

Cross-border Insolvency: A Case for a Transaction Cost Economics Analysis

Michael Guihot¹ – submission for the III *Prize in International Insolvency Studies, 2016*.

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1. Introduction

When Lehman Brothers Holdings Inc and its subsidiaries filed a petition commencing Chapter 11 proceedings on 15 September 2008, it triggered innumerable immediate questions about how that insolvency and the insolvency of its related companies around the world would be resolved. Cross-border insolvency refers to the situation, such as in Lehman Brothers, where a company that holds assets or conducts business in different countries becomes insolvent. There is no global law to govern cross-border insolvency. Without a global law, each country’s laws apply to the assets of the company that are within the country’s jurisdictional reach. However, there have been some recent initiatives by international organizations that have resulted in some greater certainty for participants and courts in this area.²

Cross-border insolvencies can range in complexity, and the law and procedures used to govern the insolvencies can be subject to varying levels of uncertainty. Multinational enterprise groups with distinct legal entities in multiple jurisdictions around the world present

¹ Senior Lecturer, Queensland University of Technology. Many thanks to Sandeep Gopalan, Colin Anderson, Richard Johnstone, Adrian Walters and Christoph Henkel.

² Notably, in 1997, the United Nations Commission on International Trade Law (UNCITRAL) promulgated its Model Law on Cross-Border Insolvency (Model Law). The Model Law was adopted in the United States as Chapter 15 of the Bankruptcy Code. Forty countries, including the United Kingdom, Canada, Japan, South Korea and Australia have so far adopted the Model Law. In a similar vein, the European Community Insolvency Regulation 1346/2000 governs cross-border insolvency within the European Union.

the highest levels of complexity and uncertainty in cross-border insolvency. Another relatively complex proceeding may involve a main proceeding in the centre of main interests (COMI) of a single entity debtor with disparate secondary proceedings run in other jurisdictions to recoup assets in those jurisdictions. At the other end of the scale lie cross-border insolvencies of single entities with perhaps only a single asset in one foreign jurisdiction. Such is the range of transaction types in the area.

There are two broad competing approaches taken by different states to resolve cross-border insolvencies: universalism and territoriality. Firstly, universalism describes a way of governing cross-border insolvencies in which a proceeding in one jurisdiction, mainly where the debtor has its COMI, claims extra-territorial effect and purports to cover the debtor's assets regardless of which country they are in.³ Pure universalism refers to the, as yet unachievable system, under which a single court applies a single law to govern the global assets of an entity. If assets are held in other jurisdictions, pure universalism necessarily must depend on other nations ceding sovereignty and jurisdiction over those assets to the country in which the debtor has its COMI. Because of this severe limitation, it only exists in modified forms in some countries. Those modified forms of universalism display varying levels of cooperation and coordination between and among courts, creditors, and insolvency practitioners to achieve a more, or less, integrated and coordinated approach to recovering and pooling assets.

Secondly, the obverse approach to universalism is referred to as territoriality. Under this mode of governing cross-border insolvencies, creditors in each country where the debtor's assets are located are left to commence proceedings to recover those assets within their own jurisdiction using that country's own courts and laws. This can lead to multiple insolvency proceedings in different jurisdictions using different laws. Westbrook argued that, for those reasons, territoriality is inefficient.⁴ However, where territoriality applies, local creditors often receive the benefit of lower costs by utilizing local insolvency proceedings, and using local agents.⁵ Bebhuk and Guzman found that, in a territorialist system, creditors as a whole receive less in the winding up than they would under a universalist structure.⁶ However, this paper argues that, for some transaction types, a territorialist approach to collecting assets might be a more transaction cost efficient option.

As a concession to the sovereignty of states, the Model Law contains a number of elements that adopt a territorialist approach; including 'adequately protecting' the interests of local creditors before debtor's assets are entrusted to a foreign representative.⁷ Despite these concessions, the Model Law has not been accepted globally, and particularly not in emerging countries such as Brazil, Russia, India or China. This failure to achieve greater global

³ See ROY GOODE, *PRINCIPLES OF CORPORATE INSOLVENCY LAW*, p 782 (Sweet & Maxwell, 4th ed 2011).

⁴ See Jay Lawrence Westbrook, *A Global Solution to Multinational Default*, 98 MICHIGAN LAW REVIEW 2276, 2320 (2000).

⁵ See Lynn M LoPucki, *The Case for Cooperative Territoriality in International Bankruptcy*, 98 MICHIGAN LAW REVIEW 2216.

⁶ See Lucian Arye Bebchuk & Andrew T Guzman, *An Economic Analysis of Transnational Bankruptcies*, 42 JOURNAL OF LAW AND ECONOMICS 775 (1999).

⁷ See Model Law, Article 21(2): 'Upon recognition of a foreign proceeding, whether main or non-main, the court may, at the request of the foreign representative, entrust the distribution of all or part of the debtor's assets located in this State to the foreign representative or another person designated by the court, **provided that the court is satisfied that the interests of creditors in this State are adequately protected.**' (emphasis added).

purchase has itself created greater uncertainty in global trade.⁸ There are many hybrid forms of governance in between universalism and territoriality that adopt greater or lesser measures of cooperation and coordination respectively. These will be discussed in Part 3.4 below. Proponents of global solutions to cross-border insolvency, such as UNCITRAL in the Model Law, aim to make cross-border insolvency processes more efficient.⁹ For example, the Model Law aims to increase ‘cooperation between the courts and other competent authorities of [enacting states] and foreign States involved in cases of cross-border insolvency’ and to increase the efficiency of the collection process.¹⁰ The question remains as to whether the various available modes of governing cross-border insolvencies are being used effectively to achieve those aims.

This paper examines cross-border insolvencies through the lens of Williamson’s Transaction Cost Economics (TCE).¹¹ It makes three arguments: firstly, it identifies some tendencies in current cross-border insolvency practices that align with the TCE methodology. Secondly, based on a normative argument using TCE, it recommends some policy arguments to increase transaction cost efficiency of cross-border insolvency processes. Thirdly, it proposes a predictive tool that might be used to pre-empt the decision about how to govern particular cross-border insolvencies based on their transaction profile. Using TCE to analyse cross-border insolvencies as proposed in this paper is novel. While various scholars have studied the relative efficiency of universalism and territoriality¹² and others have concentrated on efficiency in insolvency law generally,¹³ none has studied the governance of cross-border insolvencies in a comparative way to predict the most transaction cost efficient governance mode for different cross-border insolvency transaction types. The policy benefits of obtaining greater transaction cost efficiencies in this area are self-evident, but include those three aims set out above. A TCE analysis is not a panacea and is not without its limitations, but it can add to the pantheon of economic analyses of insolvency laws, and cross-border insolvency law particularly, and has the potential to increase overall efficiency of cross-border

⁸ See Sandeep Gopalan & Michael Guihot, *Recognition and Enforcement in Cross-Border Insolvency Law: A Proposal for Judicial Gap-Filling*, 48 VANDERBILT JOURNAL OF TRANSNATIONAL LAW 1225, 1230 (2015).

⁹ Whether this is Wealth Maximisation, Pareto, Kalder-Hicks or some other type of efficiency is a contested point. However, the stated purposes of the Model Law as set out in § 1501 of the United States Bankruptcy Code include:

- (2) greater **legal certainty** for trade and investment;
- (3) fair and **efficient administration** of cross-border insolvencies that protects the interests of all creditors, and other interested entities, including the debtor;
- (4) protection and **maximization of the value of the debtor’s assets**; and
- (5) facilitation of the rescue of financially troubled businesses, thereby **protecting investment** and preserving employment. (emphasis added)

¹⁰ The Preamble to the Model Law states that it seeks to achieve, among other things, the ‘Fair and efficient administration of cross-border insolvencies ...’

¹¹ See generally, OLIVER E WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING* (The Free Press, 1985); OLIVER E WILLIAMSON, *MECHANISMS OF GOVERNANCE* (Oxford University Press, 1996); and Oliver E Williamson, *Transaction Cost Economics: An Overview, in THE ELGAR COMPANION TO TRANSACTION COST ECONOMICS* (Peter G Klein ed. 2010).

¹² See Bebchuk & Guzman, *JOURNAL OF LAW AND ECONOMICS*, (1999); Westbrook, *MICHIGAN LAW REVIEW*, (2000); Andrew T Guzman, *International Bankruptcy: In Defense of Universalism*, see id. at 2177; Lynn M LoPucki, *Cooperation in International Bankruptcy: A Post-universalist Perspective*, 84 *CORNELL LAW REVIEW* 696 (1999); and LoPucki, *MICHIGAN LAW REVIEW*, (2000).

¹³ For a good summary of law and economics studies of local insolvency systems (as opposed to cross-border insolvency), see John Armour, *The Law and Economics of Corporate Insolvency: A Review*, Working Paper No. 197 ESCR CENTRE FOR BUSINESS RESEARCH 1 (2001). While Bebchuk and Guzman argue for purported efficiency advantages of universalism over territoriality, LoPucki argues that territoriality has its own efficiencies and argues against any purported superior efficiencies of universalism. See also Frank H Easterbrook, *Is Corporate Bankruptcy Efficient?*, 27 *JOURNAL OF FINANCIAL ECONOMICS* 411 (1990).

insolvency governance. The next section of this paper introduces the building blocks of a TCE analysis. This methodology is expanded in detail in Parts 3 and 4 of the paper.

TCE Methodology

TCE does not propose simply reducing transaction costs. Instead, it adopts a comparative approach to study the efficiencies that flow from aligning alternative available governance structures, or modes, with different transaction types.¹⁴ For example, Masten argued that the ‘correct question from a governance choice perspective, [using TCE] is “How does the performance of a firm that adopted a particular arrangement compare with how *that same firm* would have performed had it adopted an alternative?”’¹⁵ In the study of organizations, Williamson delineated three broad governance structures: a hierarchical governance structure (the firm), one of the many available hybrid forms of governance (long term contracts), and an open market approach (market).

By analogy, the three broad modes of governance of cross-border insolvency for the purposes of a TCE analysis are: firstly, universalism with a single court system and a single law to govern disparate proceedings (the equivalent of hierarchy), secondly, modified universalism that displays more limited cooperation and coordination, for example through the Model Law (hybrid) and thirdly, territoriality under which the insolvency is conducted using local agents in a number of local jurisdictions in which the debtor’s assets are held (market). These are developed in Part 3 below. This paper makes a comparative analysis between these alternative governance structures in cross-border insolvency. In Part 4, the various transactions that make up a cross-border insolvency are studied and differentiated using the independent variables specified in the TCE methodology: asset specificity, uncertainty, complexity, and frequency.

This paper proposes that an analysis of cross border insolvency using TCE will result in the following outcomes: firstly, a system of governance, such as universalism, that adopts (as nearly as possible) a single court in the COMI of the debtor using that jurisdiction’s law and facilitated by a single representative, will be the most transaction cost efficient means of governing the asset collecting transactions that display high levels of asset specificity and uncertainty, are highly complex and require frequent transactions to resolve. Conversely, a system of governance, such as territoriality, that adopts local collection and liquidation of local assets using local agents and local laws, will be the most transaction cost efficient means of governing the asset collecting transactions that display low levels of asset specificity, uncertainty, complexity and frequency. Thirdly, those asset collecting transactions that display intermediate levels of asset specificity, uncertainty, complexity and frequency will be best governed using hybrid modes of governance. Various modified or hybrid versions of universalism and territoriality have filled the void between universalism and territoriality and can be developed and applied as the circumstances dictate. Therefore, the choice of hybrid governance modes in a TCE analysis must lie somewhere between the ideals of universalism and territoriality and may yet require a new taxonomy to distinguish them.

¹⁴ See Oliver E Williamson, *Strategy Research: Governance and Competence Perspectives*, 20 STRATEGIC MANAGEMENT JOURNAL 1087, 1090–1 (1999).

¹⁵ Scott E Masten, *Transaction Costs, Mistakes, and Performance: Assessing the Importance of Governance*, 14 MANAGERIAL AND DECISION ECONOMICS 119, 124 (1993) (emphasis in the original).

Example: Lehman Brothers Holdings Inc Bankruptcy

The various elements of governance modes and transaction types examined in a TCE analysis of cross-border insolvencies is exemplified in the bankruptcy of Lehman Brothers Holdings Inc (LBHI) that commenced on 15 September 2008. The proceedings spawned over 80 bankruptcy proceedings around the world¹⁶ involving companies within the Lehman Brothers Group. Before filing Chapter 11 proceedings, the Lehman Brothers Group consisted of ‘over 7000 legal entities in 40 countries.’¹⁷ In one respect, the Lehman Brothers proceedings have provided a model for the dissolution of groups in insolvency because disparate Lehman Brothers entities entered a protocol with the parent company to ensure, as best they could, that these debtors cooperated among themselves (Protocol). According to a Lehman Brothers press release in May 2009, ‘the protocol attempts to alleviate both the disruption resulting from these filings as well as the lack of an international governing body with uniform oversight over these proceedings by ensuring cooperation and coordination among the various administrators.’¹⁸ On the other hand, several high profile entities, including Lehman Brothers International (Europe) (LBIE) in the United Kingdom and administered by PriceWaterhouse Coopers, did not enter the Protocol. This decision not to buy into the Protocol becomes understandable when LBIE’s position is compared to the other Lehman Brothers entities. Unlike many other of the Lehman Brothers entities, LBIE will achieve a surplus of approximately £7 billion in the insolvency proceedings in the United Kingdom.¹⁹ Arguments about how to distribute the surplus continue and the costs of those disputes continue to eke away at the surplus.

If the TCE argument is correct, the LBHI bankruptcy was relatively more transaction cost efficient than it might have been in one respect because a more integrated mode of governance (the Protocol) was used. However, it was also less transaction cost efficient than it could have been if an even more integrated and hierarchical governance mode (such as pure universalism) had been available and was mandated. While the Lehman Brothers Protocol was effective in reaching broad agreement between many of the Lehman Brothers entities, it did not stop the practitioners and creditors of Lehman Brothers entities in some jurisdictions from holding out and seeking to attain the best outcomes possible for the separate entity. In fact, in some instances, it involved what might best be described as a strict territorialist approach in each separate jurisdiction in which a Lehman Brothers subsidiary conducted business. This, it is argued, would be the least transaction cost efficient approach for a transaction type such as the Lehman Brothers bankruptcy. TCE predicts that transactions such as the Lehman Brothers insolvency will be less transaction cost efficient because they were not governed using the most integrated form of governance.

Part 2 of this paper outlines the costs of cross-border insolvency. Part 3 examines the governance modes used in cross-border insolvency, including universalism and territoriality.

¹⁶ Debtors’ Amended Response to Objections to Approval of Proposed Disclosure Statement, *In re Lehman Bros. Holdings*, No. 08-13555 (Bankr. SDNY Aug 23, 2011), para [1], retrieved from http://bankrupt.com/misc/LBHI_SummaryRespDSObjections.pdf.

¹⁷ Lehman Brothers press release 26 May 2009 retrieved from <http://dm.epiq11.com/LBH/Document/GetDocument/1315906>.

¹⁸ Lehman Brothers press release 26 May 2009, note 17 above.

¹⁹ See PricewaterhouseCoopers, *Lehman Brothers International (Europe) – In Administration*, joint administrators’ 14th progress report, for the period from 15 March 2015 to 14 September 2015, (12 October 2015), at 14, retrieved from <http://www.pwc.co.uk/assets/pdf/lbie-14th-progress-report.pdf>. Also see Jill Treanor, ‘Lehman Brothers administrators left with £5bn surplus after creditors paid’, *The Guardian*, (5 March 2014), retrieved from <http://www.theguardian.com/business/2014/mar/05/lehman-brothers-administrators-surplus-creditors-paid>.

Part 4 then examines the independent variables of TCE analysis and applies them to transaction types typical in cross-border insolvencies. Part 5 sets out the way that transaction types align with governance modes in cross-border insolvency and discusses the Lehman Brothers insolvency by way of example. Part 6 separately proposes a normative argument for adopting pure universalism as a governance mode for highly complex and uncertain transaction types typical in multinational enterprise groups and Part 7 concludes.

2. The costs of cross-border insolvency

This Part outlines some of the transaction costs incurred in conducting cross-border insolvency transactions. Warren has noted that ‘[p]erhaps no part of the legal system is more cognizant of the transaction costs of collection and dispute resolution than the bankruptcy system, and surely no system is so conspicuously directed toward cost reduction’.²⁰ Here, she is referring to a specific subset of costs; the professional costs that feature prominently in the reporting on insolvency, including cross-border insolvency.²¹ Professional fees may provide an indication of the work that has been performed to govern cross-border insolvencies and, in that sense, can provide a gauge of transaction cost efficiency. The measure of professional fees should equate with the level and type of transactions involved in resolving the insolvency. High professional fees may indicate that a high level of work was required (for example to combat uncertainty and complexity) and that resolving the insolvency required a longer time and more frequent transactions than for a simple insolvency transaction.²² However, if a high level of fees was charged for a simple transaction, then this may indicate that the governance mode used for the simple transaction was inappropriate.

Transaction costs are incurred for a broader range of transactions than merely those that incur professional costs and fees ex-post the decision to liquidate a company. The transaction costs in cross-border insolvency include the costs incurred ex-ante and ex-post the decision to liquidate. While this paper concentrates on the ex-post costs of cross-border insolvency, the transaction costs that are incurred in relation to cross-border insolvencies include both ex-ante and ex-post varieties. Williamson argued that ex-ante and ex-post costs ‘must be addressed simultaneously rather than sequentially’. Addressing the difficulty with quantifying both types of costs he said:

The difficulty . . . is mitigated by the fact that transaction costs are always assessed on a comparative institutional way, in which one mode of contracting is compared with another. Accordingly, it is the difference between rather than the absolute magnitude of transaction costs that matters.²³

Both ex-ante and ex-post costs are considered in turn.

²⁰ Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICHIGAN LAW REVIEW 336, 348 (1993).

²¹ See the discussion of these costs in Part 2.2 below.

²² See Stephen J Lubben, *Corporate Reorganization and Professional Fees*, 82 AMERICAN BANKRUPTCY LAW JOURNAL 77 (2008) who noted in relation to costs of bankruptcy that ‘[f]actors like the size of the debtor corporation, the number of professionals retained, and whether a committee is appointed play much bigger roles’.

²³ WILLIAMSON, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting* 21–22 (1985).

2.1. Ex-ante costs

Armour proposed that the legal responses to the costs of insolvency attend to the ‘ex-post costs of enforcement and those which seek to ensure efficient incentives ex-ante.’²⁴ An example of an ex-ante transaction cost in cross-border insolvency would be the costs of negotiating and documenting a finance agreement that anticipates the possibility of cross-border insolvency. The jurisdiction and choice of law questions are usually addressed in the contract and must be negotiated and documented. The costs of doing this are transaction costs. Other ex-ante costs include the costs associated with companies opportunistically structuring related entities within a multinational enterprise group to avoid the effects of insolvency. Another is the cost of a company shifting COMI pre-insolvency to avail itself of advantageous insolvency laws. These types of ex-ante costs are more likely to be incurred in transaction types with higher levels of uncertainty and complexity. Generally, these types of costs would likely not be incurred for simple loans to single entities for non-specific local assets.²⁵ As this paper develops, it will become clear that it would not be transaction cost efficient to develop and implement highly integrated and complex governance modes to govern these simple transaction types.

The costs of remedying opportunistic behaviour of corporate groups by seeking pooling orders or substantive consolidation are ex-post costs but the costs of creating the structures in which these behaviours can develop in the first place are incurred ex-ante. These opportunistic strategies include creating separate related entities in multiple jurisdictions to allay the risks of insolvency of the whole group, and structuring loan agreements for the benefit of secured creditors.

Germane to cross-border insolvency, Chief Justice of the New South Wales Supreme Court, Spigelman J, as he then was, referred as a transaction cost in international litigation (not cross-border insolvency per se), to ‘the fear of the unknown [that] inhibits creditors when dealing with multinational corporations in the absence of a significant level of assurance that the difficulties of cross-border enforcement in insolvency will not impede the collection of debts’.²⁶ Justice Spigelman stated that ‘one object of co-operation between courts in the context of transnational insolvency is to minimise these risks and transaction costs so that transnational trade and investment is not unduly burdened.’²⁷ Here, his honour foreshadowed a TCE analysis.²⁸ In doing so, he suggested a hybrid governance mode (a contractual assurance in relation to the debt) for a more complex and uncertain transaction type. He also cited as transaction costs to international trade the ‘the way the legal system impedes transnational trade and investment’ including in the following ways:

- Uncertainty about the ability to enforce legal rights;
- Additional layers of complexity;
- Additional costs of enforcement;

²⁴ Armour, ESCR CENTRE FOR BUSINESS RESEARCH, 17 (2001).

²⁵ For these simpler transactions, the choice of law and jurisdiction questions are typically included in the boilerplate provisions of the lender's contract and would be non-negotiable, there is no group structure and COMI will likely be difficult to change.

²⁶ J J Spigelman, *Cross-border Insolvency: Co-operation or Conflict?*, 83 AUSTRALIAN LAW JOURNAL 44, 44 (2009).

²⁷ id. at 45; see also Robert K Rasmussen, *Where Are All the Transnational Bankruptcies? The Puzzling Case for Universalism*, 32 BROOKLYN JOURNAL OF INTERNATIONAL LAW 983 (2007).

²⁸ ‘... without accepting the whole intellectual tool kit’. See J J Spigelman, *Transaction Costs and International Litigation*, 80 AUSTRALIAN LAW JOURNAL 438, 438 (2006).

- Risks arising from unfamiliarity with foreign legal process;
- Risks arising from unknown and unpredictable legal exposure;
- Risks arising from lower levels of professional competence, including judicial competence;
- Risks arising from inefficiencies in the administration of justice, and in some cases, of corruption.²⁹

To combat these transaction costs, Spigelman J suggested that courts should strive to achieve greater cooperation and coordination, or, in the language of TCE, a more integrated and hierarchical governance structure. His Honour argued that:

When the official courts are engaged, as they traditionally are when insolvency intervenes, then the underlying commercial substance of the disputes that need to be resolved is often overlooked. A perspective of national sovereignty is given priority, because the courts are regarded as a manifestation of the state. This is why co-operation between courts becomes necessary in order to minimise the additional transaction costs that arise when an insolvency has cross-border elements. Such co-operation can only occur in the exercise of a court's jurisdiction which, generally, requires express statutory provision.³⁰

Justice Spigelman also cited as a transaction cost, the cost of capital frozen in insolvency proceedings so that it cannot be used more efficiently.³¹ The costs raised by all of these factors outlined above might be classified as ex-ante transaction costs in international insolvency as these things must be considered by the parties when considering debt structures that factor in the possibility of insolvency proceedings. However, viewed another way, the various factors set out above can also be categorised as ex-post costs, as these risks materialise and become real costs at the time of insolvency. These costs do not go away at the point of insolvency. And it is these costs that might be reduced if appropriate governance modes can be used to govern the insolvency transactions. The parties in cross-border insolvencies must consider these factors, for example, when considering whether to cooperate with other parties or coordinate proceedings between jurisdictions after the decision to liquidate has been made. It is the ex-post costs (including the ex-post nature of those costs listed above) that are of especial interest in the TCE analysis in this paper.

Williamson claimed that contracting to limit these hazards is subject to the bounded rationality of humans. That is, there are limits to what can be foreseen and contracted for in a contract of any duration, but particularly longer term contracts such as loan contracts. Bounded rationality is related to 'opportunism' which Williamson refers to as 'self-interest seeking with guile'.³² An example might be the pre-emptive transfer of assets from one multinational enterprise (the first company) to a related entity to avoid having to disgorge assets when the first company becomes insolvent and enters insolvency proceedings. This is an ex-post cost. Unwinding this transaction, if it is possible, will incur costs ex-post. This possibility increases uncertainty in the insolvency transaction matrix and could, when considered with levels of asset specificity, require a more integrated governance mode. Both of these human fallibilities: bounded rationality and opportunism that are important features of TCE, will be discussed further in Part 4.2 below. Again, global initiatives to mitigate the

²⁹ Spigelman, *AUSTRALIAN LAW JOURNAL*, 44 (2009).

³⁰ *id.* at 45.

³¹ *id.* at 45.

³² WILLIAMSON, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting* 47 (1985).

effect of these transaction costs stress greater cooperation and coordination between and among all parties.

2.2. Ex-post costs

Ex-post transaction costs in cross-border insolvencies include the costs of coordinating multiple cross-border proceedings in different jurisdictions.³³ Ex-post costs include the costs of (1) creditor decision-making; (2) valuation mechanisms; (3) homogenisation of creditors' claims and (4) maintaining pre-insolvency priorities such as the priority given to secured creditors.³⁴ For example, ex-post transaction costs might include the costs of arranging and organising cooperation between and among courts and creditors, resolving conflicts of laws questions, as well as the costs incurred in collecting, valuing and selling assets, and pursuing preference claims. In the insolvency of a corporate group, ex-post costs might also include understanding the enterprise group structure and the transactions between corporate entities within the group, and seeking a pooling order or substantive consolidation of an enterprise group.

The costs that arguably receive the most attention when transaction costs are considered, are the professional fees charged by insolvency professionals, including accountants and lawyers. However, as discussed by Lee, charging high fees does not necessarily equate to inefficiency.³⁵ These insolvencies must be governed in one way or another and costs must be incurred to wind up the companies and recoup assets. The question to consider is whether the way cross-border insolvencies are conducted in each case is the most transaction cost efficient method. On one view, professional fees simply provide a dollar calculation, an indication, of what it cost to conduct the transactions to resolve the issues outlined above. In this way, they are not a separate species of costs but more a barometer of the work required to resolve a cross-border insolvency. TCE might provide guidance when these costs become disproportionate to the type of cross-border insolvency in question. For example, if the insolvency transactions are governed using a more (or less) integrated governance mode than that which is appropriate for the given transaction, higher transaction costs in the form of wasted fees will result.

The professional costs alone of the largest cross-border insolvencies can reach into the billions of dollars. A study of 102 of the largest public company bankruptcies in the United States between 1998 and 2007 found that bankruptcy professional fees and expenses alone cost USD \$5.5 billion.³⁶ Another study estimated the direct costs of bankruptcy were on

³³ The multiplicity of proceedings will be considered in more detail in Part 4.4 of this Paper in an analysis of the frequency of transactions – one of the independent variables of transaction types considered under TCE.

³⁴ See Armour, ESCR CENTRE FOR BUSINESS RESEARCH, 19–31 (2001).

³⁵ See Rachel Siew Lin Lee, How is "efficiency" determined in the insolvency context? Clarifying the meaning of efficiency with the conjunction of insolvency jurisprudence and economic methodology (2015) University of Queensland); see also Lisa Bernstein, *The Silicon Valley Lawyer as Transaction Cost Engineer*, 74 OREGON LAW REVIEW 239 (1995) who seeks to debunk the description of lawyers (in her essay, transactional lawyers rather than insolvency lawyers) 'as transaction cost' by suggesting, at 248, that 'because their structural position in the market enables them to back their representations with a meaningful reputation bond, lawyers can function as cost efficient brokers who create value by increasing the amount and reliability of the operational and reputational information available to transactors while greatly reducing the pre-transaction search costs...'

³⁶ LYN M LOPUCKI & JOSEPH W DOHERTY, PROFESSIONAL FEES IN CORPORATE BANKRUPTCIES: DATA, ANALYSIS, AND EVALUATION xiii (Oxford University Press, 2011). See also Lubben, AMERICAN BANKRUPTCY LAW JOURNAL, 80 (2008) who noted in relation to costs of bankruptcy that '[f]actors like the size of the debtor corporation, the number of professionals retained, and whether a committee is appointed play much bigger roles'.

average ‘3.1% of the book value of the debt plus the market value of equity’ of the company in the year before insolvency.³⁷ By way of example, in the 5 years since Lehman Brothers entered bankruptcy, it paid its lawyers, accountants and other insolvency professionals around USD \$2.2 billion.³⁸ Lehman’s is a complicated multi-party proceeding and the Modified Third Amended Joint Chapter 11 Plan Of Lehman Brothers Holdings Inc. and its Affiliated Debtors filed in the United States Bankruptcy Court for the Southern District of New York alone runs to some 390 pages.³⁹ Lehman Brothers’ creditors are expected to receive 18 cents in the dollar by 2016 – 8 years after it entered bankruptcy.⁴⁰ However, the multiplication of proceedings in different jurisdictions around the world has multiplied the costs and reduced the net pool of assets. This duplication increases transaction costs.

The costs of governing large complex insolvencies are further illustrated by the recent Chapter 11 proceedings involving the Canadian telecommunications company, Nortel, which involved actions in the United States, Canada and Europe, in which the legal costs alone exceeded a billion dollars (or 10% of Nortel’s global estate), depriving creditors and other stakeholders of recovering this amount.⁴¹ Also, in both the Lehman Brothers and Nortel proceedings, a large amount of capital was (and continues to be) in the hands of the insolvency representatives for years waiting for disputes over its distribution to resolve. Again, according to Spigelman J, these dormant funds are a cost of the insolvency because the funds, if freed, could be used more profitably by entrepreneurs for the benefit of society.

In a TCE analysis, transaction cost efficiencies flow once appropriate governance modes are used to govern relevant transaction types. TCE predicts that transactions that display high levels of asset specificity, uncertainty and complexity and recur with high frequency are best governed using a more integrated governance mode. Conversely, those that display low levels of each will be best governed using the least integrated (and least costly) mode. Those transactions that display intermediate levels of each of these variables will best be governed using hybrid modes of governance that can account for these intermediate levels at moderate cost. In this way, some of the ex-ante or ex-post costs referred to above should be mitigated.

TCE predicts that for highly uncertain and complex transactions where transaction specific assets are involved, such as the Lehman Brothers and Nortel proceedings, a more integrated mode of governance (such as pure universalism, as discussed in Part 6 below) could result in

³⁷ Lawrence A Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority Claims*, 27 JOURNAL OF FINANCIAL ECONOMICS 285, 299 (1990).

³⁸ Erik Larson, ‘Lehman Recovery Seen as Justifying \$2 Billion Bankruptcy’, *Bloomberg* (online), 11 September 2013 <http://www.bloomberg.com/news/2013-09-11/lehman-recovery-seen-as-justifying-2-billion-bankruptcy.html>.

³⁹ Epiq Systems, Lehman Brothers Holdings Inc Chapter 11 general information page <http://dm.epiq11.com/lehman/Project#>.

⁴⁰ See E Larson, note 38 above. However, Lubben argues that Chapter 11 is not that expensive, particularly ‘in comparison with the costs of other corporate transactions.’ See Stephen J Lubben, *The Direct Costs of Corporate Reorganization: An Empirical Examination of Professional Fees in Large Chapter 11 Cases*, 74 AMERICAN BANKRUPTCY LAW JOURNAL 509, 550 (2000).

⁴¹ Jim Christie, ‘Slim odds for clawback of attorneys’ fees in Nortel bankruptcy’, *Reuters*, May 28, 2015, at <http://www.reuters.com/article/2015/05/28/bankruptcy-nortel-idUSL1N0YJ0J120150528>; Janet McFarland, ‘Judges rip into squabbling Nortel lawyers’, *Globe and Mail*, May 14, 2015, at <https://secure.globeadvisor.com/servlet/ArticleNews/story/gam/20150514/RBSWNORTELLAWYERS>. See also Barry Critchley, ‘Will Nortel Professional Fees Finally Get Some Examination?’, *Financial Post* (online), 27 November 2013 <http://business.financialpost.com/2013/11/27/will-nortel-professional-fees-finally-get-some-examination/>. The article quotes ‘independent financial analyst’ Diane Urquhart as saying: ‘[h]ad this \$1-billion been used for restructuring, Nortel would likely still be operating effectively and creating jobs for Canadian scientists and engineers.’

greater transaction cost efficiencies. On the other hand, using a highly integrated mode of governance for a less complex transaction with low levels of uncertainty and asset specificity will also incur wasted and unnecessary transaction costs. It is akin to using an electrified nut cracking machine to crack a walnut when a rock would do the same job. In these instances professional fees must be questioned. If the appropriate governance mode is not chosen and costs increase, professional fees will increase accordingly and thus can provide measure of wasted costs.

Masten claimed that, using a TCE analysis, ‘savings of 10–20% from choosing organizational arrangements discriminately are not unrealistic’.⁴² Having considered the types of transaction costs that might be incurred in cross-border insolvencies, a firmer understanding of the various governance modes is required. The available governance modes in cross-border insolvency are discussed in Part 3 below and the relative characteristics of cross-border insolvency transaction types are discussed in Part 4.

3. Governance modes in cross-border insolvency

The first step in a TCE analysis is to define the applicable governance modes.⁴³ Governance modes differ in and can be distinguished by their ‘costs and competencies’.⁴⁴ Williamson referred to the two main governance modes in the theory of the firm, ‘markets and hierarchies [as] polar modes’.⁴⁵ TCE isolates integrated or hierarchical forms of governance and equates the firm, or the company, set up to manufacture products in-house, as the most integrated or hierarchical form of governance, and buying the product on the market as the least integrated form. In between these polar modes lay various hybrid governance modes, including long and short term contracts used as a means to corral the uncertainty and complexity inherent in various transaction types.

The most relevant ways in which universalism and territoriality differ, for the purpose of a TCE analysis, is in the mode of governing the collection and liquidation of assets. That is, is the collection and liquidation most transaction cost efficient if conducted using a single central court and a single law or in different jurisdictions using multiple solutions? Despite their arguments promoting the superiority of their respective positions, Westbrook and LoPucki leave open the possibility that aspects of either system might be used depending on the transaction type involved.⁴⁶ For some transaction types, the collection and liquidation of assets out of one jurisdiction, using one law will be the most transaction cost efficient way of governing the insolvency, while for other transaction types, allowing the collection and liquidation of assets to be conducted in local jurisdictions will be most transaction cost efficient. An analysis using TCE might be able to determine which is used and when.

In cross-border insolvencies, Westbrook and LoPucki set out the costs and competencies of universalism and territoriality respectively. As discussed, Williamson described hierarchy and market as polar modes. Similarly, LoPucki calls territoriality ‘the antithesis of universalism’.⁴⁷ Without more, this suggests that the costs and competencies of these

⁴² Masten, *MANAGERIAL AND DECISION ECONOMICS*, 126 (1993).

⁴³ Oliver E Williamson, *Transaction Cost Economics: The Natural Progression*, 100 *THE AMERICAN ECONOMIC REVIEW* 673, 679 (2010).

⁴⁴ Oliver E Williamson, *Comparative Economic Organisation: The Analysis of Discrete Structural Alternatives*, 36 *ADMINISTRATIVE SCIENCE QUARTERLY* 269, 277 (1991).

⁴⁵ *id.* at 280.

⁴⁶ See the arguments raised later in Part 3.2 and the balance of Part 3.

⁴⁷ LoPucki, *CORNELL LAW REVIEW*, 701 (1999).

disparate governance modes differ and this part of the paper will further outline those differences.

Two areas in which these systems of governance differ are in the levels of integration displayed by each and also, the setup costs. As discussed, the most integrated form of governance is pure universalism, where the cross-border insolvency is governed from one forum using one law. Conversely, the *least* integrated form of governance in cross-border insolvency is territoriality where each creditor is free to pursue its claim in its own jurisdiction. In relation to the setup costs of each governance mode,⁴⁸ there will still be transaction cost efficiencies in attempting to implement more integrated governance modes in a territorialist state if the transaction type requires it. In those situations, the most integrated and hierarchical governance mode available might well be to attempt to coerce or to negotiate with the parties to enter cross-border insolvency agreements outside the strictures of court enforced procedures to facilitate cooperation with the principal proceedings or to run synthetic secondary proceedings in the principal proceedings to reduce transaction costs as much as possible. These hybrid governance measures are discussed in Part 3.4 below.

The TCE analysis proposed in this paper invites a different perspective on the universalism versus territoriality debate. The balance of Part 3 discusses the antithetical approaches of universalism and territoriality and substantiates the use of these as choices rather than absolutes. Then, in turn, this Part discusses universalism as a governance mode (including the use of cross-border insolvency agreements), various hybrid means of governing cross-border insolvencies, and then territoriality.

3.1. Delimitation

As a normative argument for insolvency law, Jackson's 'creditors' bargain' theory modelled bankruptcy law as a system under which hypothetical creditors, ignorant of the order of the

⁴⁸ See *id.* at 753. The costs associated with developing and implementing pure universalism have proved to be, as yet, prohibitive to developing such a unified system. Developing and implementing even the modified universalism in the form of the Model Law has been high. For example, the costs of those countries, organizations and individuals involved in developing, negotiating and documenting the Model Law from its seminal stages in the 1960s until it was completed in 1997 cannot be calculated. On a country level, it took more than 10 years for Australia, for example, to negotiate the Model Law into legislation. The costs of this cannot be calculated but would include the costs of meetings, negotiations, drafting, debating, and amending and implementing the legislation. Similarly, the costs of implementing the system into the court structure in the Australian system of State and Federal courts are not calculable but would include the costs of judges and the courts negotiating, drafting, amending and agreeing on the content of practice notes and other subordinate legislation. However, once the initial setup costs had been sunk, there would not be a need to continually incur those costs. It is also argued that accessing and using such a system could only be cost effective in certain circumstances. Conversely, territoriality has been the default mode of governance for cross-border insolvency around the world and therefore would cost nothing to implement. When implementing a TCE analysis then, a distinction might need to be drawn between dealing with states that have implemented a more universalist governance system – for example, those that have adopted the Model Law like the United States, the United Kingdom, Canada and Australia – and those that have remained territorialist such as Brazil, Russia, India or China for example. The transaction costs of implementing a universalist system in territorialist countries for a one off insolvency transaction might well remain prohibitive. However, striving to achieve more coordinated proceedings in territorialist countries might prove to be transaction cost efficient for certain types of transactions. The cost to implement a universalist governance mode in a country that has adopted the Model Law would be relatively less costly because the setup costs are, as discussed, already sunk. It would often therefore be a more attractive option. Therefore, the state in which the insolvency laws are sought to be applied might impact the transaction costs of using one or another governance mode and different transaction cost results may, as a consequence, result for the same transaction type. This analysis is outside the scope of this paper.

priority of their claims, negotiate among themselves ex-ante, the position they would take in the event of bankruptcy.⁴⁹ Jackson argued that the creditors' initial impulse, to race to enforce their debt against the assets of the company, mirrors game theory's prisoner's dilemma in which individual participants act 'out of immediate self interest in such a way that a less efficient solution results'.⁵⁰ This, as is often the case, would result in the dissipation of the company's assets and the loss of the value of the company as a going concern. As Jackson's hypothetical creditors would not know whether they would win or lose the race to enforce and collect their debts from the common pool of assets, Jackson argued they would be better off to agree on a 'government-imposed' system which would stay individual actions against the debtor and impose a collective system of enforcement to maximise the value of the debtor's assets.⁵¹ Jackson proposed that if bankruptcy laws mirrored the hypothetical creditors' bargain to pool the assets of the debtor and distribute them equally in a pre-agreed order upon liquidation, then this would result in a 'reduction of strategic costs; increased aggregate pool of assets; and administrative efficiencies'.⁵² As well as an argument for efficiency as a normative goal, Jackson's arguments also raise the normative goals of having a system for collecting and pooling assets and for the equality of treatment for all creditors. These can be referred to as the principles of collectivity and equality of treatment. This raises two normative outcomes: firstly, the system of collectivity is preferred because it is efficient. Secondly, because the parties are opportunistic, a government mandated system is required to enforce the system. If this argument is accepted for an intra-state system as Jackson proposed in relation the bankruptcy system in the United States, then it may well equally apply in a global example despite differences in states' political and normative positions. If left to individual states, agreement will never be achieved as individual state policy issues will always intrude. Therefore, some mandatory global system would be required. The TCE argument proposed in this paper therefore adds to the weight of argument in favour of adopting a global system of universalism. This argument is expanded in Part 6.

In an analysis of cross-border insolvency, it is important to continue to apply the base normative principles for cross-border insolvency law: that is, the principles of efficiency, collectivity and equality of treatment.⁵³ Pure territoriality suffers because it does not accord with the principles of collectivity (on a global basis) or of equality of treatment. It rejects the claims for a global pooling of assets and prefers the interests of local creditors above creditors in other jurisdictions. On that basis, pure territoriality must be discarded as a mode of governance in the normative argument raised in this paper and be replaced with a version of territoriality that comports with the normative principles of collectivity and equality of treatment. As a proxy, a modified form of universalism can mimic the effect of territoriality but will still comport with the three normative principles described above. In some applications of modified universalism, including in the Model Law,⁵⁴ the interests of local creditors must be considered along with the interests of other creditors, but the overall aim of the process is to transfer assets to a global pool from which there can be a distribution to all creditors. This mode of governance where assets are collected by local agents using local laws and systems, is only part the system referred to generally as territoriality. The other elements of territoriality reject a collective pool of assets and global distribution. It is the

⁴⁹ T H Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE LAW JOURNAL 857, 860 (1982) using the American term 'bankruptcy' to refer to corporate insolvency.

⁵⁰ *id.* at 862.

⁵¹ *id.* at 858–61.

⁵² *id.* at 860–1.

⁵³ See SANDEEP GOPALAN & MICHAEL GUIHOT, *CROSS-BORDER INSOLVENCY* 1–24 (LexisNexis, 2015).

⁵⁴ See for example the Model Law, Article 21(2).

collection of assets that is the focus of the TCE analysis in this paper. Once that is done at the local level, the most efficient process is to mandate a collective system and equality of treatment of *all* creditors. This system of disparate collection processes in different jurisdictions that still submits to a system of collectivity will be referred to as territoriality.

Pure universalism too must be discarded in a practical application of TCE. Pure universalism, on a global basis, no matter how normatively attractive it is, does not yet exist and is not likely to be implemented in the near future. Williamson argued that, when conducting a TCE analysis, ‘hypothetical ideals [should be removed] from the relevant comparison set’.⁵⁵ Williamson suggested the parameters must be set considering ‘obstacles of both political (real politick) and economic (setup cost) kinds’.⁵⁶ The impediments to pure universalism in cost and real politick terms today appear insurmountable. However, a normative argument for the supremacy of pure universalism that results from this TCE analysis is set out in Part 6.

When referring to universalism in this paper, it then must be to a modified kind. The kind that is available to the parties under the current limitations inherently imposed on it. This limited universalism will, as closely as possible, display characteristics of high levels of cooperation, and coordination, perhaps with proceedings in a single jurisdiction (based on the debtor’s COMI) and a single pool of assets for distribution to creditors on a global basis. Today, the use of the Model Law, and particularly in conjunction with cross-border insolvency agreements, seems to provide the opportunity for the parties to attain this most integrated form of governance available. The type of universalism prescribed in the Model Law stops short of pure universalism in a number of respects. Firstly, it contemplates multiple proceedings in different jurisdictions only coordinated under the auspices of the Model Law. Secondly, it provides a range of options that cater for the interests of local creditors at the expense of the global pool, presumably as a concession to the sovereignty of those nations that would adopt it as law.⁵⁷ Therefore, it cannot rightly be classified as pure universalism. In this paper though, this most hierarchical and integrated form of governance will be referred to as universalism.

The alternative governance modes proposed in this paper will therefore be, on one end of the spectrum, universalism (in the form closest to pure universalism that exists and can be implemented) as the integrated and hierarchical form of governance.⁵⁸ On the other end of the spectrum will be territoriality;⁵⁹ that is, a collection system under which the collection and liquidation of local assets is conducted in each separate jurisdiction but which still comports to the normative goals of collectivity and equality of treatment.

3.2. Universalism and territoriality as options, not absolutes

Westbrook and LoPucki argue from positional standpoints for the superiority of universalism and territoriality respectively. Each argues for full application of either universalism or territoriality for every type of insolvency transaction. However, this positional approach has

⁵⁵ See the discussion in Part 2.5. See also, Oliver E Williamson, *Pragmatic Methodology: A Sketch, with Applications to Transaction Cost Economics*, 16 JOURNAL OF ECONOMIC METHODOLOGY 145, 153 (2009); see also Williamson, STRATEGIC MANAGEMENT JOURNAL, 1092 (1999).

⁵⁶ Williamson, JOURNAL OF ECONOMIC METHODOLOGY, 153 (2009); see also Williamson, STRATEGIC MANAGEMENT JOURNAL, 1092 (1999).

⁵⁷ See Article 21(2) for example and the provisions dealing with coordination between disparate secondary insolvency proceedings.

⁵⁸ For the sake of clarity, this modified version of pure universalism will be referred to as universalism.

⁵⁹ Again, for the sake of clarity, this will be referred to as modified territoriality.

not moved the argument about governance of cross-border insolvency forward. By looking at the problem through the lens of TCE, a fresh perspective can be gained on these opposing viewpoints. This paper proposes that it is possible for universalism and territoriality (or pragmatic modifications of each) to both apply as different governance modes in cross-border insolvency depending on the type of transaction involved.⁶⁰ Also, the intermediate modes that sit along the spectrum between universalism and territoriality can also apply as the transaction type requires. There is a range of these intermediate modes of governance available under the rubric of modified universalism – including under the Model Law. These are discussed in part 3.3 below.

It is proposed that, under a TCE analysis, universalism and territoriality can become optional governance modes for different transaction types. That is, universalism will be a more transaction cost efficient governance mode for transactions that display high levels of asset specificity, uncertainty, complexity, and frequency, while territoriality will be more transaction cost efficient for transactions that display low levels of each of these.

Westbrook conceded that ‘the international bankruptcy system [that is pure universalism] might be limited to large, multinational companies, leaving local interests to be governed by local bankruptcy laws and policies.’⁶¹ This concession leaves the door ajar for an argument based upon a choice between universalism and territoriality as the transaction type requires, rather than an argument for universalism as the only means of governing all cross-border insolvencies. A further analysis of the arguments proposed for both universalism and territoriality illustrates the differences between them in cost and competence and also reveals that each theory leaves open the possibility of the other applying in certain circumstances.

3.3. Universalism as a governance mode in cross-border insolvency

Firstly, universalism describes a way of governing cross-border insolvencies in which a proceeding in one jurisdiction, namely, where the debtor has its centre of main interests (COMI), claims extra-territorial effect and purports to cover the debtor’s assets regardless of which country they are in.⁶² Its aim is to have a single pool of assets governed in one jurisdiction and distributed according to one country’s distribution laws but in some instances, this might not be possible. Pure universalism depends on other nations ceding sovereignty and jurisdiction over assets held in that country to the country in which the principal proceedings commenced. Because of the strong pull of sovereignty by all nations in relation to claims affecting their territory, universalism has only developed to date in modified forms, and is particularly prominent in the common law world. Sensing that the obstacles to pure universalism were, as at 2000, yet insurmountable, Westbrook proffered a number of modified alternatives to pure universalism as alternative governance structures.⁶³

⁶⁰ Williamson too argued that antithetical attitudes to governance would dissolve under a TCE argument. In Williamson, *THE AMERICAN ECONOMIC REVIEW*, 679 (2010) in relation to opposing governance modes in organisational development, he proposed that ‘Rather ... than be trapped in the old ideological divide between markets or hierarchies, transaction cost economics treats the two as alternative modes of governance, markets and hierarchies, both of which have distinctive roles to play in a well working economy. The heretofore maligned mode of hierarchy is now awarded coequal status with the marvel of the market, the object being to deploy each appropriately’.

⁶¹ Westbrook, *MICHIGAN LAW REVIEW*, 2310 (2000).

⁶² See GOODE, *Principles of Corporate Insolvency Law* 782 (2011).

⁶³ Westbrook, *MICHIGAN LAW REVIEW*, 2310 (2000).

As discussed, the type of universalism used as a governance mode in this paper is not pure universalism with a single forum and single law. It must be something less than that. The advantages of this limited universalism include that, given the right circumstances, there can indeed be a single insolvency representative, increased cooperation between all parties, and increased coordination of proceedings in different jurisdictions. This, by definition, falls short of pure universalism.

Rasmussen argued against universalism that, because the ‘parties will contract around any set of rules the result must therefore be inefficient’.⁶⁴ Westbrook criticised this and argued that Rasmussen:

joins many others in giving us Coase Without Costs, ignoring the possibility that the rules may create a system that is sufficiently close to the most efficient possible that it is not worthwhile to contract around it or that it is worthwhile to do so in few enough cases that the default position creates more efficiency than it obstructs.⁶⁵

Westbrook argues here for a limited universalism. This argument is akin to the first element of Williamson’s remedialness criterion — that there is ‘no feasible superior alternative [that] can be described’ or implemented.⁶⁶ In the language of TCE, Westbrook argues that this limited universalism *is* the most transaction cost efficient governance mode possible. His concession may also be a self-defeating argument for pure universalism, as the systems of modified universalism now in place may, because of the real politick and economic costs of setup, be the most efficient means of governing cross-border insolvencies and that the extra costs that must be incurred to advance to pure universalism may remain too high.

As proposed by Westbrook then, the form of limited universalism that demonstrates the highest levels of integration, cooperation, and coordination available to the parties, and as limited in this Part, forms the most integrated mode of governance available in a TCE analysis. One method of achieving the highest levels of integration, cooperation, and coordination in governing cross-border insolvencies is by using cross-border insolvency agreements.⁶⁷ These are specifically endorsed by UNCITRAL in the *Practice Guide* as a means of achieving the greater cooperation referred to in Articles 25 and 26 of the Model Law.⁶⁸ They are also discussed in the next section as an example of a hybrid form of governance; particularly when the transaction type only requires moderate contractual intervention and a limited form of cross-border insolvency agreement will suffice. The levels of integration achieved by using this type of universalism may, in some circumstances, justify its use. Implementing this system though, is not without its costs. These elements are considered in the discussion below.

The Model Law as a means of obtaining limited universalism

The UNCITRAL Model Law provides the most pervasive attempt to implement universalism on a grand scale. Countries that have adopted the Model Law have already incurred the costs

⁶⁴ *id.* at 2303 paraphrasing Rasmussen’s argument.

⁶⁵ *id.* at 2303–4.

⁶⁶ Williamson, *JOURNAL OF ECONOMIC METHODOLOGY*, 153 (2009); see also Williamson, *STRATEGIC MANAGEMENT JOURNAL*, 1092 (1999).

⁶⁷ Article 25 of the Model Law states ‘In matters referred to in Article 1, the court shall cooperate to the maximum extent possible with foreign courts or foreign representatives...’ Article 27 then states: Cooperation referred to in articles 25 and 26 may be implemented by any appropriate means, including: (d) Approval or implementation by courts of agreements concerning the coordination of proceedings.

⁶⁸ UNCITRAL, *Practice Guide*, Chapter II, p 22 and Chapter III.

associated with adopting such regulation and have agreed to adopt universalist modes of governance in the form of access to foreign representatives, recognition of foreign proceedings, and increased cooperation and coordination between and among courts and representatives.⁶⁹ There is no requirement for reciprocity under the Model Law. It aims to have principal proceedings governed in one jurisdiction (based upon the COMI of the debtor) with all other countries (those that have agreed to be bound by the Model Law) agreeing to give access, recognition, relief and cooperation to representatives and courts in the principal proceedings.

As discussed, the Model Law was developed to give countries that have adopted it a modern, flexible and efficient law by which to govern cross-border insolvencies. According to the *Guide to Enactment*, ‘the Model Law respects the differences among national procedural laws and does not attempt a substantive unification of insolvency law. Rather, it provides a framework for cooperation between jurisdictions, offering solutions that help in several modest but significant ways and facilitate[s] and promote[s] a uniform approach to cross-border insolvency.’⁷⁰ That, in a TCE analysis, provides a gamut of governance modes. The Model Law provides options for debtors and creditors from which to choose. Under the Model Law as it stands, the parties can agree to adopt either a more or less integrated system of governance. It might involve implementing very high levels of cooperation and coordination or might only involve minimal use of cooperation between insolvency representatives to link local proceedings to a foreign main proceeding.

The Model Law addresses four elements that, according to the *Guide to Enactment*, had been ‘identified, through studies and consultations conducted in the early 1990s prior to the negotiation of the Model Law, as being the areas upon which international agreement might be possible’. Those elements include the following general rights afforded between foreign courts and representatives:

1. access to local courts for representatives of foreign insolvency proceedings and for creditors and authorisation for representatives of local proceedings to seek assistance elsewhere;
2. recognition of certain orders issued by foreign courts;
3. relief to assist foreign proceedings; and
4. cooperation among the courts of States where the debtor’s assets are located and coordination of concurrent proceedings.⁷¹

The range of solutions available under the Model Law depends on the levels of cooperation and coordination that can be achieved by agreement between the parties or as approved or mandated by the courts. However, very high levels of cooperation and coordination between and among creditors and courts can be achieved, depending on the willingness of creditors, insolvency representatives and courts to take a commercial approach to resolving disputes.

⁶⁹ However, Bebhuk and Guzman noted that, while universalism might be more efficient than territoriality to resolve cross-border insolvencies, a country that maintains a territorialist approach to insolvency is in a superior economic position to one that subscribes to a universalist approach: See Bebhuk & Guzman, *JOURNAL OF LAW AND ECONOMICS*, 779–80 (1999). Those countries that have adopted the Model Law continue to carry that cost.

⁷⁰ United Nations Commission on International Trade Law, UNCITRAL, *Model Law on Cross-Border Insolvency with Guide to Enactment*, (1997) at 19.

⁷¹ UNCITRAL, *Model Law on Cross-Border Insolvency with Guide to Enactment*, (1997) at 26–7.

To date, governance modes such as those available under the Model Law⁷² provide the most hierarchical and integrated form of cross-border insolvency governance that can be employed.

The next section will address various modifications to universalism as hybrid forms of governance. The balance of this Part discusses territoriality.

3.4. Hybrid governance modes – modified universalism

In between the two antithetical governance modes of universalism and territoriality lie various hybrid modes of governance displaying degrees of modifications to both universalism and territoriality. These governance modes will vary in cost and competence to implement and will display either more universalist or more territorialist characteristics depending on which end of the governance spectrum they congregate. It is very much a sliding scale of options between universalism and territoriality.

Looking at the matter through the lens of TCE, these intermediate modes of governance should garner greater transaction cost efficiencies if they are aligned with appropriate transaction types. That is, those transactions that display higher levels of asset specificity, uncertainty, complexity and frequency would be best governed using a more integrated form of governance. Those that display lower levels of asset specificity, uncertainty and complexity would be better governed using less of the armoury of universalism available and therefore would incur fewer transaction costs. That is, it will arguably cost less to govern a single, simple transaction using local agents who deal with local assets under local laws, without incurring the costs of, for example, developing and implementing a complex cross-border insolvency agreement.

Cross-border insolvency agreements as an example of limited universalism

Williamson stated that there is an assumption ‘common to both law and economics, that the legal system enforces promises in a knowledgeable, sophisticated, and low-cost way.’⁷³ However, he warned that ‘this convenient assumption is commonly contradicted by the facts — on which account additional or alternative modes of governance have arisen’.⁷⁴ The parties to modern, complex cross-border insolvencies have developed alternative means by which to resolve (at least portions of) cross-border insolvencies outside the constraints of the court processes. One such method is the use of cross-border insolvency agreements under which the parties agree ex-post on efficient means of resolving the insolvency.⁷⁵ However, these agreements rely on formal insolvency systems backed by the courts as the means of coercing compliance and ultimate enforcement.

The UNCITRAL *Practice Guide on Cross-Border Insolvency Cooperation*⁷⁶ defines cross-border insolvency agreements as ‘agreements entered into for the purpose of facilitating cross-border cooperation and coordination of multiple insolvency proceedings in different

⁷² The Model Law and the European Union Council regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings are examples of this type of universalism in practice.

⁷³ Oliver E Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 THE AMERICAN ECONOMIC REVIEW 519, 519 (1983).

⁷⁴ id. at 519.

⁷⁵ By way of example, see the Lehman Brothers Protocol referred to in Part 6 of this paper.

⁷⁶ United Nations Commission on International Trade Law, *UNCITRAL Practice Guide on Cross-Border Insolvency Cooperation*, 2010, (*Practice Guide*) Sales No: E.10.V.6, retrieved from http://www.uncitral.org/pdf/english/texts/insolven/Practice_Guide_Ebook_eng.pdf.

States concerning the same debtor.⁷⁷ The *Practice Guide* provides examples of the types of cooperation and coordination available to the parties under Article 27 of the Model Law. The types of cases in which cross-border insolvency agreements are used are often large, complex transactions with high levels of asset specificity and a propensity for uncertainty. The *Practice Guide* claims that cross-border insolvency agreements:

... are designed to assist in the management of ... proceedings and are intended to reflect the harmonization of procedural rather than substantive issues between the jurisdictions involved (although in limited circumstances, substantive issues may also be addressed). They vary in form (written or oral) and scope (generic to specific) and may be entered into by different parties. Simple generic agreements may emphasize the need for close cooperation between the parties, without addressing specific issues, while more detailed, specific agreements establish a framework of principles to govern multiple insolvency proceedings and may be approved by the courts involved.⁷⁸

As can be seen, the levels of integration, cooperation and coordination can vary, depending on the ability of the parties to the proceedings to agree. Highly detailed agreements can be used in the most complex proceedings while simple agreements can be most cost efficient when used to govern simpler transactions. This aligns with a TCE analysis. In that vein, the *Practice Guide* also states that the use of cross-border insolvency agreements:

... has effectively reduced the cost of litigation and enabled parties to focus on the conduct of the insolvency proceedings, rather than on resolving conflict of laws and other similar disputes. As such, they are considered by many practitioners who have been involved with their use as the key to developing appropriate solutions for particular cases ...⁷⁹

The objectives sought to be obtained by using cross-border insolvency agreements emphasise the efficiency gains attainable through their use and include:

- (a) To promote certainty and efficiency with respect to management and administration of the proceedings;
- (b) To help clarify the expectations of parties;
- (c) To reduce disputes and promote their effective resolution where they do occur;
- (d) To assist in preventing jurisdictional conflict;
- (f) To assist in achieving cost savings by avoiding duplication of effort and competition for assets and avoiding unnecessary delay;
- (g) To promote mutual respect for the independence and integrity of the courts and avoid jurisdictional conflicts;
- (h) To promote international cooperation and understanding between judges presiding over the proceedings and between the insolvency representatives of those proceedings;
- (i) To contribute to the maximization of value of the estate.⁸⁰

⁷⁷ UNCITRAL, *Practice Guide* at 27.

⁷⁸ UNCITRAL, *Practice Guide* at 27–9.

⁷⁹ UNCITRAL, *Practice Guide* at 27–9.

⁸⁰ UNCITRAL, *Practice Guide* at 29.

As can be seen, these aims neatly align with the aims of increasing the efficiency of cross-border insolvencies and address many of the transaction costs outlined in Part 2 of this Paper. On a TCE analysis, implementing cross-border insolvency agreements can be seen to counter elements of asset specificity, uncertainty, complexity, and frequency in cross-border insolvencies. These variables are discussed in detail in Part 4 below.

As referred to in the *Practice Guide* cross-border insolvency agreements are more effective in ‘particular cases’; ‘those involving multiple plenary proceedings; ancillary proceedings commenced in different States affecting the same parties; main and non-main insolvency proceedings; insolvency proceedings in one State and non-insolvency proceedings with respect to the same debtor in another State; and insolvency proceedings with respect to enterprise groups.’⁸¹ Those cases are ones that display complex transactional characteristics that are open to uncertainty. Cross-border insolvency agreements will be the most efficient governance mode when used in transactions that involve specific assets with high uncertainty and complexity and in relation to which transactions frequently recur. This use of integrated governance modes for more uncertain and complex transaction types too appears to be broadly consistent with a TCE analysis.

As has been shown, contractual arrangements are subject to bounded rationality and opportunism as it is impossible to contract for an unlimited number of unknown factors that might happen in the future. Therefore, leaving the solution to governing transaction types with intermediate levels of asset specificity, uncertainty, complexity and frequency to contract will, at a certain point, be less transaction cost efficient than governing the transaction through pure universalism. This, again, adds to the normative desirability of creating a system of pure universalism. This idea is developed further in Part 6 below.

Another mode of governance that might be described as hybrid in these circumstances, is the use of synthetic proceedings to avoid the costs of full secondary proceedings.

Synthetic proceedings as a hybrid mode of governance

The use of hybrid governance modes is particularly relevant where the state in which the assets are located is a territorialist state. In those instances, the insolvency representative who has been appointed in the COMI of the debtor has no control over secondary proceedings that must be commenced to deal with the assets in that jurisdiction. In those proceedings, without some intervention, local creditors’ interests will be met before any excess funds will be repatriated to the global pool of assets. The costs of implementing a universalist system in these circumstances would be out of the hands of the foreign representatives and creditors and, anyway, would be too costly to implement on any level for a single transaction. In order to combat these costs of duplicate secondary proceedings, parties to cross-border insolvencies have begun to implement novel solutions. For example, in some cases, creditors in jurisdictions where secondary proceedings can be commenced have agreed to the conduct of synthetic secondary proceedings within the principal proceedings. The synthetic secondary proceedings mimic the result that would have been achieved if the secondary proceedings had been conducted and distributions had been made to the local creditors. However, it is argued, that the transaction costs of running the secondary proceedings, and the uncertainty of dealing

⁸¹ UNCITRAL, *Practice Guide* at 29.

with a foreign legal system and judges are avoided.⁸² This novel solution might be categorised as a hybrid form of governance in TCE terms.

By way of example, in *Re Collins & Aikman Europe SA Collins*⁸³ Collins & Aikman was a closely linked group of companies that supplied automotive components. It had its COMI in the United Kingdom. Within the group there were 24 companies spread over 10 countries in Europe. On 15 July 2005 the 24 European companies applied to the High Court in England for administration orders. The administrators sought to adopt a coordinated approach to the proceedings. Under the European Insolvency Regulation, creditors were entitled to open secondary proceedings in the countries in which they had an establishment. However, the administrators sought assurances from creditors in the other jurisdictions that they would not commence secondary proceedings if 'their respective financial positions as creditors under the relevant local law would as far as possible be respected in the English administration'.⁸⁴ The creditors gave the assurances. Lindsay J outlined the effect of what, in effect, were synthetic proceedings conducted in the main proceedings:

With only minor exceptions creditors did not seek to open secondary proceedings or take other divisive steps but rather supported the broad strategy which the Joint Administrators had proposed. The Joint Administrators attribute both that degree of restraint on the creditors' parts and the degree of support which they achieved to such assurances so given, which enabled them to conduct sales achieving very favourable realisations, in all some \$45m more than had been the estimates that they had received. The Joint Administrators are of the view that the giving of the assurances was of critical importance to that successful execution of the administration strategy.⁸⁵

Apart from the saving of \$45 million, Pottow argued the other benefits of conducting the synthetic proceedings in *Collins & Aikman* thus:

The treatment of the claims was therefore the same economically as if a secondary proceeding had been opened, i.e., they were synthetically resolved. Yet there were two important distinctions: first, considerable cost was saved (likely to the pleasure of C&A creditors and disappointment of the Spanish insolvency bar); and second, control was preserved by the British decision-makers (the lawyers, principals, and judge), without risk of having a Spanish court inject unpredictability into the matter.⁸⁶

In terms of a TCE analysis, a more integrated and coordinated governance of the proceedings by means of obtaining assurances and conducting synthetic proceedings within the main proceedings, was a transaction cost efficient means of avoiding high levels of uncertainty and complexity in the mooted secondary proceedings. This alignment of governance mode to transaction type leads to a more transaction cost efficient outcome.

Apart from the obvious setup costs and the costs of organising, documenting, and implementing a universalist structure, the disadvantages of limited universalism as the sole governance mode for cross-border insolvency are self-evident when considered from the

⁸² See John A E Pottow, *A New Role for Secondary Proceedings in International Bankruptcies*, 46 TEXAS INTERNATIONAL LAW JOURNAL 579 (2011). See also UNCITRAL, Working Group V (Insolvency Law), *Report of Working Group V (Insolvency Law) on the work of its forty-sixth session*, Doc No. A/CN.9/829, (Vienna, 15-19 December 2014) at [41].

⁸³ *Collins & Aikman Europe SA Collins* [2006] EWHC 1343 (Ch) (09 June 2006).

⁸⁴ *Collins & Aikman Europe SA Collins* [2006] EWHC 1343 (Ch) (09 June 2006) at [8].

⁸⁵ *Collins & Aikman Europe SA Collins* [2006] EWHC 1343 (Ch) (09 June 2006) at [8].

⁸⁶ Pottow, TEXAS INTERNATIONAL LAW JOURNAL, 585 (2011).

perspective of individual local creditors, especially small creditors trying to pursue their claims in a foreign insolvency proceeding. For those creditors, a universalist proceeding becomes a foreign proceeding — one in which the creditors are subject to all of the transaction costs listed by Spigelman J in Part 2 above. Using the example of individual local creditors in foreign proceedings, the local creditors must gain access to the foreign court, perhaps using a foreign language, foreign law and foreign procedures. Seen from this angle, it seems to shift the arguments for universalism on their head and in the bargain shifts the costs of universalism onto the creditors instead of the debtor; arguably resulting in greater, rather than less uncertainty for these creditors in the process. In answer to these concerns, Westbrook argued, perhaps unsatisfactorily, that these disadvantages will even out in a ‘rough wash’⁸⁷ so that those that lose out in one insolvency will be countered by those that gain in another. The Model Law provides concessions that can approximate the effect of territoriality to address these very concerns of sovereign nations and the local creditors within those jurisdictions.

TCE analyses the various governance structures in relation to one another to determine which is most transaction cost efficient to govern the given transaction type. It is argued that a greater level of certainty and greater transaction cost efficiencies will arise by applying these hybrid modes of governance to transaction types that display intermediate levels of asset specificity, uncertainty, complexity and frequency. These governance structures involve various forms of cooperation and coordination between and among courts and insolvency practitioners. The various permutations of cooperation and coordination available under the Model Law provide an example of hybrid governance modes in cross-border insolvencies.

At the other end of the cross-border insolvency governance spectrum to universalism, is territoriality. This mode of governing asset collection in cross-border insolvencies, it will be argued, is most effective and transaction cost efficient when applied to simple transactions that display low levels of uncertainty and complexity and involve one-off or very few transactions.

3.5. Modified territoriality as a governance mode in TCE

LoPucki described territoriality as a system in which ‘each country would have jurisdiction over the portion of the bankrupt multinational firm within its borders.’⁸⁸ This approach is at the opposite end of the spectrum to pure universalism. Like that approach though, it is unlikely that it would apply without modification. Most states are amendable to some form of cooperation with other states, particularly once the local interests of local creditors have been fully accounted for.⁸⁹ LoPucki argued that territoriality was the natural state of the law in the world today. He opined that ‘[i]n each case, each country’s bankruptcy court would decide whether to participate in a transnational effort at reorganisation or liquidation or to conduct a local reorganisation or liquidation according to local law.’⁹⁰ This latter notion defines the cooperative element in LoPucki’s concession to universalism; what he calls ‘cooperative territoriality’. Under cooperative territoriality, LoPucki argued, courts are free to cooperate

⁸⁷ Jay L Westbrook, *Theory and Pragmatism in Global Insolvencies: Choice of Law and Choice of Forum*, 65 AMERICAN BANKRUPTCY LAW JOURNAL 457, 465 (1991): ‘The central argument for the Rough Wash is that a universalist rule will roughly even out benefits and losses for local creditors, who will gain enough from foreign deference to the local forum in one case to balance any loss from local deference to the foreign forum in another.’ Surely though, the rough wash argument must apply equally to a territorialist argument.

⁸⁸ LoPucki, CORNELL LAW REVIEW, 701 (1999).

⁸⁹ Some base any cooperation with other nations on reciprocity.

⁹⁰ LoPucki, CORNELL LAW REVIEW, 701 (1999).

with other states' courts at their discretion. However, any system that relies on such an arbitrary approach cannot be called a system. It is for this and the other reasons discussed above about its failure to comply with the normative goals of collectivity and equality of treatment that pure territoriality has been rejected as a governance mode in this paper.

According to LoPucki, the advantages of a modified form of territoriality in which the assets are collected in different states using local agents and local laws, include 'greater predictability to lenders' and '[i]n place of universalism's complex domestic interface, ... territoriality offers transactional simplicity. Domestic law would govern wholly domestic transactions.'⁹¹ LoPucki claimed that 'the greatest advantage of ... territoriality is that implementation would require only minimal changes in current practices... and [countries that] adopt domestic laws authorising narrow forms of cooperation [would] directly [benefit] their own citizens.'⁹² In TCE terms, territoriality provides a transaction cost efficient means of governing transactions that display low asset specificity and where uncertainty, complexity and frequency are low.

As discussed, the type of assets involved in a cross-border insolvency are also an important consideration in a TCE analysis. In response to criticisms by Westbrook and Guzman that locating assets in a territorialist system is 'problematic',⁹³ LoPucki stated that 'is certainly not true of tangible assets, such as factories, equipment, and inventory.'⁹⁴ There is the rub! Using local proceedings to collect and liquidate local assets would have transaction cost benefits for some transaction types. In a TCE framework, LoPucki's defence singles out the particular effectiveness of territoriality in relation to asset collection transactions that show low levels of uncertainty and complexity and whose liquidation would only require very few transactions.⁹⁵ Again, this supports a TCE analysis. TCE predicts that a non-hierarchical (market) system is the most appropriate when dealing with these types of assets – that is, assets that display low levels of asset specificity. It is therefore argued that using territoriality in these circumstances would effect transaction cost efficiencies. Transaction cost savings occur because the proceedings would be conducted by local professionals using local governance mechanisms such as local courts at a cost less than that to engage foreign representatives in foreign courts applying foreign law. Under a territorialist approach, assets the subject of the proceedings would be valued, priced and sold under local conditions to local buyers. In this way, the parties would economise on costs. The rough wash argument raised by Westbrook in support of universalism must wash both ways too, so that it must also apply to a territorialist approach. To paraphrase Westbrook, sometimes foreign creditors would receive more and sometimes they would receive less under territoriality and in a rough wash, this would even out over time.⁹⁶

As discussed, territoriality is the default governance mode in many jurisdictions around the world. Court decisions, even in Australia which has adopted a universalist approach by adopting the Model Law, have applied territorialist views when the interests of local creditors

⁹¹ *id.* at 751.

⁹² *id.* at 753. The costs of implementing a universalist model like the Model Law have already been spent and are now sunk. LoPucki's argument on this point loses some potency because of this.

⁹³ LoPucki, *MICHIGAN LAW REVIEW*, 2233 (2000).

⁹⁴ *id.* at 2233.

⁹⁵ WILLIAMSON, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting* 60 (1985): 'whenever assets are specific in nontrivial degree, increasing the degree of uncertainty makes it more imperative that the parties devise machinery to "work things out"'. There is no need to devise any machinery when levels of these variables are low.

⁹⁶ See Westbrook, *AMERICAN BANKRUPTCY LAW JOURNAL*, 465 (1991).

have been threatened.⁹⁷ The Model Law, which purports to adopt a universalist approach, arguably provides a concession to territoriality in that it contains a number of articles that require the courts to consider the interests of local creditors.⁹⁸ However, as was seen in *Ackers v Saad Investments Company Limited*⁹⁹ applying the Model Law to a proceeding that involved a simple local tax debt in Australia caused the parties to incur significant transaction costs in two separate failed applications to the Federal Court of Australia,¹⁰⁰ an unsuccessful appeal to the Full Federal Court¹⁰¹ and a further unsuccessful application for special leave to appeal to the High Court of Australia. It could be argued that a territorialist application of local Australian law (the ultimate result anyway) in such a proceeding might have avoided these wasted costs.

Pottow argued that modified universalism, as displayed in the Model Law, makes certain concessions to territoriality in the form of ‘choice of law carve-outs and secondary proceedings’.¹⁰² He argued that ‘when (but only when) the contingency arises that a local creditor possessing claims under local law chooses to open a secondary proceeding, then (but only then) the COMI state insolvency law will be presumptively displaced in favour of the local state’s insolvency law’.¹⁰³ Pottow rationalised the secondary proceedings concessions as ‘a necessary evil: a pitstop on the road toward universalism that was required to secure the buy-in of sceptical states.’¹⁰⁴ Pottow argued further that ‘[f]or the modified universalist, secondary proceedings should be tolerated, but they should be slowly, in successive waves of reform, restricted in scope’.¹⁰⁵ However, this paper proposes that, on a TCE analysis, this type of territoriality could provide transaction cost efficiencies if used in relation to specific transaction types so long as the principles of collectivity and equality of treatment are adhered to.

Summary of territoriality position

Westbrook argued of territoriality that ‘claims must be made, and administration and litigation must be conducted, in multiple jurisdictions at far greater cost.’¹⁰⁶ That is, the duplication of proceedings will drive up costs overall. These costs are unavoidable when dealing with a country that maintains a territorialist position. In these circumstances, the parties must strive to attain the most integrated form of governance with the highest level of cooperation and coordination available to them. Some of the hybrid forms of governance available are discussed above. Westbrook also criticised territoriality on the basis that it complicates the choice of law question:

⁹⁷ See *Ackers v Saad Investments Company Limited* [2010] FCA 1221.

⁹⁸ See for example, Art 21(2) and the way this article was interpreted in *Ackers v Saad Investments*. Article 21(2) states ‘Upon recognition of a foreign proceeding, whether main or non-main, the court may, at the request of the foreign representative, entrust the distribution of all or part of the debtor’s assets located in this State to the foreign representative or another person designated by the court, *provided that the court is satisfied that the interests of creditors in this State are adequately protected.*’

⁹⁹ *Ackers v Saad Investments* [2010] FCA 1221.

¹⁰⁰ See *Ackers v Saad Investments Company Limited* [2013] FCA 738.

¹⁰¹ *Ackers as a joint foreign representative of Saad Investments Company Limited (in Official Liquidation) v Deputy Commissioner of Taxation* [2014] FCAFC 57.

¹⁰² John A E Pottow, *Beyond Carve-outs and Toward Reliance: A Normative Framework for Cross-border Insolvency Choice of Law*, 9 BROOKLYN JOURNAL OF CORPORATE, FINANCIAL AND COMMERCIAL LAW 197, 199 (2014).

¹⁰³ *id.* at 200.

¹⁰⁴ *id.* at 200–1.

¹⁰⁵ *id.* at 200–1.

¹⁰⁶ Westbrook, MICHIGAN LAW REVIEW, 2309 (2000).

... because the territorial system requires that many courts decide what law applies to various assets and transactions rather than having most, if not all, of those decisions concentrated in the main proceeding. Thus we could look forward to six countries claiming the right to apply preference law to one pre-bankruptcy payment, with three deciding it was preferential and recoverable and three deciding it was not. That result creates large inefficiencies, ex-ante and ex-post. Modified universalism offers a substantial chance of avoiding such results, because it will often result in a single court resolving such issues.¹⁰⁷

This outcome, where one court would resolve preference claims in multiple jurisdictions is more a goal of, the yet unattainable, pure universalism. A single court with global reach and jurisdiction would be able to resolve these types of complex claims but, until such a court is in place and all jurisdictions cede their rights to adjudicate on preference claims, that system remains an ideal rather than a practicality. However, a TCE analysis of complex cross-border insolvencies supports the argument that this integrated and hierarchical system of universalism would be the most transaction cost efficient means of governing complex proceedings involving multiple preference claims. Issues of asset specificity, uncertainty and complexity must also be considered in the analysis. Westbrook gives the example of a complex transaction open to a high degree of uncertainty. He is arguably correct to assert that using territoriality for this transaction type might be transaction cost inefficient. However, as discussed, a great deal will depend on the degree of asset specificity of the transactions making up the cross-border insolvency in combination with levels of uncertainty. A number of high profile cases have ended in extremely complex arguments about choice of law in competing courts in different jurisdictions¹⁰⁸ even in jurisdictions that have purportedly adopted a universalist approach.¹⁰⁹ These arguments have arguably driven transaction costs higher because of the territorialist attitudes displayed by courts. Given higher levels of asset specificity, universalism or modified universalism might well have been the most transaction cost efficient means of governing these types of complex and uncertain transactions. Thus, Westbrook's assertion may well be correct, in relation to the particular transaction type he cites.

However, as argued above, the type of asset collection system available under a system of territoriality might well be the most cost efficient means of governing transactions where asset specificity is low, which would benefit from local knowledge and the application of local law in each jurisdiction. Thus, both Westbrook and LoPucki may be at cross purposes and may both be correct, depending on the transaction type in question.

3.6. Summary

Which governance mode should be used to govern a particular cross-border insolvency transaction will depend on the characteristics of the transaction type of the cross-border insolvency in question. For these reasons, the spectrum of governance modes available in a

¹⁰⁷ id. at 2320.

¹⁰⁸ See for example, *Barclays Bank Plc v Homan* [1993] BCLC 680; *Re Maxwell Communication Corporation Plc* 170 B.R. 800 (1994); *Re Bank of Credit and Commerce International SA (No 9)* [1994] 3 All ER 764; *Re Bank of Credit and Commerce International SA (No 10)* [1996] 4 All ER 796.

¹⁰⁹ See *Re Stanford International Bank* [2009] EWHC 1441 (Ch); *Velasquez v Stanford International Bank*, The Eastern Caribbean Supreme Court in the High Court of Justice Antigua and Barbuda, Case No ANUHCV 2009/0149, 28 October 2013. It is argued that these cases dealt with complex transactions and were subject to high levels of asset specificity and complexity and should have been governed using universalism. The point made here though is that universalism, as it stands – not as it ideally might be, does not always resolve these points neatly.

TCE analysis of cross-border insolvency range from highly integrated but limited universalism on one end of the spectrum and a modified form of territoriality at the other. Various hybrid forms of governance in between can govern the transaction types displaying intermediate levels of asset specificity, uncertainty, complexity and frequency. A closer analysis of these transaction type variables is required.

4. Transaction types in cross-border insolvency

Once the governance modes have been defined, (limited universalism, modified territoriality and the various hybrid modifications in between) it is necessary to differentiate the various cross-border insolvency transaction types using the independent variables prescribed in the TCE methodology: ‘asset specificity, uncertainty, complexity, and frequency’.¹¹⁰ TCE predicts that those transactions displaying high degrees of each variable should be aligned with a more integrated governance mode such as universalism, ‘so as to effect [a transaction cost] economizing result’.¹¹¹ Conversely, it is anticipated that those cross-border insolvency transactions that display low concentrations of each variable will not require the full arsenal of universalist machinery and would be most efficiently governed using a less integrated mode of governance such as modified territoriality.

Williamson argued that TCE provided ‘rational economic reasons for organising some transactions one way and other transactions another’¹¹² and then proposed that TCE provided predictive qualities to determine ‘which go where and for what reason?’¹¹³ Those predictive qualities require the parties to identify and explicate ‘the factors responsible for differences among transactions’.¹¹⁴ Williamson argued that those factors, which ‘apply to transactions of all kinds’¹¹⁵ are the ‘frequency with which transactions recur, the uncertainty to which transactions are subject, and the type and degree of asset specificity involved in supplying the good or service in question’.¹¹⁶ For the reasons discussed in Part 4.3 below, complexity has been added in this paper as an independent variable.

In cross-border insolvency transactions, we should then be able to predict that more integrated governance modes (such as universalism) should be used to govern transactions that display the features of higher degrees of asset specificity, greater uncertainty and higher complexity and frequency. Those with intermediate levels of each element will be governed using hybrid modes¹¹⁷ and those with low levels of each can be most transaction cost efficiently governed using territoriality. Each of these characteristics of transactions will be discussed in turn.

¹¹⁰ Howard A Shelanski & Peter G Klein, *Empirical Research in Transaction Cost Economics: A Review and Assessment*, 11 THE JOURNAL OF LAW, ECONOMICS & ORGANIZATION 335, 338 (1995).

¹¹¹ Williamson, STRATEGIC MANAGEMENT JOURNAL, 1090–1 (1999). In the study of the organisation, the most integrated governance mode is the firm. The opposite and *least* integrated mode of governance is associated with buying on the open market which does not incur the setup and other transaction costs involved in creating a firm or entering into long term contractual arrangements.

¹¹² WILLIAMSON, The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting 52 (1985).

¹¹³ *id.* at 52.

¹¹⁴ *id.* at 52.

¹¹⁵ Oliver E Williamson, *Transaction Cost Economics: The Governance of Contractual Relations*, 22 JOURNAL OF LAW AND ECONOMICS 233, 254 (1979) (emphasis added).

¹¹⁶ Williamson, ADMINISTRATIVE SCIENCE QUARTERLY, 281 (1991).

¹¹⁷ *id.* at 280: ‘The hybrid mode displays intermediate values in all four features.’

4.1. Asset specificity

Williamson placed special emphasis on the presence of asset specificity in TCE. Asset specificity, he stated, refers to ‘the degree to which an asset can be redeployed to alternative uses and by alternative users without sacrifice of productive value’.¹¹⁸ Pisano studied the combination of what he referred to as ‘transaction-specific investments under conditions of uncertainty’.¹¹⁹ When studying asset specificity, the emphasis is on the investments made in the transactions themselves. Also, the interaction of asset specificity and uncertainty is a focal point of TCE. Thus Joskow referred to the ‘combination of durable relationship-specific investments, uncertainty about future demand and cost realizations, and contractual incompleteness arising from the costs of writing, monitoring and enforcing full contingent claims contracts ...’¹²⁰ This highlights the nature of TCE as protecting investment in assets and the concomitant relationship that builds up around that specific investment. That investment creates or imbues the asset with transaction specific qualities. Williamson argued that ‘asset specificity increases the transaction costs of all forms of governance’¹²¹ and ultimately distilled six types by way of example:

- (1) site specificity, as where successive stations are located in a cheek by jowl relation to each other so as to economise on inventory and transportation expenses;
- (2) physical asset specificity, such as specialised dies that are required to produce a component;
- (3) human asset specificity that arises in learning by doing;
- (4) brand-name capital;
- (5) dedicated assets, which are discrete investments in general-purpose plant that are made at the behest of a particular customer; and
- (6) temporal specificity, which is akin to technological non-separability and can be thought of as a type of site specificity in which timely responsiveness by on-site human assets is vital.¹²²

Williamson said of asset specificity that ‘investments in labor (transaction specific human capital) can be highly specific’¹²³ — the specialist analysts in the Lehman Brothers insolvency for example. Williamson also noted that ‘... many costs that for accounting purposes are reported to be fixed are in fact non-specific, hence can be recovered (salvaged) by redeployment. Durable but mobile assets such as general purpose trucks or air planes are illustrations’.¹²⁴

Physical asset and human asset specificity

Menard claimed in relation to human specific assets that:

¹¹⁸ Id. at 281.

¹¹⁹ Gary P Pisano, *Using Equity Participation to Support Exchange: Evidence from the Biotechnology Industry*, 5 JOURNAL OF LAW, ECONOMICS, AND ORGANIZATION 109, 114 (1989).

¹²⁰ Paul L Joskow, *Asset Specificity and the Structure of Vertical Relationships: Empirical Evidence*, 4 JOURNAL OF LAW, ECONOMICS, AND ORGANIZATION 95, 100 (1988).

¹²¹ Williamson, ADMINISTRATIVE SCIENCE QUARTERLY, 282 (1991).

¹²² Id. at 281–2.

¹²³ Williamson, THE AMERICAN ECONOMIC REVIEW, 522 (1983).

¹²⁴ Id. at 522.

To be operationalized, this concept requires a sharp distinction between (a) skills that characterize human assets, that can be measured through qualifications at entry or qualifications acquired by training on the spot, and that are redeployable on the labor market; and (b) specific assets properly speaking, i.e., qualifications that are developed through interactions of agents operating within the organization and that are non-redeployable on the market. There is almost no substitute for this human asset within the organisation or on the labor market and, symmetrically, it would be extremely difficult for the holder of this asset to trade this specific know-how on the labor market: therefore, a bilateral dependency develops. It is with this precise interpretation of specific human assets that we are concerned here. This distinction is essential in understanding why asset specificity can generate transaction costs for an organization, and also influence the choice of internal arrangement: in a firm, an employee may be extremely well-qualified, but easily replaceable; conversely, another employee may have low qualifications but be extremely specific because of some know-how again through his or her activity within the organisation.¹²⁵

In their study of 63 articles that adopted some form of TCE analysis, David and Han found that '[t]he most common measures [of asset specificity] used were specialized production assets (17 tests), specialized skills (12), and a composite measure of specialized assets and skills (17)'.¹²⁶ Similarly, proxies for human asset specificity have included the 'development and deepening of human skills' developed in parts suppliers in the auto-industry¹²⁷ and human capital or know-how in research and development (R&D) agreements.¹²⁸ Pisano argued that:

Because biotechnology is a technology-intensive industry, with relatively low physical capital requirements and few geographical restrictions, the type of transaction-specific assets most likely to affect collaborations are those related to human capital or know-how. The dual presence of transaction-specific know-how and uncertainty depends on the activities of the collaboration. In biotechnology, the degree of uncertainty and transaction-specific know-how is greater in collaborations that encompass R&D than in those that involve the transfer, utilization, or commercialization of existing know-how. Examples of the latter type include agreements for technology transfer, manufacturing, materials supply, and marketing/distribution.¹²⁹

In his study of product procurement in the aerospace industry, Masten identified two species of asset specificity. The first of those, a proxy for physical asset specificity was 'based on whether an item was identified as used exclusively by this company (highly specialized), used or easily adaptable for use by other aerospace firms (somewhat specialized), or used in other industries (relatively standard)'.¹³⁰ Masten argued that 'in sum, the more idiosyncratic

¹²⁵ Claude Menard, *Inside the Black Box: The Variety of Hierarchical Forms*, in *TRANSACTION COST ECONOMICS AND BEYOND* 159 (John Groenewegen ed. 1996).

¹²⁶ Robert J David & Shin-Kap Han, *A Systematic Assessment of the Empirical Support for Transaction Cost Economics*, 25 *STRATEGIC MANAGEMENT JOURNAL* 39, 47 (2004). Their study looked at 'a representative sample of journal articles that statistically test the core tenets of TCE regarding the governance of transactions'. *Id.* at 42.

¹²⁷ See Kirk Monteverde & David J Teece, *Supplier Switching Costs and Vertical Integration in the Automobile Industry*, 13 *THE BELL JOURNAL OF ECONOMICS* 206, 212 (1982).

¹²⁸ See Pisano, *JOURNAL OF LAW, ECONOMICS, AND ORGANIZATION*, 114 (1989). Pisano also noted at 114 that '[t]he relevant laboratory instrumentation and manufacturing equipment are specialized to the industry but not to firms.'

¹²⁹ *Id.* at 114.

¹³⁰ Scott E Masten, *The Organization of Production: Evidence from the Aerospace Industry*, 27 *JOURNAL OF LAW AND ECONOMICS* 403, 408 (1984).

are the investments associated with a particular transaction, the greater are the incentives to incur the costs of writing more detailed and longer term contracts.’¹³¹

An analogy can be drawn to the asset specificity in cross-border insolvencies. In cross-border insolvency transactions, examples of human asset specificity and physical asset specificity will be most likely. The human capital in know-how generated by those tasked with resolving complex cross-border insolvencies is specific to the transaction and company at hand. That know-how includes that which the insolvency representatives, lawyers and judges build up over the term of the insolvency. There will be a correlation between the level of complexity of the insolvency with the amount of human capital in know-how that is derived through close analysis of specific complex materials and innovative solutions to resolve these complexities. Also, the interaction between asset specificity and uncertainty is critical to a TCE analysis. Neither is studied without the contingent effect of the other.

The bankruptcy of Lehman Brothers Holding Inc in the United States which began in September 2008 provides further examples of asset specificity in cross-border insolvency. The Lehman Brothers bankruptcy dealt with highly complex derivative swaps, repo transactions and collateralised debt obligations (CDOs) created by Lehmans that were securities tied to specific assets, usually bundles of mortgages. The contracts that governed these transactions were often highly complex. Lehman Brothers was heavily reliant on these assets maintaining their value to provide security and Lehman Brothers entities around the world sold securities based on these assets maintaining their value. The insolvency representatives and judges in each jurisdiction in which Lehman Brothers operated have been required to come to terms with these transactions and understand their complexities. This knowledge and these skills, once the transaction is complete and the company is liquidated, lose their value and can therefore be classified as specific to the transaction. Another type of asset specificity which is prominent in cross-border insolvency is temporal specificity.

Temporal specificity

Masten, Meehan and Snyder developed Williamson’s original four examples of asset specificity and added what they referred to as temporal specificity which they described as follows:

Where timely performance is critical, delay becomes a potentially effective strategy for exacting price concessions. Knowing that interruptions at one stage can reverberate throughout the rest of the project, an opportunistic supplier may be tempted to seek a larger share of the gains from trade by threatening to suspend performance at the last minute. Even though the skills and assets necessary to perform the task may be fairly common, the difficulty of identifying and arranging to have an alternative supplier in place on short notice introduces the prospect of strategic holdups.¹³²

In cross-border insolvency, timely performance is often crucial and representatives in other jurisdictions or of other affiliates of a company might seek to delay proceedings to benefit their own debtor’s interests. For example, in *Lehman Brothers Australia Ltd v Lehman Brothers Special Financing Inc*,¹³³ Lehman Brothers Australia (LBA), in the face of extended stonewalling by the related Lehman Brothers entity, sought leave to serve an originating

¹³¹ id. at 405.

¹³² Scott E Masten, et al., *The Costs of Organization*, 7 JOURNAL OF LAW ECONOMICS AND ORGANIZATION 1, 9 (1991).

¹³³ *Lehman Brothers Australia Ltd v Lehman Brothers Special Financing Inc* [2015] FCA 779 (18 June 2015).

process on Lehman Brothers Special Financing Inc (LBSF), in the United States. To do so, LBA needed to establish a prima facie case against LBSF in relation to a flip clause in a related party agreement. The flip clause was contained in the transaction documents between LBSF and LBA. Under the flip clause, if a swap agreement terminated early, ‘LBSF would be paid all moneys due to it in priority to note holders ... unless LBSF was the defaulting party’.¹³⁴ In that case, the right to payment would flip and the note holders would be entitled to payment. LBA had sought a declaration that, because LBSF had defaulted, under the flip clause, LBA was entitled to payment.¹³⁵ Justice Rares summarised the conflicting findings that had already been made in similar proceedings in the United States and the United Kingdom on the same issue. On the basis of those conflicting decisions, LBSF had resisted payment to LBA. After several years of trying to negotiate payment, it was not until pressure was brought to bear on LBSF in the Australian Proceedings that a settlement was reached and LBA ultimately received payment. The liquidators of LBA had informed creditors that:

... the conflicting judgments from the United Kingdom and the United States Courts continues to lock up any distribution of the underlying collateral. This is because BNY will not make distributions to Noteholders until there is final judicial clarity in all jurisdictions on the issue of the flip clause.¹³⁶

This is an example of temporal asset specificity in cross-border insolvency that would be considered high.

The table below summarises the major examples of asset specificity in cross-border insolvency and gives each type a numerical value between 1 and 5. High levels of asset specificity would equate to levels 4 or 5. Moderate levels would be classified as between 2-3 while low levels would be classified as 1. Levels of asset specificity to a ‘non-trivial degree’¹³⁷ will still engender TCE results. David and Han opined that in all of the 63 papers analysed in their study of TCE, ‘it would be reasonable to assume that asset specificity was present “to a non-trivial degree”’.¹³⁸ Only a single type of asset specificity need be apparent in cross-border insolvency.¹³⁹ Therefore, a transaction that displays even non-trivial levels of one type of asset specificity will be sufficient to anchor a TCE analysis. It is then the interaction of uncertainty with asset specificity that determines appropriate governance modes. However, several types of asset specificity might appear for a given transaction type. Problems of quantifying asset specificity have been identified in the studies

Asset specificity	Value
Site specificity, where access to specific sites is necessary to gather information about the debtor	1-5

¹³⁴ *Lehman Brothers Australia Ltd v Lehman Brothers Special Financing Inc* [2015] FCA 779 (18 June 2015) at [5].

¹³⁵ *Ibid*, at [12].

¹³⁶ PPB Advisory, ‘Lehman Brothers Australia Limited (In Liquidation) ACN 066 797 760 Report to Creditors’, 7 June 2011, at 8.

¹³⁷ WILLIAMSON, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting* 60 (1985): ‘whenever assets are specific in nontrivial degree, increasing the degree of uncertainty makes it more imperative that the parties devise machinery to “work things out”’.

¹³⁸ David & Han, *STRATEGIC MANAGEMENT JOURNAL*, 45 (2004).

¹³⁹ The case studies conducted by Masten, Joskow, Monteverde and Teece, Pisano and others pinpoint only one or two types of asset specificity in their studies. Not all types need to be identified in each study. The interaction is between the identified type of asset specificity and differing levels of uncertainty, complexity, and frequency.

Asset specificity	Value
Physical asset specificity, such as specialised computing software, and books and records	1-5
Human asset specificity that arises in learning by doing - The human capital in know-how generated in those tasked with resolving complex cross-border insolvencies is specific to the transaction and company at hand	1-5
Brand-name capital	1-5
Dedicated assets, which are discrete investments in general-purpose plant that are made at the behest of a particular customer	1-5
Temporal specificity, which is akin to technological non-separability and can be thought of as a type of site specificity in which timely responsiveness by on-site human assets is vital	1-5

4.2. Uncertainty

As stated in Part 2 above, Justice Spigelman noted the following impediments to transnational transacting:

- Uncertainty about the ability to enforce legal rights;
- Additional layers of complexity;
- Additional costs of enforcement;
- Risks arising from unfamiliarity with foreign legal process;
- Risks arising from unknown and unpredictable legal exposure;
- Risks arising from lower levels of professional competence, including judicial competence;
- Risks arising from inefficiencies in the administration of justice, and in some cases, of corruption¹⁴⁰

The *Practice Guide* too outlines the characteristics of transactions in cross-border insolvencies where cross-border insolvency agreements, a highly integrated form of cross-border insolvency governance, might appropriately be used. These transactions include:

- (a) Cross-border insolvency proceedings with a considerable number of international elements, such as significant assets located in multiple jurisdictions;
- (b) A complex debtor structure (for example, an enterprise group with numerous subsidiaries) or complex intertwining of the operations of the debtor;
- (c) Legal uncertainty regarding the resolution of choice of law or choice of forum questions;
- (d) The ordering of contradictory stays in the different proceedings;

¹⁴⁰ Spigelman, AUSTRALIAN LAW JOURNAL, 44 (2009).

- (e) The existence of a cash management system providing for the deposit of cash into a centralized account and the sharing of cash among members of an international group of companies;
- (f) The employment of the insolvency representatives appointed to the different insolvency proceedings by the same international company.¹⁴¹

These types of transactions display characteristics of uncertainty and complexity that, combined with a degree of asset specificity, would indicate that a more integrated mode of governance (such as limited universalism) would be the appropriate governance mode. Wouters and Raykin referred to the role of uncertainty in cross-border insolvency which, they said ‘diminishes incentives for cooperation between creditors’. They argued that:

Absent a guarantee that other creditors will not attempt to open secondary proceedings, any creditor with a viable claim under Article 5 faces an anticommons problem – if every creditor is grabbing for their own best interest, why would one creditor sacrifice its own interests for the corporate group's collective good?¹⁴²

While the references to uncertainty by Spigelman and in the *Practice Guide* undoubtedly are notions of uncertainty to which TCE should pay attention, Williamson was especially interested in the cognitive ability and self-interest of human actors that create uncertainty.

Opportunism – behavioural uncertainty

TCE allows that human actors are rational but that rationality is bounded by an inability to control the complexity of ex-ante contracting for every possible contingency. Also, human actors are subject to opportunism which Williamson defines as ‘self-interest seeking with guile’.¹⁴³ Williamson stated that ‘[c]ontracting agents are ... assumed to be subject to bounded rationality and, where circumstances permit, are given to opportunism’.¹⁴⁴ The combination of bounded rationality and opportunism leads to contracting situations where ‘(1) all complex contracts are unavoidably incomplete (by reason of bounded rationality); and (2) contractual hazards sometimes await (by reason of opportunism).’¹⁴⁵ Williamson argued that these contractual hazards caused by opportunism, which he referred to as a form of ‘behavioural uncertainty’,¹⁴⁶ were ‘of special importance to an understanding of transaction cost economics issues.’¹⁴⁷ He defined opportunism to include ‘subtle forms of deceit’ and argued that this behaviour included ‘calculated efforts to mislead, distort, disguise, obfuscate, or otherwise confuse.’¹⁴⁸ Williamson attributed to opportunism a purposeful ‘strategic nondisclosure, disguise, or distortion of information. ... The conscious supply of false and misleading signals’.¹⁴⁹ The opportunities for bankruptcy agents and creditors to engage in these types of behaviours in cross-border insolvencies are manifest.

¹⁴¹ UNCITRAL *Practice Guide*, p 30.

¹⁴² Nora Wouters & Alla Raykin, *Corporate Group Cross-Border Insolvencies Between The United States & European Union: Legal & Economic Developments*, 29 EMORY BANKRUPTCY DEVELOPMENTS JOURNAL 387, 408 (2013).

¹⁴³ WILLIAMSON, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting* 47 (1985).

¹⁴⁴ Williamson, *THE AMERICAN ECONOMIC REVIEW*, 521 (1983).

¹⁴⁵ Williamson, *JOURNAL OF ECONOMIC METHODOLOGY*, 151 (2009).

¹⁴⁶ WILLIAMSON, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting* 57 (1985).

¹⁴⁷ *id.* at 57.

¹⁴⁸ *id.* at 47.

¹⁴⁹ *id.* at 57.

Anderson stated that ‘... all agents will be opportunistic whenever they calculate that it will pay. The way to dampen opportunism is to develop protective governance structures which reduce the rewards of opportunism (even if undetected) or increase the penalties if detected.’¹⁵⁰ She stated that ‘a central tenet of transaction cost analysis is that vertical integration reduces the level of opportunism practised by agents’. Williamson, too, argued that ‘increasing the degree of parametric uncertainty makes it more imperative to organize transactions within governance structures that have the capacity to “work things out”’.¹⁵¹

Asymmetric information as opportunism in cross-border insolvency

One outcome of this type of behaviour relevant to cross-border insolvencies is that it leads to asymmetric information disclosure so that some parties have more information upon which to make decisions than do others. Williamson argued that this ‘vastly complicates problems of economic organization’ and that ‘[b]oth principals and third parties (arbitrators, courts, and the like) confront much more difficult *ex-post* inference problems as a consequence.’¹⁵² He argued that parties should adopt appropriate governance mechanisms to deal with opportunism and that ‘[t]ransactions that are subject to *ex post* opportunism will benefit if cost-effective safeguards can be devised *ex ante*’.¹⁵³ This entails a pre-emptive or predictive approach based upon anticipated high levels of uncertainty.

Armour referred to the need for creditors to ideally make collective decisions. In language redolent of a TCE analysis, he noted that the ‘mechanism which is adopted for making decisions is crucial to the efficiency of the procedure’.¹⁵⁴ In a tangential reference to opportunism that is borne of information asymmetry he stated:

First, it will impact on the amount of time taken to resolve the issues. On the whole, the more quickly decisions can be taken, the lower the direct costs of financial distress. It seems plausible that rapid decision-making may reduce the ‘uncertainty costs’ of financial distress. Second, the accuracy of the decisions achieved by the procedure will improve the efficiency of the allocation of the firm’s assets *ex-post*. Third, the scope for strategic behaviour — which optimally will be minimised — largely depends on the procedure that is adopted.¹⁵⁵

Armour listed some of the factors that ‘inhibit collective decision-making by creditors’ in insolvency proceedings, including that ‘individual rights give [creditors] incentives to engage in strategic “hold-up” behaviour.’ Secondly, he stated that ‘asymmetric information between creditors is likely to lead to disputes over the best means of deploying the firm’s assets.’ Thirdly, he argued that ‘heterogeneous priorities amongst creditors give parties incentives to back outcomes which result in the largest payoffs to them’.¹⁵⁶ All of these behaviours fall into the category of opportunistic behaviour which creates uncertainty in the insolvency process. Using a TCE analysis, in a cross-border insolvency context, the higher the uncertainty in a given transaction, the closer the governance mechanism for that transaction should be to universalism.

¹⁵⁰ Erin Anderson, *Transaction Costs as Determinants of Opportunism in Integrated and Independent Sales Forces*, 9 JOURNAL OF ECONOMIC BEHAVIOR AND ORGANIZATION 247, 249 (1988).

¹⁵¹ WILLIAMSON, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting* 79 (1985).

¹⁵² *id.* at 47–8.

¹⁵³ Oliver E Williamson, *Opportunism and its Critics*, 14 MANAGERIAL AND DECISION ECONOMICS 97, 105 (1993).

¹⁵⁴ Armour, ESCR CENTRE FOR BUSINESS RESEARCH, 20 (2001).

¹⁵⁵ *id.* at 20.

¹⁵⁶ *id.* at 20.

One way to address opportunism in relation to asymmetric information is to enter an agreement to govern information sharing. The UNCITRAL *Practice Guide* discusses the benefits of cross-border insolvency agreements in providing information to the relevant parties:

In addition to the sharing of information between insolvency representatives, an insolvency agreement may address the sharing of that information with other parties, such as the courts involved and the creditors or creditor committee and, where there is more than one creditor committee, between those committees. Such provisions may be useful to provide a degree of certainty and avoid potential conflict. The agreement may require, for example, that information shared by the insolvency representatives, such as monthly reports on their activities, could also be provided to the creditors, the creditor committee or the courts. Additional information may be exchanged on request, either by an insolvency representative or by a creditor committee.¹⁵⁷

Again, it can be seen that a more integrated type of governance mode is most appropriate. Shelanski and Klein argued of TCE that ‘the effect of uncertainty on governance structure ... hinges on asset specificity and the consequent bilateral dependency.’¹⁵⁸ That is, where there is asset specificity, increasing levels of uncertainty requires that a more integrated governance structure be adopted.

The table below summarises the major examples of uncertainty in cross-border insolvency and gives each example a numerical value. In this way, levels of uncertainty in cross-border insolvency transactions can be differentiated into high, medium and low. High uncertainty might be indicated by a level of 5 or more, intermediate levels of uncertainty might be between 3 and 5 while low uncertainty might be 2 or below.

While some examples are arguably more uncertain than others, for example, exposure to lower levels of professional competence, including judicial competence would create great uncertainty, each example has been given the value of 1 to avoid problems with arbitrariness in calculation. Williamson argued that precise mathematical calculations are not required because TCE takes a comparative approach. He proposed scaling up rough or crude calculations when a new model is proposed.¹⁵⁹ In this way, problems with measurement can be avoided. In a multinational enterprise group situation, 1 point might be added for each country in which these issues arise.¹⁶⁰

Uncertainty	Value
Uncertainty about the ability to enforce legal rights	1
Additional layers of complexity	1

¹⁵⁷ UNCITRAL *Practice Guide*, pp 96–7.

¹⁵⁸ Shelanski & Klein, *THE JOURNAL OF LAW, ECONOMICS & ORGANIZATION*, 339 (1995).

¹⁵⁹ WILLIAMSON, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting* 22 (1985) citing H Simon, *Rationality as Process and as Product of Thought*, 68 *AMERICAN ECONOMIC REVIEW* 1, 6 (1978): ‘... the comparison of discrete structural alternatives can employ rather primitive apparatus – “such analyses can often be carried out without elaborate mathematical apparatus or marginal calculation. In general, much cruder and simpler arguments will suffice to demonstrate the inequality between two quantities than are required to show the conditions under which these quantities are equated at the margin”’.

¹⁶⁰ It is easy to see that, even moderately simple cross-border insolvencies, are inherently subject of very high levels of uncertainty. While it is too early for such a conclusion to be drawn, the import of this might be that more integrated governance modes are required in every cross-border insolvency.

Uncertainty	Value
Additional costs of enforcement	1
Risks arising from unfamiliarity with foreign legal process	1
Risks arising from unknown and unpredictable legal exposure	1
Risks arising from lower levels of professional competence, including judicial competence	1
Risks arising from inefficiencies in the administration of justice, and in some cases, of corruption ¹⁶¹	1
Actual exposure to lower levels of professional competence, including judicial competence	1
Cross-border insolvency proceedings with a considerable number of international elements, such as significant assets located in multiple jurisdictions	1
A complex debtor structure (for example, an enterprise group with numerous subsidiaries) or complex intertwining of the operations of the debtor	1
Legal uncertainty regarding the resolution of choice of law or choice of forum questions	1
The ordering of contradictory stays in the different proceedings	1
The existence of a cash management system providing for the deposit of cash into a centralized account and the sharing of cash among members of an international group of companies	1
The employment of the insolvency representatives appointed to the different insolvency proceedings by the same international company ¹⁶²	1
Asymmetric information disclosure so that some parties have more information upon which to make decisions than do others leading to, for example (a) strategic “hold-up” behaviour, (b) disputes over the best means of deploying the firm’s assets, and (c) incentives to back outcomes which result in the largest payoffs to them ¹⁶³	1
Opportunism in the form of the grab for assets by local creditors in a territorialist state ¹⁶⁴	1
Cross-border insolvency that involves assets or subsidiaries in countries that are universalist (for example, have adopted the Model Law) and also assets or subsidiaries in countries that are territorialist.	1

¹⁶¹ The first seven items are observed by Spigelman, AUSTRALIAN LAW JOURNAL, 44 (2009).

¹⁶² The six elements above are identified in the UNCITRAL *Practice Guide*, p 30.

¹⁶³ See Armour, ESCR CENTRE FOR BUSINESS RESEARCH, 20 (2001).

¹⁶⁴ Wouters & Raykin, EMORY BANKRUPTCY DEVELOPMENTS JOURNAL, 408 (2013).

Uncertainty	Value
The use in multinational enterprise groups of competitor insolvency firms for each entity within the enterprise.	1

Also, the relative complexity of transactions must be considered in a TCE analysis. Again, to counter higher levels of complexity combined with high asset specificity and uncertainty requires a more integrated governance mode. Masten used complexity as a proxy for uncertainty. He stated that ‘Complexity ... may be used as a proxy for the degree of uncertainty on the production side; the more complex a component, the more details to be accounted for and the more dimensions in which something can go wrong.’¹⁶⁵

4.3. Complexity

While he did not specifically list complexity as an independent variable of transactions, Williamson did leave room for complexity as a distinct problem. He said that ‘[s]urprise moves often elicit complex replies. Bounded rationality limits are quickly reached—since the entire decision tree cannot be generated for even moderately complex problems’.¹⁶⁶ As discussed, later studies using TCE incorporated complexity as a transaction characteristic. Shelanski and Klein included complexity as an independent variable.¹⁶⁷ Macher and Richman¹⁶⁸ and Joskow¹⁶⁹ also include complexity as a distinguishing feature of transaction types. Like increasing levels of uncertainty, the effect of greater levels of complexity in transactions also drives the choice of governance mode to a more integrated type. Masten argued that:

The greater the complexity of the transaction and the level of uncertainty associated with it, the greater the likelihood of being bound to an inappropriate action, and hence the greater the implicit costs of contractual organization. ... In sum, the more idiosyncratic are the investments associated with a particular transaction, the greater are the incentives to incur the costs of writing more detailed and longer term contracts. Greater uncertainty or complexity of a transaction, however, implies, on the one hand, an incentive to write more detailed agreements and, on the other, a disincentive to commit to long term contractual relationships.¹⁷⁰

By way of example again, the complexity of the transactions in the Lehman Brothers insolvency, considered together with high levels of asset specificity and uncertainty would suggest that that particular insolvency would have been best governed using a highly integrated governance mode.

The table below summarises some examples of complexity in cross-border insolvency and gives each example a numerical value. In this way, levels of complexity in cross-border insolvency transactions can be differentiated into high, medium and low. Some of these are

¹⁶⁵ Masten, JOURNAL OF LAW AND ECONOMICS, 409 (1984).

¹⁶⁶ WILLIAMSON, The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting 59 (1985).

¹⁶⁷ Shelanski & Klein, THE JOURNAL OF LAW, ECONOMICS & ORGANIZATION, 338 (1995).

¹⁶⁸ Jeffrey T Macher & Barak D Richman, *Transaction Cost Economics: An Assessment of Empirical Research in the Social Sciences*, 10 BUSINESS AND POLITICS 1, 5 (2008).

¹⁶⁹ Joskow, JOURNAL OF LAW, ECONOMICS, AND ORGANIZATION, 101 (1988).

¹⁷⁰ Masten, JOURNAL OF LAW AND ECONOMICS, 405–6 (1984).

also included in the examples of uncertainty which shows the interaction between uncertainty and complexity referred to by Masten above.

Complexity	Value
A complex debtor structure (for example, an enterprise group with numerous subsidiaries) or complex intertwining of the operations of the debtor	1
Legal uncertainty regarding the resolution of choice of law or choice of forum questions	1
Cross-border insolvency proceedings with a considerable number of international elements, such as significant assets located in multiple jurisdictions	1
The ordering of contradictory stays in the different proceedings	1
Multiple computer systems being used by the debtor and its affiliates	1
Highly complex asset structure such as finance transactions	1
Interaction with complex legal issues subject to inconsistent laws in different countries	1
A very large scale transaction or multiple transactions	1

4.4. Frequency

The higher the frequency of transactions, the more cost effective it becomes to adopt a more integrated governance mode to govern it. Frequency, though, is not of itself a determining characteristic and must be considered amongst the other differentiating characteristics of asset specificity, uncertainty and complexity.

Almost all the literature discussing cross-border insolvencies contains some assertion about the increasing incidence of cross-border insolvency claims in recent years. This assertion is usually tied to an increase in global trade.¹⁷¹ The data shows that global commerce has indeed increased.¹⁷² However, of the 40,075 business bankruptcy filings in the United States in 2012,¹⁷³ 121 cases were filed under Chapter 15,¹⁷⁴ the Chapter of the United States Bankruptcy

¹⁷¹ See for example, Jay Lawrence Westbrook, *An Empirical Study of the Implementation in the United States of the Model Law on Cross Border Insolvency*, 87 AMERICAN BANKRUPTCY LAW JOURNAL 247, 248 (2013): ‘the number of insolvency cases involving a multinational debtor has risen with increasing globalisation. The flow has been a torrent since the near collapse of financial markets in 2008, developments which have stirred interest in the management of these cases.’

¹⁷² World Trade Organisation, *International Trade Statistics 2012*, 204. Figures on the increased volume of world merchandise exports and gross domestic product, 1950-2011 which shows consistent growth from 1950-2011 except for a sharp decline in 2009
http://www.wto.org/english/res_e/statis_e/its2012_e/its2012_e.pdf.

¹⁷³ Kerry A Mastroianni, *The 2013 Bankruptcy Yearbook & Almanac 4* (New Generation Research Inc 23rd ed. 2013). The 20 year average for business bankruptcies in the United States is 43,794 per year. The number of bankruptcies increased in 2009 (60,837) and 2010 (56,282) but had returned to slightly above average in 2011 (47,806) and below average in 2012 (40,075).

Code dealing with cross-border insolvencies. It is interesting to note that, of the 577 Chapter 15 filings between 2005 and 2011 reported by Westbrook, by far the biggest proportion of cases come from Canada (282 – 48%).¹⁷⁵ In one respect, the increasing frequency and prevalence of cross-border insolvencies drives the governance mode for cross-border insolvencies toward a more hierarchical structure in each case. It is also a factor that highlights the increasing need for a more integrated and hierarchical governance mode such as pure universalism. However, it is the frequency of transactions within the cross-border insolvency itself that is pertinent for a study using TCE.

This is evidenced in the Lehman Brothers proceedings which have been ongoing since 15 September 2008. The number of transactions that have been conducted in those proceedings in that timeframe is extremely high. These have included court applications for cross-border insolvency specific matters such as recognition, stays, injunctions and declarations. The transactions also included claims and suits involving parties in foreign jurisdictions including related entities. They also have included cataloguing and responding to creditor claims from multiple jurisdictions. This highly frequent recurrence of complex transactions is relevant to the analysis of transaction types in TCE. An insolvency with frequent transactions, such as the Lehman Brothers proceedings, when considered with high levels of asset specificity, uncertainty and complexity, again adds to the call for implementing a more hierarchical and integrated system of governance such as universalism.

The table below sets a number for a given frequency of transactions in cross-border insolvencies. In this way, levels of frequency of transactions can be differentiated into high, medium and low.

Frequency	Value
More than 20 interactions or transactions between jurisdictions to complete the insolvency	3
Between 10 and 20 interactions or transactions to complete the insolvency	2
Fewer than 10 interactions or transactions to complete the insolvency	1

5. Aligning transaction types with governance modes

TCE aligns the transaction types with appropriate insolvency governance structures to create efficiencies. Given the raft of governance modes available as listed above, a theory that predicts appropriate governance modes from various transaction matrices could be extremely useful in choosing the most transaction cost efficient governance mode for cross-border insolvency. As discussed, the three relevant governance structures, adopting the TCE methodology, are universalism, various hybrid modes between universalism and territoriality and a modified form of territoriality. David and Han summarised what they derived as the

¹⁷⁴ *id.* at 19. In the 7 years from 2006 to 2012 there were 632 filings under Chapter 15 of the US Bankruptcy Code. In the 7 years before Chapter 15 was enacted (1999 to 2005), there were 456 filings under Section 304 of the US Bankruptcy Code, the previous section dealing with Cross-border insolvency. In 2004-5 there were 173 filings under Section 304. In 2011-12 there were 179 filings under Chapter 15.

¹⁷⁵ Westbrook, *AMERICAN BANKRUPTCY LAW JOURNAL*, 253 (2013). This figure rises to 65% when the United Kingdom claims are included (101).

‘core tenets’ of TCE as it applies to the make or buy decision. Modifying this to apply to cross-border insolvency as proposed in this paper, results in the following predictions:

1. As asset specificity increases, the transaction costs associated with [territoriality] increase.
2. As asset specificity increases, hybrids and [universalism] become preferred over [territoriality]; at high levels of asset specificity, [universalism] becomes the preferred governance form.
3. When asset specificity is present to a nontrivial degree,¹⁷⁶ uncertainty raises the transaction costs associated with [territoriality].
4. ...
5. When both asset specificity and uncertainty are high, [universalism] is the most cost-effective governance mode.
6. Governance modes that are aligned with transaction characteristics should display performance advantages over other modes; for example, when both asset specificity and uncertainty are high, [universalism] should display performance advantages over [territoriality] and hybrids.¹⁷⁷

As stated, TCE predicts that transactions with a high degree of asset specificity, and also high levels of uncertainty, complexity and frequency, will be more efficiently governed under a more integrated or hierarchical governance mode such as universalism. Conversely, those transactions with low asset specificity and low levels of uncertainty, complexity and frequency will be more efficiently governed under a modified territorialist regime. Those transactions that display intermediate levels of each aspect will be best governed using a hybrid form of governance such as available under the umbrella of modified universalism. At the point of insolvency in a cross-border insolvency, we can summarise the governance choices available against the transaction cost framework as set out in the table below:

	Asset specificity	Uncertainty	Complexity	Frequency of transactions
Universalism	Intermediate to high	Intermediate to high	High	Intermediate to high
Hybrid – Modified Universalism	Intermediate	Intermediate	Intermediate	Intermediate
Modified Territoriality	Non-trivial degree ¹⁷⁸	Low	Low	Low

5.1. Case study: Lehman Brothers Holdings Limited

An example to illustrate the application of TCE to cross-border insolvency is the bankruptcy of Lehman Brother Holdings Inc (LBHI) which filed Chapter 11 bankruptcy proceedings on

¹⁷⁶ WILLIAMSON, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting* 60 (1985).

¹⁷⁷ David & Han, *STRATEGIC MANAGEMENT JOURNAL*, 41–2 (2004).

¹⁷⁸ WILLIAMSON, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting* 60 (1985): ‘whenever assets are specific in nontrivial degree, increasing the degree of uncertainty makes it more imperative that the parties devise machinery to “work things out”’.

15 September 2008. That filing spawned over 80 bankruptcy proceedings around the world¹⁷⁹ including amongst companies within the Lehman Brothers Group. Before filing Chapter 11 proceedings, the Lehman Brothers Group consisted of ‘over 7000 legal entities in 40 countries.’¹⁸⁰ According to the Debtors’ Amended Response to Objections to Approval of Proposed Disclosure Statement filed in the United States proceedings ‘The chaos that ensued was unprecedented and presented the potential for highly fractious proceedings permeated by years of extended, complex and expensive litigation among competing interests and entities’.¹⁸¹

Similar proceedings were invoked in relation to Lehman Brothers subsidiaries and their affiliates in Europe, Asia and Australia among other regions. Groups of Lehman Brothers affiliates in each broad jurisdiction, for example, the United States, Europe, Asia and Australia, retained their own insolvency professionals, mostly large accounting firms who had the experience and resources to undertake such a task. Alvarez & Marsal was appointed as the professional services firm to LBHI and its affiliates in the United States. In the United Kingdom, PricewaterhouseCoopers was appointed as the administrator for Lehman Brothers International (Europe). In Asia, KPMG was the firm appointed and, in Australia, the large advisory firm PPB Advisory. Each of these insolvency firms is a competitor of the other, each also has concomitant obligations to obtain the best outcome for creditors of its respective entities. Without more, the environment for opportunism and uncertainty is set.

The assets involved in the Lehman Brothers proceedings have become highly specific and include complex global equity investments and derivative transactions created by specialist staff with industry specific knowledge. Unwinding and resolving these transactions will require human specific assets with specialist skills. As mentioned earlier, temporal specificity is also present. On the scale outlined above, the level of asset specificity is probably a 4 or 5 out of 5.

Such a complex insolvency creates high levels of legal and structural uncertainty for all participants. Every example of uncertainty listed above is evidenced in the Lehman Brothers insolvency. This equates to a score of 18 for uncertainty which is in the high bracket. Levels of complexity are also high and each of the 8 indicators of complexity listed above are present. Similarly, many more than 20 interactions or transactions between jurisdictions have been implemented and many more will continue to be required to complete the insolvency. For all of the independent variables of asset specificity, uncertainty, complexity, and frequency, the Lehman Brothers proceedings score high. On that analysis, this proceeding should have been governed using the most integrated form of governance; that is, universalism. The hazards of not doing this have become clear as the proceedings have evolved.

On May 12, 2009, LBHI and a number of its debtor and non-debtor affiliates entered the Cross-Border Insolvency Protocol for the Lehman Brothers Group of Companies (Protocol)

¹⁷⁹ Debtors’ Amended Response to Objections to Approval of Proposed Disclosure Statement, *In re Lehman Bros. Holdings*, No. 08-13555 (Bankr. SDNY Aug 23, 2011), para [1], retrieved from http://bankrupt.com/misc/LBHI_SummaryRespDSObjections.pdf.

¹⁸⁰ Lehman Brothers press release 26 May 2009 retrieved from <http://dm.epiq11.com/LBH/Document/GetDocument/1315906>.

¹⁸¹ Debtors’ Amended Response to Objections to Approval of Proposed Disclosure Statement, *In re Lehman Bros. Holdings*, No. 08-13555 (Bankr. SDNY Aug 23, 2011), para [1].

that established an agreed framework to govern the conduct of the various proceedings worldwide.¹⁸² Its intended benefits are set out in that document:

Given the integrated and global nature of Lehman's businesses, many of the Debtors' assets and activities are spread across different jurisdictions, and require administration in and are subject to the laws of more than one Forum. The efficient administration of each of the Debtors' individual Proceedings would benefit from cooperation among the Official Representatives. In addition, co-operation and communication among Tribunals, where possible, would enable effective case management and consistency of judgments.¹⁸³

The Protocol represents an attempt to govern the insolvency process that exhibits high levels of cooperation between and among courts and insolvency professionals and coordination of court proceedings and asset recovery and could best be described as exhibiting the characteristics of 'modified' universalism. As discussed in Chapter 6, cross-border insolvency agreements are increasingly prevalent. TCE predicts that adopting this hierarchical governance mode for the Lehman Brothers proceedings will create transaction cost efficiencies. According to TCE, such an insolvency would be less transaction cost efficient if a territorialist approach was implemented in each separate jurisdiction in which a Lehman Brothers subsidiary had conducted business or held assets.

In one respect, the Lehman Brothers proceedings have provided a model for the dissolution of groups in insolvency because disparate Lehman Brothers entities entered a protocol with the parent company to ensure, as best they could, that these debtors cooperated among themselves. According to a Lehman Brothers press release in May 2009, 'the protocol attempts to alleviate both the disruption resulting from these filings as well as the lack of an international governing body with uniform oversight over these proceedings by ensuring cooperation and coordination among the various administrators.'¹⁸⁴ On the other hand, several high profile entities, including Lehman Brothers International (Europe) (LBIE) in the United Kingdom and administered by PriceWaterhouse Coopers, did not enter the Protocol. PwC has subsequently announced that it will achieve a surplus of approximately £5 million in the insolvency proceedings in the United Kingdom.¹⁸⁵ A report on the administration noted that 'PwC is on course to receive £1bn in fees from the administration which Lomas has previously warned could take at least another 10 years. More than 500 people are employed on the administration'.¹⁸⁶ This does not include the fees of the teams of lawyers retained to provide legal advice on the matter. A report in 2012, four years after the bankruptcy filing of LBHI, noted that 'Some 500 former employees of the European arm of the bank remain on the payroll while administrators PricewaterhouseCoopers have 300 staff working on unravelling the operation. Payouts for around 6,000 creditors have been delayed by a series of complex court judgments'.¹⁸⁷

¹⁸² Epic Systems, *Cross-Border Insolvency Protocol for the Lehman Brothers Group of Companies* (Approved by the Court on June 17, 2009) retrieved from <http://dm.epiq11.com/LBH/Document/#maxPerPage=25&page=1>.

¹⁸³ Ibid p 2.

¹⁸⁴ Lehman Brothers press release 26 May 2009, note 17 above.

¹⁸⁵ Jill Treanor, 'Lehman Brothers administrators left with £5bn surplus after creditors paid', *The Guardian*, (5 March 2014), retrieved from <http://www.theguardian.com/business/2014/mar/05/lehman-brothers-administrators-surplus-creditors-paid>.

¹⁸⁶ Id.

¹⁸⁷ Jill Treanor, 'Lehman administrators earn £500m in fees', *The Guardian*, (13 April 2012), retrieved from <http://www.theguardian.com/business/2012/apr/13/lehman-debt-pwc-unravel>.

In the end, several of the Lehman Brothers subsidiaries entered the Protocol. However, it is notable that PwC, representing Lehman Brothers International (Europe) and a number of other Lehman European subsidiaries refused to enter the Protocol. In its fourteenth progress report, for the period 15 March 2015 to 14 September 2015, PwC reported that the administration of LBIE would return a surplus of between £7.3 billion and £7.7 billion.¹⁸⁸ Given the positive outcome for LBIE and its creditors, it is easy to understand the reluctance of LBIE and PwC to enter any protocol that could jeopardise that position. However, it is also a clear indication of the potential for and the damage that can be caused by opportunism when the separate legal entity doctrine is adhered to and parties choose not to cooperate. A system of pure universalism in which one court would resolve all claims in relation to all entities would arguably result in a fairer outcome for all creditors, not only those of LBIE.

6. Normative Argument for Pure Universalism

The UNCITRAL Model Law does not apply to separate entities within a larger corporate enterprise. Each separate entity must file a main proceeding in its COMI state. This entails multiple main proceedings that are ostensibly unconnected. The Model Law allows for coordination between disparate primary and secondary proceedings involving the same debtor but does not apply directly to ameliorate proceedings involving separate legal entities. The separate legal entity doctrine is too entrenched. In these circumstances, because no global law exists, Lubben and Woo argue that efficiencies can be had if ‘the main proceedings are linked together through accords or protocols entered into by the principals in those proceedings. That is, contract fills the gap left by statute.’¹⁸⁹ These types of cross-border insolvency agreements (such as the Lehman Brothers Protocol) are an example of modified universalism. As described, modified universalism is not the most integrated form of governance that can be imagined; pure universalism remains a goal. Lubben and Woo argued that the separate legal entity doctrine should be subverted when large multinational financial institutions (such as banks) are involved. They proposed that, ‘where the horizontal linkages among firms are extreme, reorganization is the only way to avoid systemic collapse. Thus, it may be quite necessary to harm the “lesser” entities in order to avoid the disruption that would result from the collapse of the core of the enterprise’.¹⁹⁰ This is akin to substantive consolidation of entities within the corporate enterprise. While Lubben and Woo’s arguments refer specifically to financial institutions, this could equally be argued to apply to all multinational enterprise groups where sufficient transaction characteristics exist.

Westbrook argued the benefits of a global law to govern cross-border insolvencies. Such a convention he said would require ‘a single law and a single forum to govern each ... case’.¹⁹¹ These could be achieved by either establishing ‘unified international institutions, or a unified set of conflicts rules’.¹⁹² Westbrook’s preferred approach would be to ‘establish a single international bankruptcy law and a single international bankruptcy court system’. This, he argued was because choice-of-law rules are ‘notoriously non-uniform and unpredictable, so a single law is, in principle, much more desirable from an ex ante perspective’.¹⁹³ Westbrook

¹⁸⁸ PricewaterhouseCoopers, *Lehman Brothers International (Europe) – In Administration, joint administrators’ 14th progress report, for the period from 15 March 2015 to 14 September 2015, (12 October 2015)*, at 14, retrieved from <http://www.pwc.co.uk/assets/pdf/lbie-14th-progress-report.pdf>.

¹⁸⁹ Stephen J Lubben & Sarah P Woo, *Reconceptualizing Lehman*, 49 *TEXAS INTERNATIONAL LAW JOURNAL* 297, 321 (2014).

¹⁹⁰ *id.* at 321.

¹⁹¹ Westbrook, *MICHIGAN LAW REVIEW*, 2292 (2000).

¹⁹² *id.* at 2292.

¹⁹³ *id.* at 2292.

argued that a pure universalist system, one in which there would be one court system applying one law in relation to cross-border insolvencies around the world, would:

- produce a far higher level of predictability in commercial transactions than we now have;
- maximize asset values, even in liquidation, by providing a unified approach to assembly and sale of assets as a whole;
- If it commanded a worldwide stay, could most effectively protect those assets prior to sale;
- make preventing or undoing debtor fraud far easier and more certain, an especially urgent goal in a world of electronic funds transfers and asset protection trusts;
- lower the risk of parochialism in the administration of the case;
- create a single set of priorities and method of distribution, ensuring equality for stakeholders with similar legal rights everywhere in the world; and
- provide one consistent set of transfer-avoidance rules (such as preference and fraudulent conveyance avoidance), so that creditors would know the rules and would know they were protected against strategic behaviour by debtors and other creditors.¹⁹⁴

‘The consequence’ Westbrook argued ‘would be a great reduction in risk premiums and transaction costs and a great increase in fairness and efficiency.’¹⁹⁵ These are lofty aims and lofty claims but, as discussed, on a normative analysis based on an application of TCE, such a system would provide the most integrated and hierarchical system of governance and should be implemented. The reasons that this system has not been adopted include the economic and real politick costs of setting up and running it, including the resistance by most nations to intrusions on their national sovereignty.

The economic costs of implementing such governing scheme with a single court system set up (for example, in New York) with global reach, implementing a single insolvency law would include (a) the costs to develop and maintain the system and (b) the costs and other impediments to insolvent debtors and global creditors in accessing and using the system. However, once the initial setup costs had been sunk, there would not be a need to continually incur those costs. It is also argued that accessing and using such a system could only be cost effective in certain circumstances – for example in a case such as the Lehman Brothers bankruptcy. Westbrook acknowledged that establishing a system to implement pure universalism in which there would be ‘a single law and a single forum to govern each multinational case’¹⁹⁶ was ‘implausible, but not ... impossible’¹⁹⁷ and that ‘a truly universalist system may be many years away’.¹⁹⁸ The impediments would seem to be insurmountable, at least in the short term. However, these impediments do not impinge on the extremely attractive normative arguments based on the TCE analysis in this paper for such a system. This is an open question for further research based upon costing a full universalist system but such an analysis is outside the scope of this paper.

¹⁹⁴ id. at 2292–3.

¹⁹⁵ id. at 2309.

¹⁹⁶ id. at 2292.

¹⁹⁷ id. at 2294.

¹⁹⁸ id. at 2315.

7. Conclusion

This paper examined the governance structures available to debtors and creditors in cross-border insolvencies including universalism, hybrid modes of universalism and territoriality. A transaction cost economics analysis of these structures should be able to determine which is the most efficient, given variations in transactions. This should give participants in cross-border insolvencies more certainty and increase the efficiency of cross-border insolvencies. If TCE theory applies as suggested, given the various differences in asset specificity, uncertainty, complexity and frequency in given transactions, parties should be able to align the most transaction cost efficient governance structure to appropriate transaction matrices before, or at the time the insolvency commences.

The paper provides the structure that might be used to further apply TCE to cross-border insolvency. The relevant governance modes are set on a spectrum between universalism at one end and territoriality at the other. The hybrid modes of governing cross-border insolvencies lie between these two ends and take the form of variations on modified universalism. Once the governance modes are set, the different transaction types can be delineated using the independent variables: asset specificity, uncertainty, complexity, and frequency of transaction. Those cross-border insolvencies, such as the insolvency of LBHI that display high levels of these variables, are arguably best governed using the most integrated and hierarchical form of governance available to the parties. Reducing duplication and creating greater certainty in the process of using an integrated governance mode realises transaction cost efficiencies for these types of transactions.

Conversely, cross-border insolvency transactions that display low levels of the independent variables will obtain transaction cost efficiency by allowing the parties, including local creditors, to resolve the transaction at a local level using local agents and court processes. In this way, the costs of developing and implementing a more hierarchical governance structure are averted and transaction cost savings ensue.

A TCE analysis of cross-border insolvency provides a new way of viewing the debate between universalism and territoriality that has dominated the literature on cross-border insolvencies to date. This new approach adds to the literature and proposes a new way of analysing these theories. The following policy outcomes from the research in this thesis might be argued:

- A predictive tool to allow participants in cross-border insolvencies to predict the most transaction cost efficient means of governing various cross-border insolvency transaction types based upon the likely levels of asset specificity, uncertainty, complexity and frequency of the transactions.
- The research provides support for the normative argument to implement pure universalism at a global level to govern the most complex cross-border insolvencies, including those of multinational enterprise groups.
- The concessions granted in the Model Law to appease state sovereignty concerns are anathema to pure universalism. The aim of universalists is to implement a system of universalism on a global basis. Presumably, the aim is to eventually remove these territorialist concessions. However, an application of TCE as proposed in this paper suggests that there are transaction cost efficiencies in retaining some territorialist elements as a means of governing some transaction types. Those developing and implementing global laws may consider retaining some system of territoriality to be

implemented as the transaction type requires. This might have interest at the global level with UNCITRAL and also at a local level when states are considering implementing a cross-border insolvency provisions into their national laws.

The application of TCE to cross-border insolvency as proposed in this paper is obviously only in its seminal stages. The case study chosen (Lehman Brothers Holdings Inc) provides enough confirmation of the TCE methodology to warrant further and more detailed research in the area. Only in this way, as stated by Williamson, can a more authoritative statement be made on the applicability of the theory and a more authoritative and predictive theory can be developed.