not adopted the Model Law and therefore applied common law principles. *Singularis*, UKPC 36, [1], [9].

Opti-Medix[37] case the Singapore court focused on COMI-type factors for choosing a central court rather than the old incorporation doctrine.[38]

COMI (the location of the "main" proceeding) is the central-court concept generally accepted in the United States, the European Union, and elsewhere.[39] In the Model Law, the place of incorporation remains as an initial presumption about the center of the debtor's affairs,[40] but ease of manipulation and lack of connection to economic reality have made that standard subject to challenge in contentious insolvency cases.[41] On the other hand, the empirical work that I and others have done in the United States has shown that COMI is rarely subject to serious dispute in U.S. cases under the Model Law.[42] In turn, the finding of COMI in a jurisdiction provides a strong, legitimate basis for recognition of that jurisdiction's proceeding as central and promotes deference to its rulings to the maximum extent possible under local laws.[43]

B. *Non-COMI Central Court*

Nonetheless, there are circumstances in which it may be plausible to argue for a central court other than the COMI court:

1. Where the case cannot be filed in the COMI court;[44]

---

37. Re Opti-Medix Ltd. [2016] SGHC 108 (Sing.).

38. *See id.* at [24]–[25] (using the COMI test and recognizing the main insolvency proceedings in Japan, where the debtor's principle businesses were carried out).

39. 11 U.S.C. § 1502(4) (2012); Regulation 2015/848 of the European Parliament and of the Council of 20 May 2015 on Insolvency Proceedings (Recast), 2015 O.J. (L 141) 19, 21–22; UNCITRAL MODEL LAW, *supra* note 2, art. 2(b); Block-Lieb, *supra* note 19, at 1395–1400.

40. UNCITRAL MODEL LAW, *supra* note 2, at 8 ("In the absence of proof to the contrary, the debtor's registered office, or habitual residence in the case of an individual, is presumed to be the centre of the debtor's main interests.").

41. *See, e.g.*, *In re* Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd., 374 B.R. 122, 129 (Bankr. S.D.N.Y. 2007) (refusing to recognize Cayman Islands proceedings despite Cayman Islands being the place of the debtor's incorporation); *In re* BRAC Rent-A-Car Int'l Inc. [2003] EWHC (Ch) 128 [1], [4]–[5] (Eng.) (finding English court's jurisdiction to make an administration order over debtor company, which is incorporated in Delaware, United States, because debtor's center of main interest is in England and it had no employees in the United States); MG Rover [2005] EWHC 874 (Ch) (Eng.) (finding MC Rover France's center of principal interest located in England despite the company registration in France).

42. *See* Jay Lawrence Westbrook, *An Empirical Study of the Implementation in the United States of the Model Law on Cross Border Insolvency*, 87 AM. BANKR. L.J. 247, 261–62 (2013) (reporting that the COMI-based objection was raised only in 64 out of 573 chapter 15 cases in the study, and the argument was seriously litigated in only 7% of the overall cases).

43. Westbrook, *supra* note 34, at 1032–33. Sometimes local laws will not permit a grant of all of the relief that the central court has prescribed. For example, in a few countries it may not be possible to do anything that affects the rights of a secured creditor.

44. *See* Stipulation as to Republic of Marshall Islands Law, *In re* Ocean Rig UDW, Inc., 570 B.R. 687 (Bankr. S.D.N.Y. 2017) (No. 17-10736 (MG)) (Marshall Islands have no bankruptcy or insolvency laws).

2. Where the insolvency system in place in the COMI jurisdiction is simply unable to properly manage a multinational case, so that a filing in a control court would better serve all or virtually all the debtor's stakeholders; and
3. Where it is claimed that there is consent to the non-COMI court as the central court.

The first case is self-explanatory.

The most common situation under the second heading may be where the laws of the COMI country do not permit invocation of an indirect global stay and the debtor cannot be efficiently reorganized or liquidated on a global basis without such a stay. As long as the debtor company has a significant connection with a control court, it may be in the best interests of all concerned to permit that court to take over the case and manage it on a worldwide basis. On the other hand, the control court might still defer to the COMI court, providing the stay as assistance to that court, something that happened between the United States and Japan some years ago.[45] Another example is a debtor whose COMI jurisdiction lacks any reorganization proceeding in its laws, while the debtor is a solvent company with a cash-flow problem such that virtually all of its stakeholders would benefit from a reorganization under a modern statute.

A recent case of a corporate group, Pacific Andes Resources Development Limited, includes some elements of both examples. Pacific Andes had subsidiaries in Peru that were in insolvency proceedings there, while its parent holding company filed in Singapore, which may have been its COMI.[46] It appears that neither Peru nor Singapore was able at that time to impose an indirect global stay,[47] so some of its lenders proceeded to file full insolvency proceedings and take other actions in several other jurisdictions. The debtor group responded by filing several of its affiliates in a chapter 11 proceeding in New York, where the bankruptcy court had personal jurisdiction over the key creditors and thus could enforce an indirect global stay.[48]

The case illustrates some of the serious issues that can arise when a potential control country (here, the United States) assumes jurisdiction. First,

45. Arnold M. Quittner, *Cross-Border Insolvencies – Ancillary and Full Cases: The Concurrent Japanese and United States Cases of Maruko Inc.*, 4 INT'L INSOLVENCY REV. 171, 181 (1995).

46. *See In re* Pac. Andes Res. Dev. Ltd. [2016] SGHC 210, [4] (Sing.) (noting that PARD was listed on the Singapore Exchange and carried out business activity in Singapore). "China Fisheries" is another common name for this case.

47. *See id.* at [53] (denying a global stay).

48. *See In re* China Fishery Grp. Ltd. (Cayman), No. 16-11895 (JLG), 2016 WL 6875903, at *1–3 (Bankr. S.D.N.Y. Oct. 28, 2016) (granting creditors' motion for the appointment of a chapter 11 trustee).

the United States had no substantial connection with the corporate group or any of its affiliates.[49] American jurisdiction was founded on a fictional connection arising from the deposit of money with the group's law firm in New York.[50] If one believed action by the U.S. court was justified nonetheless because of the absence of an alternative jurisdiction able to impose the necessary multinational stay, the court could have deferred to the Singaporean or Peruvian courts, using its control–country power in aid of coordination by the central court. Instead, it chose to take over the case and appoint a trustee to seek a solution on a worldwide basis.[51] While I am not involved in the case and do not know the details, I cannot believe that a U.S. court should take a central role absent a substantial connection with the debtor or the debtor group.[52]

Another separate insolvency proceeding was filed after the U.S. court acted, this time in the British Virgin Islands (BVI) where some of the Pacific Andes group affiliates were incorporated.[53] Lack of perceived legitimacy of the U.S. proceeding may have been part of the reason for this additional filing. Overall there have been proceedings in four or five jurisdictions and a great need for international coordination.

Pacific Andes would have been a quite different case if the debtor had had substantial assets or operations in the United States. That fact combined with the special position of the United States as a control country might have justified the United States acting as the central court and the COMI court might have agreed. If the COMI court did not agree, the courts, directly or

49. *See id.* at *2 (recognizing that the Debtors China Fishery Group comprise a small part of the Pacific Andes Group of companies and have no assets in the United States apart from retainers pre-paid to advisors).

50. *See id.*

51. *See id.* at *20 (asserting that a trustee would be able to review and address Debtors' balances and investigate accounting irregularities without conflicts of interest, facilitate between hostile parties in the proposal, and evaluate the optimal way to maximize and realize the value of the Peruvian business; it should be said that the trustee has apparently been doing all that pretty well). It remains to be seen if the prestige of the American courts can overcome the fictional nature of this jurisdictional assertion.

52. *Cf. In re* Patriot Coal Corp., 482 B.R. 718, 747 (Bankr. S.D.N.Y. 2012) (referring to domestic venue, explaining that a forum like Manhattan would always trump many other fora if only efficiency mattered). In that case, Judge Chapman also noted that the location of key corporate functions matters more when the company is seeking to reorganize. *Id.* at 753–54. *See generally* Gregory W. Fox, *Patriot Coal: Interest of Justice Trumps Convenience of the Parties*, 32 AM. BANKR. INST. J., Feb. 2013, at 20. The larger point, for another day, is that bankruptcy implicates many public interests that should be considered by the courts most closely connected with the debtor company by real economic ties.

53. *See* Bank of Am., N.A. v. Pac. Andes Enter. (BVI) Ltd. (*In re* Pac. Andes Enter. (BVI) Ltd.), BVIHC (COM) 132 (2016), at https://www.eccourts.org/bank-america-n-v-pacific-andes-enterprises-bvi-limited-et-al/ [https://perma.cc/T2QN-3MY8] (allowing the Debtors' corporate group's insolvency to proceed in the British Virgin Island court and appointing joint liquidators over the debtors).

through the professionals, could seek a middle ground in negotiations, as discussed below.[54] In that situation, at least three courts important to the result—Singapore, the BVI, and the United States—would be adherents to the Model Law and thus required by statute to communicate and cooperate.[55]

A closely related point is the claim in some cases that a court other than the COMI court has "better law" and should therefore take the central role.[56] In a broad sense, that is the basis for a court to exercise the role of a central court in the cases discussed above where the COMI court cannot enforce an indirect global stay effectively or where that jurisdiction lacks a reorganization law and a reorganization is clearly best for all concerned. However, this justification blurs in a more nuanced circumstance where a COMI country has the necessary legal tools, but its laws will not permit the relief that some or all of the parties would like to see.

A leading example of this last situation in the United States involved a foreign airline that had regular flights to New York, along with many other destinations.[57] It presumably had assets of the usual sort associated with regular airline activities in the United States, but its COMI was clearly in another country.[58] Despite recently enacted modern legislation in the COMI country, the U.S. bankruptcy court found that the United States had "better law" for the case because of the favorable treatment that U.S. bankruptcy law provided to airplane lessees.[59] It is hard to see just why the U.S. Bankruptcy Code necessarily represented better choices than the decisions the legislators in the COMI country had made for their companies in their recent enactment—especially as applied to their national airline. This example illustrates why the "better law" ground may be subject to serious challenge as to the legitimacy of a non-COMI court's assumption of the role of central

---

54. *See infra* text accompanying notes 87–90.

55. *See* UNCITRAL MODEL LAW, *supra* note 2, at 95 (explaining that articles 25 and 26 mandate cross-border cooperation by providing that the court and the insolvency representative "shall cooperate to the maximum extent possible"). Note that the statutory language is not precatory. For more discussion of Model Law communication requirements, see generally Jay Lawrence Westbrook, *The Duty to Seek Cooperation in Multinational Insolvency Cases*, *in* THE CHALLENGES OF INSOLVENCY LAW REFORM IN THE 21ST CENTURY 361 (Henry Peter et al., eds., 2006), *reprinted in* ANNUAL REVIEW OF INSOLVENCY LAW 187 (Janis P. Sarra ed., 2004).

56. *See* Westbrook, *supra* note 54, at 23–28 (explaining the "better law" arguments). *See also In re* Aerovias Nacionales de Colombia S.A. Avianca, 303 B.R. 1, 10–11 (Bankr. S.D.N.Y. 2003) (pointing out that both the creditors and debtors had benefitted from application of U.S. law and that applicable Colombian bankruptcy law was relatively new and untested); *In re* Monitor Single Lift I, Ltd., 381 B.R. 455, 469 (Bankr. S.D.N.Y. 2008) (noting the additional protections that U.S. bankruptcy laws provide to debtors).

57. *In re* Avianca, 303 B.R. at 1.

58. *Id.* at 3–4 (finding that Avianca has 14 locations in Colombia and 12 locations in other countries, mostly in Central and South America, and that Avianca employed 4,153 employees in Colombia and 28 in the United States, but allowing Debtor's chapter 11 proceeding to continue in the United States).

59. *Id.* at 10–11.

court. That role may thus be seen as illegitimate and may provoke a justified refusal to enforce the result.

Another case in which there is reason to question a non-COMI assumption of jurisdiction would arise where the debtor is not eligible to file an insolvency proceeding in the COMI country. For example, in the United States and some other countries, an insurance company cannot file for bankruptcy;[60] there is a separate procedure for distressed insurers that is initiated by regulators. Should an English court permit an American insurer to file an insolvency proceeding in England? It would not be inconsistent with the Model Law if the English court simply accepted the filing and maintained the status quo in England, along with protection of English creditors, in close consultation with the American regulators and with a proceeding brought in the United States. A plenary proceeding with a claim to global effects on the U.S. insurance company and its stakeholders would not be legitimate.

The third ground to support non-COMI management of a case is consent.[61] In the airline case discussed above, it appeared that the great majority of creditors preferred the United States as a forum.[62] Yet the decision arose from precisely the fact that one substantial creditor objected to United States management.[63] Absent unanimous agreement (which might suggest an out-of-court solution in the first place), it seems problematic to rest non-COMI case management on consent. The ultimate practical solution that balances cost and fairness may require negotiation among courts as well as the parties unless the circumstances permit a buyout of the dissenting creditors. This solution should start from the idea that the proceeding should be centered in the COMI jurisdiction absent strong reasons to the contrary.[64]

A situation that may involve consent is the quandary posed by the "solitary non-COMI proceeding."[65] The airline case was an example here, too. It is clear that the non-COMI jurisdiction (in that case, the United States) has the right to deal with the case as to its creditors and the assets it controls,

60. 11 U.S.C. § 109(b)(2) (2012).

61. *See* TRANSNATIONAL INSOLVENCY: COOPERATION AMONG THE NAFTA COUNTRIES, INTERNATIONAL STATEMENT OF UNITED STATES BANKRUPTCY LAW 76 (AM. LAW INST. 2003) (stating that the U.S. courts can exercise control over debtors' overseas assets and prohibit creditors access to these assets only if (1) the U.S. courts have jurisdiction over the creditors, or (2) "[the creditors] have consented to United States jurisdiction").

62. *In re Avianca*, 303 B.R. at 8.

63. *Id.* at 7–8.

64. Any exceptions create the risk of unjustified deviations because of the disincentives discussed below.

65. I use this name to refer to a proceeding that could have been brought in its COMI jurisdiction but was not. *See* Westbrook, *supra* note 25, at 16–17 (defining the "solitary nonmain proceeding").

provided no COMI proceeding is filed. But a series of such cases would be a return to the inefficiencies and inequities of territorialism.

Instead, the non-COMI jurisdiction should maintain the status quo (possibly including the exercise of an indirect global stay) but order extensive notice to all creditors, including those in the COMI jurisdiction, along with notice to the appropriate court and officials responsible for insolvency matters in the COMI jurisdiction. If no proceeding is filed within a reasonable time, the non-COMI court could then proceed on a worldwide basis. If a proceeding is filed in the COMI jurisdiction, the non-COMI court still could maintain the status quo for the benefit of a worldwide proceeding led by the COMI court. In this way, a global-market approach could be maintained while adapting to the realities of a specific case.[66]

V. Obstacles to Cooperation in Coordination Through a Central Court

Although a variety of factors challenge that multinational coordination, the three most important are as follows:

1. The variations in national policies concerning allocation of values realized in insolvency proceedings;
2. The treatment of corporate groups; and
3. The incentives for professionals to resist centralization.

A. Differing Policies and Priorities

Several factors may result in varying allocations of value in a given case, but the most important are differences in national policies about social or commercial priorities. It is important to realize that these differences in policies comprise not merely traditional liquidation-distribution rules, but broader issues of preferred results. For example, some countries will be more concerned with preserving employment while others will emphasize a quick return to creditors. Given these varying policies and a natural concern for local stakeholders, courts must be persuaded that the overall benefits of cooperation in multinational cases exceed the costs of accepting a compromise in the application of local priorities and social policies.[67] The

---

66. On some occasions, the COMI is unclear. This problem can arise where the principal executive office and the principal assets of the debtor are in different jurisdictions. The awkward result is best resolved by negotiation as discussed below, with each jurisdiction maintaining the status quo in the meantime. *See infra* text accompanying notes 87–90.

67. *See* Jay Lawrence Westbrook, *Theory and Pragmatism in Global Insolvencies: Choice of Law and Choice of Forum*, 65 AM. BANKR. L.J. 457, 465 nn. 27–28 and accompanying text (1991) (exploring this issue).

case for their cooperation must include their agreement that the court seeking to act as the central court is truly entitled to assume that role.

B. Corporate Groups

A corporate group presents an important, common, and sometimes difficult case, largely because of legal technicalities. The group should ordinarily be understood to require the same unified treatment as an individual company. Generally, when a corporate parent files a bankruptcy proceeding, its COMI should be considered the COMI for the group. However, there are sometimes obstacles to this common-sense solution. First, some laws insist that each subsidiary must file in its own COMI as if it were an entirely independent entity[68]—a result that elevates form over substance in the great majority of cases. Second, because subsidiaries are routinely incorporated in various jurisdictions for tax and other reasons, jurisdictions that insist on an incorporation-based COMI almost guarantee a scattered and diffuse set of filings—as in the Pacific Andes case.[69] The diffuse filings make liquidation inefficient[70] and reorganization very difficult. Although some have concerns about ignoring the corporate form, permitting the affiliates to file with the parent in no way requires some form of consolidation of assets and liabilities other than for purely administrative purposes.[71]

C. Disincentives of Professionals

The third serious obstacle to centralized coordination is the natural desire of professionals—lawyers, accountants, investment bankers, and others—to seek substantial opportunities for professional employment in the jurisdictions where they practice. A number of cases have failed to achieve coordination in recent years at least in part because of this difficulty. When the professional fees and costs for a company like Nortel in North America

---

68. *See* U.N. Secretariat, Centre of Main Interests in the Context of an Enterprise Group, Note by the Secretariat, ¶¶ 5, 16, UNCITRAL Working Grp. V (Insolvency Law), U.N. Doc. A/CN.9/WG.V/WP.114 (Feb. 13, 2013) [hereinafter Centre of Main Interests] (reporting that an entity-by-entity approach to COMI of members of an enterprise group has been maintained, and the difficulty of defining COMI for enterprise group demands a focus on facilitating coordination and cooperation between the various courts); U.N. Secretariat, Treatment of Corporate Groups in Insolvency, ¶ 4, UNCITRAL Working Grp. V (Insolvency Law), U.N. Doc. A/CN.9/WG.V/WP.76/Add.2 (Mar. 6, 2007) [hereinafter Treatment of Corporate Groups] (noting that the Model Law does not specifically address the concept of COMI as it might apply to a corporate group).

69. Treatment of Corporate Groups, *supra* note 68, ¶ 6 (indicating that if the COMI test were adopted for each individual member in a corporate group, it would likely lead to insolvency proceedings being commenced in different jurisdictions).

70. See the discussion of Nortel, *infra* text accompanying notes at 72–82.

71. A second obstacle to a simple group COMI, where the subsidiaries file with the parent, is that sometimes the parent does not file. All these situations cry out for negotiated solutions, often requiring substantial judicial encouragement.

can reach nearly $2 billion,[72] it is understandable that local practitioners would oppose coordination procedures that they believe will leave them substantially excluded and that local judges would feel social pressure to prevent that exclusion. On the other hand, the *Nortel*[73] case paradoxically demonstrates the enormous benefits of coordination.

Nortel was a true multinational group engaged in the development and marketing of certain kinds of high-tech gear all over the world.[74] The parent company was based in Canada, as was the main operating subsidiary, while much of its business involved a subsidiary in the United States.[75] It also had subsidiaries in Europe, notably in the United Kingdom. Insolvency proceedings were filed in those three jurisdictions, although the United Kingdom court did not participate in the major international decisions in *Nortel*.[76] The results in the case represented the high and the low of recent multinational insolvencies:

High. After reorganization failed, the parties cooperated to sell the debtor's assets on a global basis, in large pieces that spanned many countries. In particular, the global sale of intellectual property yielded many billions of dollars.[77] The cooperative disposition, without regard to jurisdiction or geography, produced far more value than any isolated, jurisdiction-by-jurisdiction sales could have achieved. This result represented modified universalism at its best.

Low. After the great sales success, the parties could not agree on allocation of the roughly $7 billion in proceeds, rejecting repeated pleas by the U.S. and Canadian courts that the parties resolve the issue by negotiation or arbitration.[78] The final resolution took years, resulting in the nearly

---

72. Jeff Montgomery, *Nortel OK'd for $14.2M Payout Amid 'Pandora's Box' Warnings*, LAW360 (June 6, 2016), https://www.law360.com/articles/803875/nortel-ok-d-for-14-2m-payout-amid-pandora-s-box-warnings [https://perma.cc/T3C4-GLH9] (reporting that the professional fee payouts in the case reached more than $1.9 billion in the United States by June 2016).

73. *In re* Nortel Networks, Inc., 669 F.3d 128 (3d Cir. 2011). I gave an opinion as an expert witness in the case on behalf of the UK pension creditors.

74. *Id.* at 130–31.

75. *Id.* at 131.

76. *Id.*

77. Nortel Networks Inc. v. Ernst & Young Inc. (*In re* Nortel Networks Inc.), Nos. 15-196(LPS), 15-197(LPS), 2016 WL 2899225, at *1 & n.1 (D. Del. 2016) (introducing the background of this litigation related to the allocation of the $7.3 billion proceeds of court-supervised sales of assets, principally an extensive portfolio of patents).

78. *See, e.g.*, *In re* Nortel Networks, Inc., 669 F.3d at 143. The court observed:

> Mediation, or continuation of whatever mediation is ongoing, by the parties in good faith is needed to resolve the differences. No party will benefit if the parties continue to clash over every statement and over every step in the process. This will result in wasteful depletion of the available assets from which each seeks a portion.

Id.

$2 billion of professional fees and costs.[79] The resolution of the case required joint management between the Canadian and U.S. courts, including a joint televised trial and coordinated (although independent) decisions by the two courts.[80] While the courts involved did a wonderful job in managing the awkward jumble of litigation, it seems clear that large amounts of money and time would have been saved had either court been permitted to manage the case centrally, albeit with mutual consultation at every stage.

In the *Nortel* case, as in other large cases in recent years, there was a failure to act quickly at the start of the case to seek recognition and coordination among the courts involved. The result is two or more independent insolvency proceedings with limited cooperation. The Lehman insolvency is a notable example. In the Lehman case, recognition and coordination were not even sought for many months.[81] In *Nortel*, the efforts were less laggard, but still too little and too late to produce the best results. Early cooperation permits the establishment of protocols and lines of authority in a cooperative direction from the start. It also has the benefit of being put in place before tactical considerations have become so apparent as to make it difficult for parties to agree.[82]

I do not suggest for a moment that the professionals in these and other cases planned, much less conspired, to delay or defeat coordination so they could feather their own nests. But I do think that the incentives for professionals are such that they require judicial encouragement to focus on international cooperation and recognition from the very start of a case—or indeed, during workout negotiations prior to any insolvency filing.[83] I think

---

79. Montgomery, *supra* note 72.

80. *In re* Nortel Networks Inc., 2016 WL 2899225, at *1; *see also* Tom Hals, *Nortel Cleared to End Bankruptcy, Distribute $7 Billion to Creditors*, REUTERS (Jan. 24, 2017), https://www.reuters.com/article/us-nortelnetworks-bankruptcy/nortel-cleared-to-end-bankruptcy-distribute-7-billion-to-creditors-idUSKBN1582TO [https://perma.cc/CDR8-UZ4S] (reporting that the two courts were linked by video throughout the proceedings).

81. After the filing of bankruptcy, it took the insolvency administrators of the eighteen Lehman's affiliates seven months to work out a coordination and cooperation protocol. Lehman Bros. Holdings Inc., *Cross Border Insolvency Protocol for the Lehman Brothers Group of Companies* (May 12, 2009), https://www.insol.org/Fellowship%202010/Session%209/Lehman%20protocol%20executed.pdf [https://perma.cc/N3KF-L3RE]. For further discussion, see Hon. Allan L. Gropper, *The Model Law After Five Years: The U.S. Experience with COMI*, *in* LESSONS LEARNED AND PROBLEMS EXPOSED IN CROSS-BORDER CASES: THE JUDICIAL PERSPECTIVE (Int'l Insolvency Inst. ed., 2010), https://www.iiiglobal.org/sites/default/files/Allan_Gropper.pdf [https://perma.cc/Z7L3-JSLL].

82. There is a sort of Rawlsian proposition here that parties will be more cooperative and focused on common interests—like maximization of value—when the rush of events at the start of a case provides something of a "veil of ignorance." *See generally* JOHN RAWLS, A THEORY OF JUSTICE 17 (rev. ed. 1999).

83. If a clear judicial signal is sent that, after filing, professionals will be asked pointed questions about pre-filing negotiations with regard to these cooperation issues, professionals will be encouraged to give them attention even before filing.

that judicial encouragement may also serve to overcome difficulties of coordination among professionals who are naturally motivated to consider tactical and strategic advantages for their clients and who lack a broad vision of the needs of the case as a whole. In short, there is a substantial need for judicial activism to guide the parties toward the best results. Where such activism may be found, there will be opportunities for professionals to advance the interests of their clients by being in the forefront of an internationalist approach and being seen by the courts as taking cooperative and efficiency-promoting positions.

VI. Strategies for Coordination

At the heart of the needed process is communication. When we were working on the UNCITRAL negotiations that produced the Model Law in the mid-Nineties, our inclusion of provisions concerning communication, including direct communication among courts, was regarded by many as radical and dangerous.[84] But we persisted in that effort through the American Law Institute Transnational Project. Others took up the banner in the Global Principles effort at the International Insolvency Institute.[85] These communications have increasingly become routine, although not always timely. Most recently, the creation of the Judicial Insolvency Network (JIN) and its Guidelines further extend those initiatives.[86] A special virtue of the

84. *See* U.N. Secretariat, Cross-Border Insolvency: Possible Issues Relating to Judicial Cooperation and Access and Recognition in Case of Cross-Border Insolvency, ¶¶ 99–100, UNCITRAL Working Grp. V (Insolvency Law), U.N. Doc. A/CN.9/WG.V/WP.42 (Sept. 26, 1995) (recognizing that communications between judges "may raise varying degrees of concern in particular in legal systems that are not accustomed to such initiatives by judges, and also concerns about procedural safeguards for the parties"); UNCITRAL, Rep. of the Working Group on Insolvency Law on the Work of the Eighteenth Session, ¶ 82, U.N. Doc. A/CN.9/419 (Dec. 1, 1995) (discussing judicial communication as an aspect of cooperation); AM. LAW INST., TRANSNATIONAL INSOLVENCY PROJECT: INTERIM REPORT 7–8 (1999) (reporting that some of the proposals being considered "are necessarily controversial," and special difficulties existed in implementing any particular approach to cooperation); Memorandum from Jay Lawrence Westbrook to Nat'l Bankr. Review Comm'n, Am. Law Inst. Transnational Insolvency Project 3 (July 29, 1997) ("The [UNCITRAL] insolvency project began with countries very reluctant to take substantial steps toward cooperation with foreign proceedings.").

85. ALI-III GLOBAL PRINCIPLES, *supra* note 11.

86. *See generally* GUIDELINES FOR COMMUNICATION AND COOPERATION BETWEEN COURTS IN CROSS-BORDER INSOLVENCY MATTERS (Judicial Insolvency Network ed. 2016), http://www.insol.org/emailer/January_2017_downloads/doc1a.pdf [https://perma.cc/6RRL-QESH] (providing rules to improve the interests of those involved in cross-border insolvency proceedings by "enhancing coordination and cooperation amongst courts under whose supervision such proceedings are being conducted"). Recently, the chief bankruptcy judge for the Southern District of Florida has ordered the adoption of JIN Guidelines on court-to-court communication and cooperation. Adoption of Guidelines for Communication and Cooperation Between Courts in Cross-Border Insolvency Matters, Administrative Order 2018-03 (Bankr. S.D. Fla. 2018), http://www.flsb.uscourts.gov/sites/flsb/files/documents/news/AO_2018-03_Adoption_of_Guidelines_for_Communication_and_Cooperation_Between_Courts_in_Cross-Border_Insolvency_Matters.pdf

JIN initiative comes from the fact that the establishment of personal relationships among commercial judges from different countries is a key to success in multinational cases. In that regard, not the least important benefit of the JIN Guidelines is the likelihood that they will tend to produce early direct communication by judges (with due notice to all) and will incentivize professionals to act quickly as well.

It may be useful to offer one example of an approach that can produce coordinated results. Some years ago, a financial company in North America called Inverworld collapsed in scandal, revealing that it had defrauded large numbers of investors in the United States and a number of Latin American countries of hundreds of millions of dollars.[87] The accountants had uncovered quite substantial assets for distribution, although much less than enough to pay creditors in full. Insolvency proceedings were brought in the United States, the Cayman Islands, and England.[88]

The representatives of various parties in the case agreed to a protocol that led to dismissal of the English insolvency proceeding, upon certain conditions protecting the claimants therein, and the allocation of functions between the two remaining courts.[89] The U.S. court was to resolve the outstanding legal and factual issues relating to entitlements as among various classes of investors, while the Cayman Islands court was to oversee the creation and operation of the mechanism of distribution of proceeds to claimants. Each court was to take the other court's actions as binding and thus to prevent parallel litigation. Ultimately, the process agreed to in the protocol led to a worldwide settlement at a cost far less than would have attended a three-court struggle.[90]

The key point is that there was substantial communication directed to the global case and its resolution. The judges involved actively encouraged the professionals to engage in cross-border negotiations with an emphasis on non-litigious solutions despite plausible conflicting claims for several groups of claimants under each of the seven arguably applicable laws. The professionals from each jurisdiction were importantly involved. Judicial activism combined with a first-rate performance by the professionals produced spectacularly fast, fair, and efficient results.

[https://perma.cc/ANB6-WLVP].

87. San Antonio Express-News v. Blackwell (*In re* Blackwell), 263 B.R. 505, 506 (W.D. Tex. 2000).

88. *Id.*

89. See Jay Lawrence Westbrook, *International Judicial Negotiation*, 38 TEX. INT'L L.J. 567, 571 (2003) for a detailed discussion of the *Inverworld* case. I should mention I was appointed "special counsel" in the case and given a role similar to that of an examiner under § 1104(c) of the Bankruptcy Code. *See* 11 U.S.C. § 1104(c) (2012).

90. Westbrook, *supra* note 89, at 571.

VII. Conclusion

Globalization continues to accelerate; new supply chains form every day. It is fueled by the enormous wealth it creates, despite the inevitable debacles it leaves in its wake. Globalization of the management of financial distress will be its companion. Some insist the process must await elegant ruminations about the evolution of the common law or endless debates over treaties about cross-border insolvency, but they will be disappointed. Economics will incentivize procedures to make cross-border insolvency proceedings efficient, and citizens will demand procedures to make it fair. Those results require cooperation around a coordinating central jurisdiction and the internationalization of the relevant professions. While legislation is necessary, the courts will, as always, be confronted with issues that run ahead of the legislative process. Indeed, court decisions will often drive that process. Judges and lawyers will continue to build the international insolvency system even though it's a bit like completing the assembly of an aircraft while in flight.

It is an exciting time to be an international lawyer or judge and not a time for the timid.

[DRAFT - Forthcoming Texas International Law Journal]

Applying the Presumption Against Extraterritoriality to Bankruptcy Avoidance Provisions

—A Modified Universalism Solution to the Current Circuit Split

Yanan Zhao [Texas '18]

ABSTRACT

In recent years, New York and Delaware have witnessed a marked increase in bankruptcy cases involving multinational debtors. Exciting as these cases are, however, many fundamental questions regarding the application of the U.S. Bankruptcy Code are unsolved. One of those questions concerns the extraterritorial application of the Code. In the last five years, federal courts have gone back and forth and issued conflicting decisions on the question of whether the avoidance provisions of the Bankruptcy Code can be applied to extraterritorial transactions.

The federal courts' struggle has revealed an irreconcilable conflict between the underlying rationale of the presumption against extraterritoriality and the practical need for "asset control" in international insolvency proceedings. Reviewing the dynamic roles played by procedural and choice-of-law analyses in recent multinational bankruptcy decisions, this article concludes that the presumption against extraterritoriality can achieve only limited, if any, value that purportedly serves. A generalized presumption against extraterritoriality, even applicable to each transaction separately, fails to consider the bankruptcy court's and the state's interests in operating the insolvency proceeding of a multinational debtor as a whole. This Paper suggests that when the United States provides the main proceeding for a multinational debtor's insolvency, the presumption shall not be applied to prevent courts from exercising the avoidance power over transactions involving foreign elements. Instead of using the presumption as a shortcut, courts should take the choice-of-law and international-comity analyses seriously and consider the state's interests in efficient control over a debtor's assets and management of the multinational insolvency proceeding.

I. Introduction to the Presumption Against Extraterritoriality

A. Origin and the Current Practice

The presumption against extraterritorial application of United States laws, as originated in *American Banana Co. v. United Fruit Co.*,[1] dates back to the idea of "territoriality" from the time

There are many people that have made great impact on this Paper in different ways. I am grateful for the help and support of Professor Jay L. Westbrook. His advice and comments are invaluable to me. I am also thankful for my friend Giulio Ernesto Yaquinto, who has been criticizing and helping with my writing since the first day I wrote

of *Pennoyer v. Neff*[2] and has been applied by U.S. courts for over a century. As noted by Justice Holmes, "all legislation is prima facie territorial in nature."[3] Thus, the "legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States."[4] As a judge-made rule, the presumption against extraterritoriality has experienced a "fall and rise" in its lifetime. For example, this doctrine almost lost its bite when federal courts applied an "effect-based test."[5] Nevertheless, in *Morrison v. National Australia Bank Ltd.*,[6] the Supreme Court "rediscovered" this doctrine against extraterritoriality by demanding an "affirmative indication" of Congressional intent to overcome the presumption against extraterritoriality. The change in Supreme Court's attitude reflected a change of U.S. foreign relations and international economic interdependence.[7]

B. Current Approach under *Morrison*

In *Morrison*, the Supreme Court formally adopted a two-step approach to decide the applicability of U.S. law. At the first step, courts are required to decide whether a presumption against extraterritorial application of the statute has been rebutted by a "clear indication" of Congress in the statute.[8] Justice Scalia clarified in *Morrison* that the Court did not mean that the statute must say "this law applies abroad." However, over and over again, the Court emphasized that: "[w]hen a statute gives no clear indication of an extraterritorial application, it has none;" "uncertain indications do not suffice;" and that anything less than an "affirmative indication" in the statute is not enough to overcome the presumption.[9] It is not surprising that lower courts have interpreted *Morrison* as adopting a "clear statement rule." In its following decisions, the Supreme Court further indicated its insistence on a strict presumption against extraterritoriality.[10] It

---

serious English. Finally, I would like to thank the Texas International Law Journal for their diligent work and valuable input. I am fully responsible for any mistakes and imperfections of this Paper.

[1] 213 U.S. 347 (1909) (quoting *Ex parte* Blain (1879) 12 Ch.D. 522, 528 (Brett, L.J.) (Eng.).

[2] 95 U.S. 714 (1877).

[3] Am. Banana Co. v. Untied Fruit Co. 213 U.S. 347, 357 (1909).

[4] EEOC v. Arabian Am. Oil Co. (Aramco), 499 U.S. 244, 248 (1991).

[5] *E.g.* United States v. Aluminum Co. of Am. (Alcoa), 148 F.2d 416, 421 (2d Cir. 1945); Consol. Gold Fields PCL v. Minorco, S.A., 871 F.2d 252, 263 (2d Cir. 1989); Mannington Mills, Inc. v. Congoleum Corp., 5895 F.2d 1287, 1294 (3d Cir. 1979); Timberland Lumber Co. v. Bank of Am., 549 F.2d 597, 609 (9th Cir. 1976). *See also* Andreas F. Lowenfeld, *Conflict, Balancing of Interests, and the Exercise of Jurisdiction to Prescribe: Reflection on the* Insurance Antitrust Case, 89 AM. J. INT'L L. 42, 48–50 (1995); Austen Parrish, *The Effects Test: Extraterritoriality's Fifth Business*, 61 VAND. L. REV. 1455 (2009); Hannah L. Buxbaum, *Territory, Territoriality, and the Resolution of Jurisdictional Conflict*, 57 AM. J. COMP. L. 631, at 646–50 (2009) (describing cases and commentary).

[6] 130 S. Ct. 2869 (2010)

[7] KAL RAUSTIALA DOES THE CONSTITUTION FOLLOW THE FLAG: THE EVOLUTION OF TERRITORIALITY IN AMERICA LAW 93–125, 101 (2009).

[8] *Morrison*, 130 S. Ct. at 255; Zachary D. Clopton, *Replacing the Presumption Against Extraterritoriality*, 94 BOSTON U. L. REV. 1 (2014); Jeffrey A. Meyer, *Dual illegality and Geoambiguous Law: A New Rule for Extraterritorial Application of U.S. Law*, 95 MINN. L. REV. 110, 114 (2010);

[9] *Morrsion*, 130 S. Ct. at 255, 265.

[10] Kiobel v. Royal Dutch Petroleum Co., 569 U.S. 108 (2013) (denying an extraterritorial application of the Alien Tort Statute); RJR Nabisco, Inc. v. European Comy., 136 S.Ct. 2090, 2093–94 (2016).

specifically emphasized that merely having boilerplate terms like "any" or "every" in the statute is not enough to rebut the presumption against extraterritoriality.[11]

When the presumption cannot be rebutted, federal courts move to the second step to decide whether the contested dispute is "foreign" or "domestic."[12] The latter will permit the court to apply the U.S. law since applying laws to domestic disputes would not trigger the presumption against extraterritoriality. For better or worse, the Supreme Court did not provide much guidance on how to "locate" the disputed transaction. Contrary to its insistence on a clear rule that prevents judges from second guessing the Legislature's intention, *Morrison* asked judges to consider the object and purpose of the federal statute to determine the "focus" of the contested provision.[13] This puzzling question causes lots of uncertainty and invites "judicial creativity."[14]

C. Application of the Presumption in Bankruptcy Cases—the Circuit Split

The Supreme Court's decisions regarding the extraterritorial application of federal statutes significantly affected international insolvency practice. In recent years, more and more U.S. courts have adopted a "modified universalism" approach in multinational bankruptcy cases.[15] Under this regime, courts are supposed to "seek a result in multinational cases as close as possible to a unified worldwide administration and distribution."[16] For each of the four key features in a bankruptcy proceeding—control, avoidance, priority, and reorganization policy—the applicability of U.S. Bankruptcy law determines the power of bankruptcy courts, as well as the efficiency and quality of an insolvency proceeding.[17]

The Supreme Court has required a provision-by-provision examination in the question of extraterritoriality. When a statute provides for some extraterritorial application, the presumption against extraterritoriality is rebutted only in the provision that contains the rebutting terminology.[18] Therefore, even though it is widely accepted that Congress explicitly allows courts to issue automatic stays on debtors' foreign assets,[19] an allowance does not implicate the avoidance

---

[11] *Kiobel*, 569 U.S. at 1665.
[12] *Morrison*, 130 S. Ct. at 266–68.
[13] *Id.*
[14] Lee Brilmayer, *The New Extraterritoriality: Morrison v. National Australia Bank, Legislative Supremacy, and the Presumption Against Extraterritorial Application of American Law*, SW. L. REV. 635 (2011) ("Sober examination in the cold light of day reveals that *Morrison*'s new approach provides considerably greater opportunity for creative judge than the method it replaces.")
[15] Jay Lawrence Westbrook, *Avoidance of Pre-Bankruptcy Transactions in Multinational Bankruptcy Cases*, 42 TEX. INT'L L.J. 899, 901 (2007).
[16] Jay Lawrence Westbrook, *Universalism and Choice of* Law, 23 PENN ST. INT'L L. REV. 625, 626 (2005); American Law Institute, Transnational Insolvency Project, Principles of Corporation in Transnational Insolvency Cases Among the Members of the North American Free Trade Agreement 8 (2003) [hereinafter A.L.I Principles].
[17] Jay Lawrence Westbrook, *Locating the Eye of the Financial Storm*, 32 BROOK. J. INT'L L. 1019, 1021 (2007).
[18] Morrison v. National Australia Bank Ltd., 561 U.S. 247, 265 (2010) (citing Microsoft Corp. v. AT & T Corp., 550 U.S. 437, 455–56 (2007)).
[19] Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, 474 B.R. 76, 82–83 (S.D.N.Y. 2012) (finding the presumption against extraterritoriality is overcome in Chapter 11 cases because "Congress has expressed its intent that bankruptcy courts are to have jurisdiction over a debtor's estate of 'property, *wherever* located and by whomever held.' 11 U.S.C. §541(a)"); *In re* Elcoteq, Inc., 521 B.R. 189, 198–99 (Bankr. N.D. Tex. 2014) (citing Nakash v. Zur (In re Nakash), 190 B.R. 763, 768 (Bankr. S.D.N.Y. 1996); Sinatra v. Gucci (*In re* Gucci), 309 B.R. 679, 683_84 (S.D.N.Y. 2004)); *In re* Rimast, Ltd., 98 F.3d 965, 961–62 (7th Cir. 1996). In addition to automatic stay, federal courts

provisions from the same Code or otherwise allow bankruptcy courts to rescind overseas transactions of debtors' assets. Instead, a split among the courts on this question has caused serious uncertainty for international insolvency cases.[20]

The Supreme Court justified the presumption against extraterritoriality based on three policy considerations:(1) to protect against unintended clashes between U.S and foreign laws;[21] (2) to promote the administration of law and predictability;[22] and (3) to avoid judicial interference with Congressional decisions on foreign relations.[23] However, the two-step approach adopted in *Morrison* has been vigorously criticized by scholars, including professors Zachary Clopton[24] and John H. Knox.[25] They have attacked the *Morrison* decision for its unpredictability and circular logic,[26] arguing that the presumption fails to achieve the goals it purported to serve.[27] However, these articles did not address the area of bankruptcy in particular. This article aims to fill the gap by discussing the relationship and interaction among courts' analyses for personal jurisdiction, choice-of-law, international comity issues, and the presumption against extraterritoriality. This Paper aims to fill the gap.

II. Extraterritorial Application of the Avoidance Law—Practice of Federal Courts

A. Decisions Before *Morrison*

Even before *Morrison*, lower courts adopted a "loose" two-step approach to decide whether a U.S. statute can be applied to an extraterritorial transaction. The presumption was narrowly interpreted. First, courts applied a choice-of-law analysis to determine if the conduct was extraterritorial; and if so, the courts would then decide whether the presumption has been rebutted

---

recognized the extraterritorial effect of the discharge injunction of Bankruptcy Code §§ 524, 1141. *See Hong Kong and Shanghai Banking Corp., Ltd. v. Simon (In re Simon)*, 153 F.3d 991 (9th Cir. 1998); *In re Dow Corning Corp.*, 287 B.R. 396 (E.D. Mich. 2002).

[20] Compare *In re* FAH Liquidating Corp., 572 B.R. 117, 125–27 (Bankr. D. Del. 2017) (holding that 11 U.S.C. §548 applies extraterritorially); *In re* Lyondell Chem. Co., 543 B.R. 127, 151–55 (Bankr. S.D.N.Y. 2016) (same); Picard v. Bureau of Labor Ins., 480 B.R. 501, 523–28 (Bankr. S.D.N.Y. 2012) (same); *In re* French, 440 F.3d 145, 151–52 (4th Cir. 2006) (same), *cert. denied*, 549 U.S. 815 (2006) ***with*** *In re* Ampal-American Israel Corp., 562 B.R. 601 (Bankr. S.D.N.Y. 2017) (holding the avoidance provisions of Bankruptcy law do not apply extraterritorially); Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (*In re Madoff Sec.*), 513 B.R. 222, 226–32 (S.D.N.Y. 2014) (holding that 11 U.S.C §550(a) does not apply extraterritorially); *In re* Sherwood Inv. Overseas Ltd., Inc., No. 6:10-AP-00158-KSJ, 2015 WL 4486470, at *18–22 (Bankr. M.D. Fla. 2015) (holding that 11 U.S.C. §548 does not apply extraterritorially); *In re* Bankr. Estate of Midland Euro Exch. Inc., 347 B.R. 708, 717–19 (Bankr. C.D. Cal. 2006) (holding that 11 U.S.C. does not apply extraterritorially), and *In re* Maxwell Commc'n Corp. PLC, 170 B.R. 800, 808–14 (Bankr. S.D.N.Y. 1994) (holding that 11 U.S.C. §547 does not apply extraterritorially), *aff'd*, 186 B.R. 807 (S.D.N.Y. 1995). *See also* Michael J. Colarossi, *An Uncertain Future: The Questionable Extraterritoriality of the Bankruptcy Code's Core Pre-Petition Avoidance Provisions*, 25 AM. BANKR. INST. L. REV. 229, 274 (2017).

[21] E.E.O.C. v. Arabian American Oil Co., 499 U.S. 244 (1991); Kiobel v. Royal Dutch Petroleum Co., 569 U.S. 108 (2013); RJR Nbisco, Inc. v. European Comty., 136 S. Ct. 2090 (2016).

[22] Morrison v. National Australia Bank Ltd., 561 U.S. 247 (2010).

[23] *Kiobel*, 569 U.S. 108 (2013) (citing *Benz v. Compania Naviera Hidalgo, S.A.*, 353 U.S. 138, 147 (1957)).

[24] *E.g.* Zachary D. Clopton, *Replacing the Presumption Against Extraterritoriality*, 94 B.U. L. REV. 1 (2014) [hereinafter Clopton, *Replacing*].

[25] John H. Knox, *The Unpredictable Presumption Against Extraterritoriality*, 40 SW. L. REV. 635 (2011) (arguing that the presumption does not approximate legislative intent).

[26] *Id.*

[27] Clopton, *Replacing*, *supra* note 23 (challenging the purported justifications for the presumption against extraterritoriality on the basis that its underlying rational of territoriality has changed).

by a congressional intent to apply the statute to the facts presented.[28] Early cases in New York and the Fourth Circuit created a split under this analytical framework.

1. *In re* Maxwell—A Choice-of-Law Solution to Extraterritoriality Question

In its famous decision *In re Maxwell Communication*,[29] the Southern District of New York discussed and denied the extraterritorial application of U.S. avoidance law. The debtor was Maxwell Communication Corporation ("MCC"), an English company with its primary assets pool and largest sources of revenue located in the United States. Parallel insolvency proceedings of the debtor were filed in London and New York, where bankruptcy judges in the two countries engaged in an unprecedented cooperation in the multinational debtor's case. Before the U.S. bankruptcy court, the administrator brought claims under §547 of the Bankruptcy Code to avoid the debtor's pre-bankruptcy transfers of proceeds generated from sales of its U.S. assets. A choice-of-law issue was presented—whereas U.S. law would allow the administrator to avoid the transfer, English insolvency law would not. The question was further complicated by the presumption against the extraterritoriality doctrine in both countries.[30]

In this case, MCC parted with the transferred funds in England. In other words, the transfer was made by an English entity, to English transferees, entirely within the United Kingdom. However, on appeal at the district court, MCC argued that the transfer was "domestic" to the United States for two reasons: first, the money received by the transferee was derived from the sale of U.S. assets; and second, the Banks acquiesced in MCC's chapter 11 case and therefore subjected themselves to equitable relief in the U.S. bankruptcy proceeding. The bankruptcy court rejected both arguments. Instead, the court determined that the transfer was "foreign" after considering all the component events. Those events included the citizenship of the debtors; the antecedent debts underlying the transfer; and the bank account used in such transfer. Among those events, the source of the funds alone insufficient to displace the presumption against extraterritoriality.[31]

The court went further and analyzed whether Congress intended to apply the avoidance provision extraterritorially, thus overcoming the presumption. Taking into consideration the text and legislative history of the statute, the object and purpose of the entire bankruptcy code, as well as any other evidence which may shed light on Congress's intent, the court found the presumption was not rebutted. In fact, *Maxwell* applied a strict "clear intent" standard by emphasizing that when Congress desires an extraterritorial application of the statute, it "knows how to place the high seas within the jurisdictional reach of the statute."[32] As a pre-*Morrison* decision, the court also discussed whether the effect of the transfer in the United States was so strong that the presumption was inapplicable. Specifically, the court considered the following facts: (1) most creditors were English and it would be difficult to foresee any significant domestic effects of the

---

[28] Westbrook, *Avoidance of Pre-Bankruptcy Transactions*, *supra* note 15, at 906.
[29] 186 B.R. 807 (1995). This case is regarded as "one of the most important insolvencies of modern times." Jay Lawrence Westbrook, *The Lessons of Maxwell Communication*, 64 FORDHAM L. REV. 2531, 2534 (1996).
[30] Westbrook, *The Lessons of Maxwell Communications*, *supra* note 29, at 2538.
[31] Westbrook, *The Lessons of Maxwell Communications*, *supra* note 29, at 2540.
[32] *In re Maxwell*, 186 B.R. at 820.

transfers; and (2) the debtor's U.S.-based assets were sold as going concerns, which meant the transfer of the proceeds would not put U.S. citizens, jobs, and communities at a risk. The court's focusing on predictability and local small creditors' interest largely overlaps with the factors that professor Westbrook proposed in locating a multinational debtor's "center of main interest (COMI)," which includes "predictability" and the "acceptability of the substantive law."[33]

At the end of its discussion, the district court addressed the question of international comity, on which basis the Second Circuit affirmed the lower court's decision.[34] The idea of international comity is based on respect of foreign nation's sovereignty. States will restrict the exercise of their sovereign power and reach of domestic law to allow regulation by a foreign nation with stronger interests at stake. Indeed, comity is a traditional component of choice-of-law theory.[35] Considering the stronger interest of the United Kingdom in regulating the London-based debtor and managing its insolvency proceeding, the court found that both the choice of law and international comity doctrines mandated the application of U.K. avoidance law in this case.

After a close reading of the specific facts and factors that the court addressed in *Maxwell*, it is hard to discern what real value is added by the presumption against extraterritoriality. Instead, the analyses concerning choice of law, international comity, and the location of the COMI played a decisive role in the court's reasoning.

2. *In re French*—Considering the Overall Object and Purpose of the Bankruptcy Code

Maxwell was discussed and disagreed with by *In re French*.[36] This is a chapter 7 case filed by an individual debtor residing in Maryland. Less than one month before the bankruptcy filing, the debtor transferred her real estate located in Bahamas to her children. The trustee filed an adversary proceeding against the transferees to avoid the transfer and recover its value. Before the court, the debtor argued that the avoidance provisions were not applicable on the bases of presumption against extraterritoriality and international comity.

On appeal at the Fourth Circuit, the court started with the "particularly challenging" question regarding the location of the disputed transfer.[37] The Fourth Circuit adopted a "flexible inquiry" by considering whether the "participants, acts, targets, and effects involved" in the transaction at issue "are primarily foreign or primarily domestic."[38] Essentially, the court balanced the U.S. and foreign interests at stake and made the following observations (1) the transfer was a "constructive fraud" because, based on a comparison of the debtor's domestic debts and assets, the debtor was insolvent; (2) the debtor's decision to not receive a "reasonably equivalent value" for the transfer was made within the United States. The court also recognized sovereign nations' strong interest in and long practice of regulating real properties within its territory. Therefore, even though the court concluded that the transfer was essentially "domestic," it conceded that the outcome might be different if the Bahamian interests merited a special weight. Nevertheless, this

---

[33] Westbrook, *Locating the Eye of the Financial Storm*, *supra* note 17, at 1022–23, 30–31.
[34] *In re* Maxwell, 93 F.3d 1036 (2d Cir. 1996).
[35] Hartford Fire Ins. Co. v. California, 509 U.S. 764, 816 (1993).
[36] 440 F.3d 145 (4th Cir. 2006).
[37] *Id.* at 149.
[38] *Id.* at 150.

court did not ultimately resolve whether the transfer was extraterritorial because it concluded that Congress intended to apply the Bankruptcy Code's avoidance provisions extraterritorially.

Unlike the Southern District of New York bankruptcy court in *Maxwell*, the Fourth Circuit focused on the relationship among different provisions in the Bankruptcy Code and its overall object and purpose. Pursuant to §541 of the Code, any "property of the estate" is subject to the bankruptcy court's *in rem* jurisdiction, and the "property of estate" is defined as, *inter alia*, all "interest of the debtor in property."[39] Moreover, under §548, the bankruptcy court can avoid certain transfers of an "interest of the debtor in property."[40] Accordingly, by incorporating the language of §541, the text of §548 indicates that Congress intended the avoidance provision to apply to all property that, "absent a prepetition transfer, would have been property of the estate, *wherever* that property is located."[41] As the court correctly observed, reading §548 in this manner is consistent with the purpose of the Bankruptcy Code since the avoidance provisions are to prevent debtors from "illegitimately disposing of property that should be available to their creditors."[42]

Once again, the debtor urged the court to not apply U.S. bankruptcy law on the basis of international comity. The court rejected this argument based on a choice-of-law analysis and repeated the factors it considered at the first step: the interests of the United States to manage the bankruptcy proceeding as a whole to protect the local creditors.

In comparison to the judge in *Maxwell*, the judges in *In re French* were more thoughtful with respect to the overall object and purpose of the Bankruptcy Code. The idea of preventing a debtor's illegal transfer of assets as adverse to the interests of other creditors, in another word, is to emphasize the importance for the bankruptcy court to exercise control over the debtor's wealth. It is important in consumer bankruptcy cases like *French* to realize a fair distribution of the debtor's assets among the domestic creditors. But controlling debtors' assets would serve an even more fundamental role in multinational bankruptcy proceedings to increase efficiency and maximize the value generated from the insolvency.[43] As indicated by *French*, the bankruptcy court's interest in controlling the debtor's assets is addressed through the discussion of international comity—leaving no room for the presumption against extraterritoriality.

B. Bankruptcy Court Decisions after *Morrison*

1. New York

Before *Morrison*, courts moved towards accepting the modified universalism scheme and did not shy away from expanding the application of U.S bankruptcy law to insolvency proceedings that involved foreign elements. However, these decisions under the "substantive effect test" are challenged by *Morrison* and its progeny. After 2011, the bankruptcy court in the Southern District of New York went back and forth on the issue extraterritorial application of avoidance provisions.

---

[39] 11 U.S.C. §541(a) (1).
[40] 11 U.S.C. §548
[41] *In re* French, 440 F.3d 141, 151–52 (4th Cir. 2006).
[42] *Id.* at 152.
[43] Jay Lawrence Westbrook, *Global Insolvency Proceedings for a Global Market: The Universalist System and the Choice of a Central Court* (2017 forthcoming); *see also* Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEXAS L. REV. 795, 798 (2004).

(1) *In re* Madoff (2012)

In re Bernard L. Madoff[44] was the first post-*Morrison* case brought before the Bankruptcy Court in the Southern District of New York. There, the trustee tried to avoid a transfer of the debtor's assets from a foreign subsequent transferee.[45]

As an initial mater, the Bankruptcy court decided that it had territorial jurisdiction over the defendant–transferee. Bankruptcy courts can avoid a transfer to a foreign transferee only if its jurisdiction over the defendant satisfies the due process requirement under the U.S. Constitution.[46] Applying the "minimum contact test,"[47] the court looked beyond the contested transaction itself to the defendant's investment in the debtor, the due diligence research conducted within the United States for the transaction, and the quantity and quality of such investment.[48]

Pointing to the "interweaving terminology" and "cross-reference approach," the *Madoff* court closely followed the textual argument of *French* and found that Congress intended the avoidance provisions of U.S. Bankruptcy Code to apply extraterritorially.[49] However, it is hard for the "cross-reference approach" to survive *Morrison*'s "affirmative indication" standard. Therefore, the *Madoff* court addressed the "focus test" at the very beginning of its discussion to discern the objects of the "statute's solicitude" and what the statute "seeks to regulate."[50] *Madoff* found that the regulatory focus is on the "improper depletion of the bankruptcy estate's assets." Interestingly, to support its argument, *Madoff* cited *French*.[51] However, *Madoff* did not cite *French's* discussions of extraterritoriality. Instead, *Madoff* used *French*'s choice-of-law and international comity analyses to decide where the challenged transfer was located.[52]

On appeal, however, the bankruptcy court's decision was overruled by the district court.[53] According to the court, tying "property of the estate" to the avoidance provisions is "clever" but "proves too much"—this logic would justify the extraterritorial application of the whole Bankruptcy Code. Instead of examining the "focus" of the Bankruptcy statute, the district court shifted its analysis to the "component events of those transactions." Because both the transferor and transferee in were "foreign," the district court found that the transfer was extraterritorial despite the fact that the chain originated in New York.

The district court also made an alternative ruling based on international comity. Specifically, the court compared the interests of Untied States and the relevant foreign nation. In a paralleling proceeding in the British Virgin Islands, a court determined that the trustee could not reclaim transfers made to its customers under a common-law theory. Therefore, the district court

---

[44] Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, 480 B.R. 501, 507 (Bankr. S.D.N.Y. 2012).

[45] For a detailed discussion of *In re Madoff*, see Edward R. Morrison, *Extraterritorial Avoidance Actions: Lessons from Madoff*, 9 BROOK. J. CORP. FIN. & COM. L. 163 (2014).

[46] *Id.* at 516.

[47] Int'l Shoe Co. v. Washington, 326 U.S. 310, 316 (1945)

[48] *Madoff*, 480 B.R. at 516–17.

[49] *Id.* at 526.

[50] *Id.* at 523–24.

[51] *In re French*, 440 F.3d 145, 153–54 (2006).

[52] *Id.*

[53] Sec. Inv'r Prot. Corp.v. Bernard L. Madoff Inv. Sec. LLC, 513 B.R. 222 (S.D.N.Y. 2014).

found that the trustee should not be allowed to take advantage of a U.S. forum and seek a judgment conflicting with the foreign court's decision.[54]

(2) *In re Lyondell* (2016)

Lyondell Chemical Company ("Lyondell"), a Delaware corporation headquartered in Houston, was acquired by a Luxembourg entity in a leveraged buyout ("LBO"), in which Lyondell took on $21 billion of secured indebtedness. Shortly after the LBO, Lyondell suffered financial problems and filed chapter 11 bankruptcy in the Southern District of New York.[55] Before the bankruptcy court, unsecured creditors challenged the pre-bankruptcy transfers made by the debtor to the shareholder recipients. In response, the defendant filed "a large number of motions"[56] that raised questions of personal jurisdiction and the extraterritorial application of the U.S. Bankruptcy Code. The court found the plaintiff's "alter ego" theory insufficient to establish the court's jurisdiction. Though that finding was dispositive in the case, the court moved forward anyway to discuss the question of extraterritoriality.

The creditors raised a series of "U.S. components" in the transaction, including that: (1) the parties made the transfer in the United States; (2) the transfer was part of a merger for the acquisition of a U.S. corporation; and (3) the transfer had a substantial effect on the U.S. forum since it caused the undercapitalization of the resulting company. However, the bankruptcy court found that these connections were "minimal" and, therefore, insufficient to bring the transfer to Luxembourg shareholders subject to "domestic" regulation.[57] Once again, in deciding where the focus of the transfer was located, the court considered the same facts and made the same conclusion as it did in its discussion concerning personal jurisdiction. Nothing indicates that the court adopted a different standard with respect to the transferees' contact with the United States forum in the two contexts.

The bankruptcy court nevertheless found that §548 of the Bankruptcy Code was applicable to the transfer because Congress expressly intended its extraterritorial applicability. This conclusion was largely based on *French* and Professor Westbrook's academic opinion.[58] It is surprising that the bankruptcy court did not discuss or even mention anything about *Madoff*. We don't know whether such omission is intentional or not, but it clearly shows that in the Southern District of New York, judges have different interpretations of the "focus test" and the "affirmative indication" prescribed by *Morrison*.

(3) ***In re Ampal–American Israel Corp* (2017)**

After *In re Lyondell*, the bankruptcy court, once again, quickly changed its mind. In the Chapter 7 case for Ampal–American Israel Corp. ("Ampal"), Judge Bernstein made it clear that none of the avoidance provisions under the Bankruptcy Code can be applied extraterritorially.[59]

---

[54] *See Morrison*, *supra* note 46, at 174–78 (criticizing the district court's international comity discussion).
[55] *In re* Lyondell Chemical Company, 543 B.R. 127, 132–33 (Bankr. S.D.N.Y. 2016).
[56] *Id.* at 133.
[57] *Id.*
[58] *Id.* at 152–55.
[59] *In re* Ampal-American Israel Corp., 562 B.R. 601 (Bankr. S.D.N.Y. 2017).

Ampal was New York corporation that served as a holding company for its Israeli headquarters. The debtor's trustee brought claims under §547 and §550 to recover transfers made to an Israeli law firm hired by the debtor prior to the bankruptcy filing. Similar to the transaction in *Maxwell* that was made extraterritorially in the United Kingdom, the challenged transfer was made in Israel, to an Israeli transferee, and through an Israeli bank. Therefore, it is unsurprising that the court concluded that the transaction was "foreign."

The court spent lots of time summarizing precedents from different jurisdictions regarding extraterritorial application of the Bankruptcy Code. After a detailed review of *French* and *Maxwell*, the court found that property transferred to a third party prior bankruptcy is "neither property of the estate nor property of the debtor *at the time the bankruptcy case is commenced*."[60] Therefore, the cross-reference in §547 does not refer to any extraterritorial property. Instead, the provision is presumed to apply domestically only.

To support its conclusion, the court considered the "context" of the Code in light of the *expressio unius* doctrine. Because some provisions of the Bankruptcy Code contain the language "wherever located" and other provisions do not, the court concluded that Congress did not intend for the latter provisions to apply extraterritorially.[61] However, even though this is a plausible reading of the bankruptcy code, it does not adhere to the strict textualism approach applied in *Morrison*. Instead, it added "at the time the bankruptcy case is commenced" as a condition to the definition of "property of the estate." In addition, such reading cannot find support from the Congressional intent or the object and purpose of the Bankruptcy Code.

(4) ***In re Arcapita Bank B.S.C. (c)* (2017)**

The latest decision from the Southern District of New York is *In re Arcapita Bank*.[62] In this case, the debtor Arcapita was an Islamic wholesale bank headquartered in Bahrain. Defendant–transferee Tadhamon was a Bahraini corporation and a subsidiary of a Yemeni bank. Less than one month before Arcapita filed chapter 11 bankruptcy in New York, the debtor made a series of investment agreements with the defendant and transferred $20 million from its account at JP Morgan Chase Bank in New York to defendant's account at HSBC Bank in New York.

Defendant Tadhamon filed a motion to dismiss the debtor's preference claim on two familiar bases: presumption against extraterritoriality and international comity. Prior to filing that motion, the parties had already litigated whether the court had personal jurisdiction over the defendant in the Southern District Court of New York. The district court found specific jurisdiction over the defendant based on its deliberate use of New York correspondent bank accounts to receive funds from the debtor, which met the threshold of minimum contacts.[63] Based on these same facts, the bankruptcy court found that the transfer was "domestic."

According to *Arcapita*, the question for the extraterritoriality analysis is the focus of the statute, which looks to the "transfer of an interest of the debtor in property."[64] Therefore, using

---

[60] *Id.* at 612.
[61] *Id.*
[62] *In re* Arcapita Bank B.S.C.(c), 12-11076 (SHL), 2017 WL 4620967 (Bankr. S.D.N.Y. Oct. 13, 2017).
[63] Official Comm't of Unsecured Creditors of Arcapita v. Bahrain Islamic Bank, 549 B.R. 56, 69–71 (S.D.N.Y. 2016).
[64] *In re Arcapita Bank*, 2017 WL 4620967, at 12.

bank accounts in New York was sufficient to displace the presumption against extraterritoriality.[65] Nevertheless, unlike *Madoff*, in which the bankruptcy court emphasized the "*depletion*" of debtor's property,[66] the court in *Arcapita* underscored the Defendant's "*receipt*" of the transferred funds in the New York correspondent bank account, which was "at the heart of the cause of action."[67]

Despite *Arcapita* relying heavily on the district court's finding of personal jurisdiction over the defendant, the court tried to clarify the difference between the two concepts. In its motion to dismiss, the defendant argued that the transfer was foreign since it was only a "one-time recipient" of funds from the U.S. bank. The court rejected defendant's argument because it would "conflate the personal jurisdiction inquiry."[68] Nevertheless, the issue is not as easy to decide as the court in Arcapita suggested. Rather, it may be that the "focus test" analysis concerning the presumption against extraterritoriality unavoidably overlaps with the personal jurisdiction analysis. When the court's personal jurisdiction over the defendant is based on a specific transaction, judges will look at the broader scope of facts that indicate any contact between the defendant and forum state, provided such contact is "relevant" to the disputed transfer.[69] At the same time, bankruptcy courts often look at the parties' contacts with the U.S. forum in the preparation or realization of the transfer to discern the nature and focus of the challenged transaction.[70]

2. **Delaware—*In re FAH* (2017)**

Over the summer of 2017, the District of Delaware finally joined the discussion and decided that the avoidance and recovery provisions of the Bankruptcy Code are applicable extraterritorially, which further deepens the divide among federal courts. Considering the importance of the Southern District of New York and the District of Delaware, the split can lead to serious problems concerning forum shopping and unpredictability.

In in re FAH, the debtors were the electronic vehicle manufacturers Fisker Automotive Holdings and Fisker Automotive, Inc. ("FAH").[71] In November 2013, the debtors filed Chapter 11 bankruptcy in Delaware and sold their assets with the court's approval. Prior to the filing, the debtors entered a purchase agreement with Bayerische Motoren Werke Aktiengesellschaft ("BMW"), a German corporation with its principal place of business in Munich, German. The agreement specified that disputes arising from the transaction would be governed by German law and that Munich would be the exclusive place of jurisdiction. Pursuant to its obligation under the agreement, the debtor transferred $32 million to BMW at different times from June 30, 2011 to April 9, 2012. The debtors' trustee sued BMW to avoid the transfer under §548(a) of the Bankruptcy Cod and relevant state laws. Still, assuming §548(a) was applicable, it would allow

---

[65] *Id.* at 10.
[66] Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, 480 B.R. 501, 524 (Bankr. S.D.N.Y.2012) (citing *In re* French, 440 F.3d 145, 154 (4th Cir. 2006)).
[67] *In re Arcapita*, 2017 WL 4620967, at 9–10.
[68] *Id.* at 12.
[69] Int'l Shoe Co. v. State of Wash., 326 U.S. 310, 320 (1945); Helicopteros Nacionales de Colombia, S.A. v. Hall, 466 U.S. 408, 414 (1984); Burger King Corp v. Rudzewicz, 471 U.S. 462, 475–77 (1985).
[70] *See, e.g.*, *In re* Lyondell Chemical Co., 543 B.R. 127, 149 (Bankr. S.D.N.Y. 2016) (considering the parties' contact with the forum before the challenged transfer but found the court lacks personal jurisdiction over the defendant and the transaction is "foreign").
[71] *In re FAH Liquidating Corp.*, 527 B.R. 117 (Bankr. D. Del. 2017)

only a two-year look back period.[72] Therefore, to avoid the transfer made on June 30, 2011, the trustee further asked the court to apply the Delaware or California Uniform Fraudulent Transfer Act (UFTA), which allows a longer trace-back period of four years.[73]

The court first decided that the transfers made by debtor pursuant to the agreement were "extraterritorial" by looking at the "center of gravity" of the transfer.[74] Specifically, the agreement was centered on development work undertaken by a German company pursuant to German contracts that required the application of German law. BWM was also required to deliver the work in Germany in exchange for debtor's payment in Euros.[75] However, relying entirely on *Lyondell* and *French*, the Delaware court found that the avoidance provisions of the Bankruptcy Code applied extraterritorially. As to the question whether Delaware or California UFTA was applicable, the court conducted a choice-of-law analysis for the second time, balancing the interests of Germany and Delaware or California. Using the same factors as in its "extraterritoriality" analysis, the court nevertheless concluded that German law should control.

California and Delaware state law are different from the Bankruptcy Code for two reasons. First, whereas state UFTA law is substantive law, the bankruptcy code is essentially a procedural rule. This is significant because courts are generally allowed to apply domestic procedural rules, but a choice-of-law analysis is required for the application of substantive law. And second, there is a strong interest underlying the Bankruptcy Code for the court to exercise control over the debtor's assets and avoid debtor's illegal transfer or hide of assets before filing bankruptcy. The fact that Delaware court was willing to apply the Bankruptcy Code but not state law in the "foreign" transaction is particularly telling with respect to the dilemma that bankruptcy judges face after *Morrison*. The sweeping presumption against extraterritoriality takes away judges' choice-of-law discretion, which prevents judges from taking states' interests in operating the whole bankruptcy proceeding into consideration. Nevertheless, in international insolvency cases, different debtors demand different arrangements, and bankruptcy judges are more willing to ratify private bargains and negotiations between creditors and debtors. Therefore, the flexibility provided by the choice-of-law and international comity analyses is greatly needed for judges to achieve the goal of efficiency and maximization of value in bankruptcy proceedings.

C. Summary and comments

Reviewing decisions both before and after *Morrison*, it is clear that federal courts have different understandings on two issues: (1) how much courts can deviate from the text of the statute and look at the context and connections among different provisions in the Bankruptcy Code; (2) when deciding the "focus" of the statute, what is the proper level of generality a court should apply to discern the object and purpose of the avoidance provisions. Despite these differences, the

---

[72] 11 U.S.C. §548(a).

[73] 11 U.S.C. §544(b); DEL. COD. TIT. 6, §1304 (2017); CAL. CIVIL CODE §3439.07 (2017).

[74] *In re* FAH, 572 B.R. at 124. Once again, the court used choice-of-law concept in its discussion. Russell J. Weintraub, *Choice of Law in Contract*, 54 IOWA L. REV. 399, 412 (1968) ("'[T]he emerging consensus ... appears to be that questions of validity should be controlled by the "center of gravity" of the transaction, this being the state having the most significant relationship with the parties and with the transaction.").

[75] *In re* FAH Liquidating Corp., 572 B.R. 117 (Bankr. D. Del. 2017).

methodologies adopted by the courts share lots of similarities. Courts often use the defendant's purposeful availment to the forum and a conflict-of-law balancing test to decide whether a transfer is "foreign" or "domestic." Meanwhile, the question of international comity is often brought up by the defendant together with a presumption-against-extraterritoriality challenge, where consideration of "clashes with other sovereignty's law" can be resolved by focusing on discussions about the interests of parallel foreign proceedings and the different roles played by main and non-main bankruptcy courts. This review of recent case law indicates that the presumption against extraterritoriality can play only a very limited role in these discussions.

III. Extraterritorial Application of the Avoidance Provision in Main Proceedings

The prior section shows the overlaps between the presumption against extraterritoriality and other basic jurisdictional and choice-of-law questions. These overlaps are especially obvious when federal courts use choice of law and international comity factors to decide the "location" of the disputed transaction and the "focus" of bankruptcy avoidance law in the application of a specific action.[76] This section will analyze those factors under the universalism bankruptcy scheme where U.S. courts provide the main proceeding of a multinational insolvency. In this context, the "focus" for both choice-of-law and presumption-against-extraterritoriality questions is the main bankruptcy case instead of individual transactions. Therefore, this Paper argues that the presumption against extraterritoriality should not prevent the application of the avoidance and recover provisions of the Bankruptcy Code in U.S. main proceedings.

A. The Debtor's Center of Main Interests (COMI)

1. Defining COMI

The underlying goal of bankruptcy law is to bring all the claims and actions involving the bankruptcy debtor into one proceeding where the court can issue decisions binding on all stakeholders.[77] In a multinational insolvency case, having a single court that provides a unified approach to "assembly and sale of assets as a whole" efficiently protects the debtor's assets and maximizes the value generated in the insolvency proceeding.[78] Under the modified universalism approach, the court where the debtor's Center of Main Interests (COMI) is located serves as the main proceeding of the insolvency,[79] and its control over the debtor's assets is of great significance to achieve the overall object and purpose of the bankruptcy proceeding and the Bankruptcy Code.[80]

---

[76] *See e.g. Maxwell*, 186 B.R. at 822; *French*, 440 F.3d at 152; *In re* Madoff, 512 B.R. 222, 231 (S.D.N.Y. 2014); *In re* Arcapita Bank B.S.C. (c*)*, 2017 WL 4620967, at *4 (2017).

[77] TRANSNATIONAL INSOLVENCY: GLOBAL PRINCIPLES FOR COOPERATION IN INTERNATIONAL INSOLVENCY CASES (AM. LAW INST. & INT'L INSOLVENCY INST. 2012), at 11 principle 36 (plan binding on participants).

[78] Jaw Lawrence Westbrook, *A Global Solution to Multinational Default*, 98 MICH. L. REV. 2276, 2293 (2001).

[79] Council Regulation 2o15/848, Regulation of the European Parliament and of the Council on Insolvency Proceedings, 2015 O.J. (L 141/19) (EC); U.N. Comm'n on Int'l Trade Law (UNCITRAL), *Model Law on Cross-Border Insolvency with Guide to Enactment*, U.N. Sales No. E99. V.3 (1999) [hereinafter UNICITRAL Model Law].

[80] Westbrook, *The Control of Wealth in Bankruptcy*, *supra* note 44, at 823; Westbrook, *The Global Insolvency Proceeding for a Global Market*, *supra* note 44, at *5; *see also* Oscar Couwenberg & Stephen J. Lubben, *Corporate Bankruptcy Tourists*, 70 BUS. L. 719, 742 (2015) (noting that the global stay available in the U.S. bankruptcy proceedings provides better protection of debtors' assets and therefore was one of the reasons that attract foreign corporation to file bankruptcy in the United States).

Deciding the debtor's COMI can be a hard question when a multinational corporation with a complicated structure has a significant presence in more than one jurisdiction. Nevertheless, policy considerations related to predictability and acceptability of the substantive law provide helpful guidance.[81] Under the UNCITRAL Model Law, it is presumed that the COMI is located at the debtor's place of incorporation or its principal place of business.[82] While this presumption can be rebutted occasionally, nevertheless, a court shall not serve as the main proceeding in an international insolvency case unless the forum state has substantive connection with the debtor.[83]

2. Claims in the Main Proceeding—Personal Jurisdiction Limitation

Even in a main proceeding, the court's controlling power over the debtor's assets is limited by the rule of personal jurisdiction,[84] as indicated by *Madoff*.[85] Federal courts' personal jurisdiction over a transferee can be specific[86] or general,[87] depending on the transferee's contact with the forum state. In practice, such contact also bears an important role in deciding whether the challenged transfer is "domestic" and therefore displaces the presumption against extraterritoriality. For example, contacts such as the parties' pre-transfer negotiations within the United States or the use of U.S. banking accounts to make such transfer will largely render the transaction as subject to "domestic" regulation of U.S. law.[88] Meanwhile, a transfer of property located outside of the United States territory is still "domestic" when both the debtor and the transferee are residents or corporations that are "at home" in the United States.[89]

The personal jurisdiction requirement by itself can serve the purpose of avoiding clashes with foreign laws. Comparative studies indicate that Bankruptcy laws from different countries vary most in treatment of priority rules.[90] Protecting the interests of local creditors becomes an important justification against the universalism approach of international insolvency.[91] However, when a transferee is merely a local creditor or resident of a foreign country who does not have sufficient contact with the U.S. forum, U.S. avoidance law will not be applicable to such transferee or otherwise clash with foreign laws.

---

[81] Westbrook, *Locating the Eye of the Financial Storm*, *supra* note 17, at 1021.
[82] UNCITRAL Model Law, *supra* note __, art. 16.
[83] *See* Westbrook, *The Global Insolvency Proceeding for a Global Market*, *supra* note 44, at **10–11.
[84] Jay Lawrence Westbrook, *Multinational Insolvency: A First Analysis of Unilateral Jurisdiction*, *in* Morton Annual Review of International Insolvency, 17–18 (2009) (explaining the personal jurisdiction requirement of U.S. bankruptcy court to exercise control over the bankruptcy proceeding and the court's power to have effects on debtors' assets and actions outside of the United States).
[85] Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, 480 B.R. 501, 516 (Bankr. S.D.N.Y. 2012).
[86] *Madoff*, 480 B.R. at 516–17; *cf. In re Lyondell*, 543 B.R. 127, at 147 (Bankr. S.D.N.Y. 2016).
[87] Burnham v. Superior Court of California, 495 U.S. 604 (1990); Daimler AG v. Bauman, 134 S. Ct. 746 (2014).
[88] *In re* Arcapita Bank B.S.C.(c), 12-11076 (SHL), 2017 WL 4620967 (Bankr. S.D.N.Y. Oct. 13, 2017).
[89] *In re* French, 440 F.3d 141, 151–52 (4th Cir. 2006).
[90] *See* Jay Lawrence Westbrook, *Cooperation in Multinational Insolvencies*, 27 PENN ST. INT'L L. REV. 869, 869.
[91] Andrew T. Guzman, *International Bankruptcy: In Defense of Universalism*, 98 MICH. L. REV. 2177, 2180 (2000); Bob Wessels, *The European union Insolvency Regulation: An Overview with Trans-Atlantic Elaborations*, 2003 ANN. SURV. BANKR. L. 481, 487 (2003).

3. Choice of Operative Law in Main Proceeding

U.S. Bankruptcy law does not adopt an "explicit choice-of-law rule" in multinational bankruptcy cases. However, a close analysis of its operation by federal courts reveals the existence of a conflicts approach.[92] Generally speaking, this conflicts-of-law discussion is a two-step inquiry: first, the choice of bankruptcy law for management and procedural issues; second, the choice of substantive law that determines the validity of creditors' claims. The choice of avoidance law is particularly unique. On the one side, it is closely related to the procedural question of the bankruptcy court's power to control the debtor's assets and manage the insolvency proceeding in its entirety; on the other, the validity of a pre-bankruptcy transfer is a substantive law question about the title and ownership of property rights.

In fact, how to apply the choice-of-law rule is the main question that divides scholars supporting different international insolvency theories,[93] and that question is at the heart of the universalism insolvency scheme. Professor Westbrook has moved further by suggesting that under the ideal bankruptcy theory of universalism, the "main" court should apply its own law to the four overarching bankruptcy policies: control, priority, avoidance, and reorganization.[94] This Paper endorses the universalism approach, but it does not intend to (and cannot) resolve the long-lasting discussion among scholars. Nevertheless, these discussions indicate, in the international insolvency regime, the choice of avoidance law is a key issue requiring a delicate balance at different levels. At the level of sovereign states, it requires a balance of the interests of the COMI state in operating and managing the insolvency proceeding and the interests of other states to enforce their policy concerning the protection of property rights. At the level of private entities, it requires the interest of a fair and efficient distribution of value for all the creditors at stake to be balanced with the finality of the transferees' property rights.

As suggested by section II, U.S. judges have taken these balancing factors into consideration. However, the sweeping presumption against extraterritoriality is an obstacle that forces judges to reframe their reasoning to fit into the two-step analytical structure. A strict enforcement of this presumption in each transaction will necessarily result in a denial of deference to the management interests of the bankruptcy courts and the sovereign states. Its application in cases where U.S. courts supervise main multinational insolvency proceedings is an endorsement of the territorialism approach,[95] which adds to the cost of every international transaction because

---

92 Hannah L. Buxbaum, *Rethinking International Insolvency: The Neglected Role of Choice-of-Law Rules and Theory*, 36 STAN. J. INT'L L. 23, 25 (2000). Also see discussions in Section-II.

93 *Compare* Westbrook, *Universalism and Choice of Law*, *supra* note__, at 626; *with* Lynn M. LoPucki, *Cooperation in International Bankruptcy: A Post Universalist Approach*, 84 CORNELL L. REV. 696, 750 (1999); *and* Edward J. Janger, *Universal Proceduralism*, 32 BROOK J. INT'L L. 819 (2007).

94 Westbrook, *Locating the Eye of the Financial Storm*, *supra* note 17, at 1021; *see also* Jay Lawrence Westbrook, *Choice of Avoidance Law in Global Insolvencies*, 17 Brook. J. Int'l L. 499 (1991) (Proposing a general rule that "the avoiding court should apply its own law if it will distribute the proceeds, but should apply the home-country avoiding law if it turn over the proceeds to the home country court for distribution).

95 *See* Samuel L. Bufford, *Global Venue Controls Are Coming: A Reply to Professor LoPucki*, 79 AM. BANKR. L.J. 105, 108 (2005) (noting that through the territorialism approach "the courts in each national jurisdiction seize the property physically within their control and distribute it according to local rules").

of the unpredictability.[96] These avoidance-law-applicability decisions do not necessarily indicate a circuit split in judges' understanding of international insolvency theory or the application of U.S. bankruptcy law.

B. Applying the Presumption Against Extraterritoriality in U.S. Main Proceedings

1. Understanding the Presumption—A Judicial Canon for Choice-of-Law Rule

Historically, the extraterritorial application of U.S. law to disputes involving some foreign elements is a choice-of-law question.[97] Early discussions of the presumption against extraterritoriality focused on regulatory schemes like antitrust and securities regulation.[98] The United States has played a leading role in their early development when there was no compatible foreign regulation in these areas. As a result, a simple conflicts analysis in these cases inevitably favored the application of U.S. law because the lack of foreign regulation was often interpreted as a lack of foreign interests at stake. However, these outreaches invited criticisms and serious resistance by foreign nations.[99] It was under these circumstances that the presumption against extraterritoriality was developed and gradually expanded to its current cross-border application.

The presumption reflects a judgment that "assumes cases meeting the definition of "extraterritorial" are enough alike to be treated similarly for the purpose of determining prescriptive jurisdiction."[100] That assumption is consistently challenged by scholars and judges since different areas of law demand a different balance of U.S. and foreign interests.[101] Particularly in the area of insolvency, nation states share similar economic goals and policy considerations.[102] States indeed have different priorities concerning which interests should be protected by their domestic bankruptcy codes. Nevertheless, the common demand of efficiency often motivates them to cooperate with each other to maximize the value of the debtors' assets.[103] This is indicated by

---

[96] Jay Lawrence Westbrook, *Theory and Pragmatism in Global Insolvencies: Choice of Law and Choice of Forum*, 65 AM. BANKR. L. J. 457, 460–61 (1991).

[97] *See generally* William S. Dodge, *Extraterritoriality and Conflict-of-Laws Theory: An Argument for Judicial Unilateralism*, 39 HARV. INT'L L. J. 101 (1998).

[98] *See, e.g.*, Russell J. Weintraub, *The Extraterritorial Application of Antitrust and Securities Laws: An Inquiry into the Utility of a "Choice-of-Law" Approach*, 70 TEXAS L. REV. 1799 (1992).

[99] P.C.F. Pettit & C.J.D. Styles, *The International Response to the Extraterritorial Application of United States Antitrust Laws*, 37 BUS. LAWYER 697 (addressing the great concern arising from the U. S. agencies' exercise of investigatory and regulatory powers over companies headquartered and operating entirely outside of the Untied States).

[100] Clopton, *Replacing the Presumption Against Extraterritoriality*, *supra* note__ at 4.

[101] For example, professor Clopton has urged courts to make separate presumption against extraterritoriality in civil, criminal, and administrative law cases. *Id.* at 21. *See also* KAL RAUSTIALA *supra* note __, at 177 (finding the extraterritorial application of different areas of law are not treated in the same manner).

[102] BOB WESSELS, BRUCE A. MARKELL & JASON J. KILBORN, INTERNATIONAL COOPERATION IN BANKRUPTCY AND INSOLVENCY MATTERS 172 (2009).

[103] *See* Ron W. Harmer, *Insolvency Law Reforms in the Asian and Pacific Region*, 1 L. & POL'Y REFORM ASIAN DEPT. BANK 8, 25 (2000) (summarizing the "similarity in needs and expectations found within the commercial community," such as the needs for (1) certainty and predictability in commercial affairs; (2) sensible commercial stability; (3) commercial efficiency; (4) fair commercial or equitable treatment; and (5) transparency).

the wide acceptance of the universalism approach in different countries,[104] as well as the increasing international judicial coordination and cooperation.[105]

At the same time, the presumption against extraterritoriality is a judicial canon for statutory construction,[106] which gives federal courts flexibility in its application. The presumption was applied within various strengths at different times in the history and in different areas of law.[107] In addition, this interpretive cannon should not be applied in a way that circumvents the explicit intent of Congress.[108] Congress clearly foresees, if not encouraged, the U.S.-managed international insolvency proceedings. For example, Congress adopted Chapter 15 of the Bankruptcy Code, which allows courts to issue a "global stay" on debtors' assets wherever they are located.[109] Therefore, if federal courts reject the extraterritorial application of avoidance provisions and undermine the function of international the function of international insolvency proceedings, it would circumvent Congressional intent.

2. Applying the Presumption—Focus on Bankruptcy Proceedings as a Whole

It is undisputed that Congress can fix this longstanding split of extraterritoriality question by amending the avoidance provisions. However, legislative inertia by itself brings significant costs to the system. Therefore, this article suggests that courts apply a choice-of-law and international comity analysis when considering the presumption against extraterritoriality, with an emphasis on the state's interests in managing a multinational debtor's insolvency scheme as a whole.

At step one, courts must decide whether the focus of a challenged transfer is domestic or extraterritorial. In a bankruptcy setting, the interests at stake extend beyond a specific transaction. More relevant is the operation of the whole proceeding. With that in mind, courts can decide the focus of the disputed transfer based on its nature and its impact on the U.S. bankruptcy proceeding. For example, the Fourth Circuit and the bankruptcy court in *Madoff* found the challenged transfers were "domestic" by emphasizing the "depletion of the debtor's U.S. assets" arising from the transfer.[110] Courts can also look at factors including the origin of the money transferred; the

---

[104] For example, the UNCITRAL Model Law on Cross-Border Insolvency, for instance, has been adopted in 43 States in a total of 45 jurisdictions. *Status: UNCITRAL Model Law on Cross-Border Insolvency (1997)*, U.N. COMMISSION ON INT'L TRADE L., http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model_status.html.

[105] TRANSNATIONAL INSOLVENCY: GLOBAL PRINCIPLES FOR COOPERATION IN INTERNATIONAL INSOLVENCY CASES (AM. LAW INST. & INT'L INSOLVENCY INST. 2012); Westbrook, *The Global Insolvency Proceeding for a Global Market*, *supra* note 44, at *17; Hannah Buxbaum, *Conflict of Economic Laws: From Sovereignty to Substance*, 42 VA. J. INT'L L. 931, 952 (2002) [hereinafter Buxbaum, *Conflict of Economic Laws*]. For a detailed discussion for the convergence of international insolvency practices though legislation and professional cooperation, see BOB WESSELS ET AL, *supra* note 108, 167–95 (2009).

[106] RJR Nabisco, Inc. v. European Community, 136 S. Ct. 2090, 2100 (2016)

[107] KAL RAUSTIALA, *supra* note 7, at 93–125, 101.

[108] For a detailed discussion of legislative supremacy and judicial constraints, see Daniel A. Farber, *Statutory Interpretation and Legislative Supremacy*, 78 GEO. L.J. (1989) (noting that the legislative supremacy principle subordinate the judiciary's policy-making power in nonconstitutional areas to the legislators').

[109] 11 U.S.C. § 362

[110] *In re French*, 440 F.3d 145, 153–54 (4th Cir. 2006); Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, 480 B.R. 501, 523–24 (Bankr. S.D.N.Y. 2012).

amount transferred relative to the debtor's overall assets; reliance of the creditors in the U.S. proceeding on such assets; as well as the identity and location of the transferee. This is essentially an interest balance in the choice-of-law and international comity discussions. It is important to notice that these factors indeed focus on the "impact" of the transaction on the U.S. forum. However, it is different from the idea of "touch and concern" rejected by the Supreme Court in the context of extraterritorial application of the Alien Torts Statute.[111] The "concern" raised by the challenged transfer is not merely about "enforcing U.S. law and justice" in an abstract sense. Instead, every dollar being transferred overseas means a direct one dollar loss for the domestic creditors—which is substantive by all means.

At step two, courts will decide whether the presumption against extraterritoriality has been overcome by a clear Congressional intent. Once on again, the interpretation of the avoidance provision should focus on the objective and purpose that Congress intends to achieve through the bankruptcy proceeding *as a whole*. The *French* line of cases, which found that Congressional intent overcame the presumption, mainly relied on the *textual* connection between the automatic stay provision and the avoidance provision, both of which refer to the "property of the estate." However, as challenged by courts in the Second Circuit, that textualism argument is hard to reconcile with the "clear intention" requirement established by the Supreme Court.[112] In fact, what is missing from this discussion are the underlying *functional* connections between the different sections of the Bankruptcy Code. Both avoidance law and the automatic stay serve the common goal in insolvency proceedings to preserve the bankruptcy court's power to control the debtor's assets and to prevent creditors from racing to grab the debtor's assets in violation of the priority rule. An automatic stay is effective only when the debtor cannot transfer its assets shortly before filing for bankruptcy. A global stay on debtor's assets "wherever located" is effective only when there is a comparative "global avoidance" rule that preserves the debtor's assets. If the bankruptcy courts cannot reach assets transferred before the bankruptcy filing, the post-bankruptcy "stay" would be meaningless—powerful creditors can always design a "foreign" transfer and deplete the debtor's assets before the filing, leaving nothing to be "stayed." Reading the Bankruptcy Code as a whole, courts can find a clear intent from Congress to displace the presumption against extraterritoriality.

IV. Conclusion

A strict application of the presumption against extraterritoriality in bankruptcy avoidance rules causes great uncertainty. Creditors' recovery from an insolvency proceeding will depend entirely on fortuitous facts such as the transferee's location and the mechanism used to make such transfer. This is the exact result that international insolvency practitioners have been working to avoid. Globalization and an increase in multinational business activities has fundamentally challenged the traditional "territoriality" idea.[113] When cooperation and communication among

[111] Kobel v. Royal Dutch Petroleum Co., 569 U.S. 108, 125 (2013).
[112] *In re* Ampal-American Israel Corp., 562 B.R. 601 (Bankr. S.D.N.Y. 2017).
[113] Hannah Buxbaum, *Conflict of Economic Laws: From Sovereignty to Substance*, 42 VA. J. INT'L L. 931, 942 (2002).

different nation-states becomes the pillar of international bankruptcy proceedings,[114] it is important that the application of domestic law does not deter judges from taking these actives steps to achieve uniformity and efficiency.

[114] TRANSNATIONAL INSOLVENCY: GLOBAL PRINCIPLES FOR COOPERATION IN INTERNATIONAL INSOLVENCY CASES (AM. LAW INST. & INT'L INSOLVENCY INST. 2012); Westbrook, *The Global Insolvency Proceeding for a Global Market*, *supra* note 44, at *17; Buxbaum, *Conflict of Economic Laws*, *supra* note 105, at 952.