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6. International Jurisdiction of Courts in the USA and England

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Section 426 UK Insolvency Act 1986

During this lecture I would like to introduce you to Section 426 of the UK Insolvency Act 1986, which acts as a coordination model for the relevant designated countries. Recent cases and their context will also be discussed. These include the HIH case[1], which went up to the House of Lords, and the Bear Stearns case[2].
Section 426 Insolvency Act 1986 is the English statutory provision for recognition and judicial assistance, which unfortunately only applies to a limited number of countries. Most of these are either existing or former British colonies or Commonwealth countries. There are only two exceptions: Ireland and Hong Kong, countries that used to be colonies but now are no longer colonies or even part of the Commonwealth. Ireland is the only country that has two overlapping statutory provisions. It is a member state of the European Union and is also mentioned within Section 426.

In one of the more obscure parts of the Insolvency Regulation, in Article 44, there is a list of exceptions for pre-existing treaties and provisions. Sub-paragraph 3(b) of Article 44 states that the Regulation shall not apply "in the United Kingdom of Great Britain and Northern Ireland, to the extent that is irreconcilable with the obligations arising in relation to bankruptcy and the winding-up of insolvent companies from any arrangements with the Commonwealth existing at the time this Regulation enters into force." Since the country became a republic outside the Commonwealth around 1920 this does not apply to Ireland, which is the only EU member state that is affected by this. So, in fact, in relation to Ireland the Regulation takes precedence because it was not part of the Commonwealth at the time when the Regulation came into force in 2002. However, if there is a conflict between the Regulation and Section 426 for those countries that are Commonwealth countries then Section 426 would take precedence by way of exception. For Hong Kong the same reasoning can be followed as for Ireland, because it wasn't part of the Commonwealth at the time the Regulation came into force. However, for all the other countries listed in Section 426 this exception mentioned in Article 44 of the Regulation still has effect. These include a couple of major jurisdictions like Canada and Australia, which used to be colonies. Apart from Canada and Australia there are a lot of offshore islands that are used for tax and regulatory purposes, for example the Cayman Islands, the British Virgin Islands and Bermuda, and a lot of them are located relatively close to the United States of America (USA). Therefore a lot of important business goes through these offshore islands. For example, Bermuda is the world's third largest reinsurance centre and the Cayman Islands are the world's largest hedge fund centre by incorporation.

To understand the context of Section 426 I will provide some background to try to explain what Section 426 is all about in domestic United Kingdom (UK) terms. All of the countries involved used to be part of what was called the British Empire, which ceased to exist in the 1950s and 1960s when all of the bigger colonies (in terms of population) wanted to become independent. Nowadays only a few islands or peninsulas are still

[1] 9th of April 2008, McGrath and others v Riddell and others (sub nom Re HIH Casualty and General Insurance Ltd and other companies; McMahon and others v McGrath and another), House of Lords
[2] *Bear Stearns High-Grade Structured Credit Strategies Master Fund Ltd,* United States District Court Southern District of New York, 22 May 2008.

colonies of the British Empire, about which it used to be said that the sun never sets on it, because when the sun set in one part of the empire it rose in another part.

Let me take you back to 1914, when one of the high points for the British Empire before the outbreak of the First World War was the enactment of a bankruptcy statute, called the Bankruptcy Act of 1914. The Bankruptcy Act was an imperial statute, so it applied everywhere where there was red on the map, which was the case for a lot of places. In all of these places the laws were based on English laws, although they had their own local legal jurisdiction. The bankruptcy statute contained a Section 122, which stipulated that all British courts had to cooperate with each other in insolvency matters.

The Bankruptcy Act 1914, however, only applied to individuals and not to companies. So once again the English judges and practitioners had to use the flexibility of the common law (judge-made law) to close the gap that arose because of the fact that from around the middle of the 19th century onwards most business was conducted through what are called joint-stock companies. Obviously, just like individuals, companies could become insolvent, sometimes even in different jurisdictions. Due to the fact there were no statutory provisions for cross-frontier co-operation in the case of insolvent companies, the judges developed what was called the 'ancillary liquidation' principle. It was called the ancillary *liquidation* principle because in those days not a lot of corporate rescue and reconstruction operations were going on. So if there were proceedings they were liquidation proceedings, and there might be liquidation proceedings of the same entity in England, Australia, New Zealand and maybe in Hong Kong or Singapore. The judges wondered how to manage this. Having rival proceedings was not possible because according to English legal theory each proceeding was universal. Therefore this principle was developed by the courts in London, setting a precedent that was quickly followed in all of the other countries by the adoption of what was called 'ancillary liquidation'.

The question is: how does the ancillary liquidation doctrine work? This is very simple. In order to have this doctrine work, one must find the domicile of the company. This is by analogy to the domicile of a human being, which in those days was generally accepted in private international law to be the place where a person had his habitual residence and therefore was likely to die, write his will or become bankrupt. In English domestic law, however, domicile is a complicated idea, and does not just refer to one's habitual residence. It is a kind of habitual residence *plus* and it was very complicated in English law because a lot of English people were born in England but spent a great part of their lives either in business or civil service in Hong Kong, Australia, New Zealand or Canada. Therefore, a person's domicile would not necessarily be the same as his habitual residence. It was a more complicated idea of where your *ultimate* permanent home is. There were a couple of rules to reinforce this domicile principle. One of them was that one had a domicile of origin, which was where one was born: it was assumed that one was born where one's parents had their habitual residence. One could then move somewhere else and acquire another permanent home, which was one's domicile of choice. If one left one's domicile of choice one would automatically revert to one's domicile of origin unless and until a new domicile of choice was acquired.

Unfortunately, this does not apply to companies. Companies are not born so they do not have a domicile of origin, nor do companies die. They are registered though, which is the equivalent of being born and thus corresponds with the domicile of origin of individuals. Companies can 'die', but under private international law this can only happen at the place where they were 'born', because they need to be dissolved and de-registered. It has been generally accepted in private international law that a company can only be dissolved in the place where it was registered. For companies this was very convenient because they always had the same domicile, which was their place of registration in the country were they conducted their business.

The ancillary liquidation doctrine now said that liquidation must be done in the place where a company was incorporated. If the domicile of a company opened insolvency proceedings these needed to be treated as the main proceedings and any other proceedings around the world had to be treated as ancillary proceedings. Due to the fact that all of the judges followed the same precedents this had effect within the whole British Empire. So this is how the ancillary liquidation doctrine worked: once main proceedings were opened in the place of registration other proceedings in different jurisdictions had, so to speak, an ancillary function.

The conceptual problem with this approach was that, based on the domestic law jurisdictions, in each country each proceeding was 'universal'. Therefore one could wonder how the ancillary liquidations could be ancillary and support the main liquidation in the way that the secondary proceedings concept works in the Regulation. The way in which this is done is that under English law, whatever the statute says on a certain subject, the courts retain a kind of special power to give directions to the liquidator as an officer of the court. So even though in theory an ancillary secondary liquidation might be universal, what the ancillary liquidation doctrine does is that the courts require the secondary liquidator not to act as if he is running universal proceedings but to act as if it concerns secondary proceedings. Firstly, the secondary liquidator only acts territorially and not universally. Secondly, when all the assets and claims are collected the surplus, net of costs and local preferential claims, has to be sent to the main proceedings. All claims and liabilities from around the world have to be collected and then one universal distribution takes place whereby everybody ranks *pari passu*, apart from any preferential claims under the main proceedings' jurisdiction.

In 1985 there was a statute reform, which was based upon a 1982 report by a committee called the Cork committee. Norman Cork, the chairman of this committee, was a very famous liquidator and receiver in England. As a result of the committee's recommendations a reform took place and the provisions of the old Bankruptcy Act of 1914 relating to cross-border insolvency co-operation, which applied to individuals, were replaced by statutory provisions that applied to companies as well. Starting in 1986 there now was a statutory requirement in England, which applied to a designated list of mainly Commonwealth countries (like Australia, New Zealand, Canada, the Cayman Islands, Bermuda and the British Virgin Islands), that if a request was received in relation to either a personal or corporate insolvency from a judge with insolvency jurisdiction in these designated countries, assistance shall be given. This request to assist in foreign proceedings gives an English insolvency judge authority under the English statute to apply either the law of the requesting country or the equivalent English law in terms of insolvency proceedings or insolvency law benefits. This is an aspect of Section 426 that is better and more flexible than any other system I know. That is, if you look at the Regulation it generally gives you a choice of *one* law: it's either the law of the main proceedings or the law of the secondary proceedings or some other law. Normally, there is only one law that can apply to any kind of problem. Under the UNICITRAL Model Law on Cross-Border Insolvency one can only apply the law of the forum and under common law discretion one also can only apply the law of the forum.

Section 426 is the only statutory system in the world where one can either apply the law of the forum or the foreign law, depending on what is deemed more appropriate. In that sense it is a more flexible system than any other. English judges have made it even more flexible, though. What they have permitted is that you can request the English Court to do something under English law that is not possible under either the foreign law or under the English law. Let me explain this.

A case called Dallhold[3] originated from a famous insolvency in Australia. One of the things that the liquidators in the main proceedings for the companies in Australia discovered was that one of those nameplate companies owned some property in England. Now what the liquidators of the Australian proceedings wanted to do was put Dallhold not into liquidation but into administration, even though it was an Australian company that owned property in England. At that time, however, administration was not possible in Australian law. The liquidators wanted something that in those days only existed in English law. Therefore they asked the English Court to follow English law. But in English law it was thought that the remedy of administration could not apply to foreign registered companies. Therefore there was somewhat of a double impossibility, i.e. under Australian law there was no administration possible and in English law administration was an option, but not for Australian companies. However, in first instance the judge upheld this possibility and the case met with approval by the Court of Appeal. In this manner the Australian liquidators achieved a double impossibility. So under Section 426 an administration order could be made in England at the request of an Australian court even though that would not have been possible under domestic English law, because Section 426 was deemed special and was therefore not limited by the ordinary jurisdictional rules of English law. In this way the judges expanded the effects of the statute and made it even more flexible than it was already.

There was also a dispute that focussed on the basis on which Section 426 worked. Was it mandatory or not to give assistance when requested? In other words: did one have to respond to the request for assistance? The controversy revolved around the use of the word 'shall' in the statute.

What happened in the well-known Hannover Re case[4], which went to the Court of Appeal, was that a very distinguished American bankruptcy lawyer read Section 426 and saw the word 'shall'. And he thought: "The court *must* do it." He was giving advice on the liquidation of an insurance company in Bermuda, which is one of the Section 426 countries, and the liquidators had a bit of an embarrassing problem. They were faced with a potential reinsurance arbitration in Massachusetts under the reinsurance contract and they wanted to stop it and deal with it in the liquidation in Bermuda. Unfortunately, they had already migrated from Massachusetts to Bermuda on the basis of being solvent. Quite soon after they had moved to Bermuda they found that they were insolvent and went into liquidation. This upset the reinsurance companies because they felt that under Bermuda law, in contrast to Massachusetts law, the contingent claims against reinsurance under the reinsurance contract would be accelerated. One of the smaller reinsurers was Hannover Re. This German company had a reinsurance contract that theoretically provided for arbitration anywhere in the world, but in practice for arbitration in Massachusetts. Now the insurer, EMLICO, had moved out of Massachusetts where it originally started its business activities and where it had been registered not long before. After its move the company was registered in Bermuda, where it went into liquidation proceedings. EMLICO could obviously go back, request assistance on the basis of the old Section 304 of the US Bankruptcy Code and ask the US Bankruptcy Court in Massachusetts to stop the arbitration. This was felt as being a little bit embarrassing, though, because the company had just moved out of Massachusetts on the basis of being solvent. Returning to Massachusetts on the basis of being insolvent therefore posed a little bit of a problem.

When reading Section 426, the American lawyer thought: "Bermuda is listed under Section 426 and it says 'shall', so all we have to do is ask the Bermuda Court to request the English Court to make an injunction against Hannover Re that has a representative office in London on the basis of personal jurisdiction. This must work because Section

[3] Re Dallhold Estates (UK) Pty Ltd. [1992] BCC 394

[4] Hughes & Ors v Hannover Ruckversicherungs-Aktiengesellschaft. [1997] BCC 921

426 says ‘shall’.” Unfortunately the request was rejected, in first instance by the judge and subsequently also by the Court of Appeal. The Court of Appeal said that ‘shall’ did not literally mean ‘shall’. It means “shall, if it is a proper case for assisting” and this was certainly not a proper case. I argued the case in the Court of Appeal - things were obviously more difficult than had been imagined. My argument was that ‘shall’ meant ‘shall’ and that the correctness of this point of view was proven by many years of case law. Every case said that helping is mandatory if it says ‘shall’. However, the *mode* of helping is discretionary. Therefore one has to help, but exactly in what way one needs to help is discretionary. In other words: one has to help as is deemed appropriate. This was fine because in this case there was only one way in which the court could help, which was by making an injunction against Hannover Re.

Now the Court of Appeal somehow came to the conclusion that ‘shall’ doesn’t really mean ‘shall’. It actually means ‘yes’ every time it’s proper and ‘no’ if it is believed to be improper, which is a very strange way of reading the statute. The Court of Appeal was horrified by the idea that one could simply pick on a company in London with personal jurisdiction because it has a local office there, and stop it from doing something in Massachusetts when there is no connection between the subject matter and London. The judges could have chosen a much more clever approach. They could have followed the earlier cases and said that assisting was mandatory but that the mode of assistance was discretionary. Therefore they could have made a worldwide injunction against Hannover Re from arbitrating, because theoretically arbitration could take place anywhere, but carve out Massachusetts - which was were they actually wanted to arbitrate. Then the English courts had assisted under Section 426 but had done so in a way that prevented the English jurisdiction from being used in an excessive way. Unfortunately, since then it has been established that ‘shall’ doesn’t really mean ‘shall’ but that its meaning depends on how good your case is.

HIH case[5]

Let us now turn our attention to the HIH case, which involved a huge Australian insurance group. HIH was one of the largest insurance groups in Australia when it went bust, a few years ago. Again this was a corporate group with multiple corporate entities, but it will be treated as one for the purpose of this lecture. In the HIH case there were ancillary proceedings in London and main proceedings in Australia. What was special about this case was that under Australian insurance insolvency law, instead of the normal *pari passu* solution for paying creditors, two special priorities were created. One was related to Australian creditors regarding Australian assets and is not relevant for this case. The other special priority under Australian insurance insolvency law is that if you have an insurance policy and there is a corresponding reinsurance to cover the same risk, you have priority in respect of the proceeds of the reinsurance. Therefore, the money collected from reinsurers has to be given to the people whose risks were being reinsured. In England things were completely different at the time. There the *pari passu* principle had to be applied and no other priorities were accepted, except for costs and normal preferential creditors like taxes. There was one exception relating to the separation of the assets and liabilities of general and long-term business, respectively.

In the HIH case, there obviously was a very clear clash of priorities between the two different systems. The question that one had to bear in mind was whether, as a matter of principle, the surplus assets (net of costs and preferential claims) in England should be sent with the claims in England to Australia and dealt with in one universal proceeding in accordance with the ancillary liquidation doctrine. A very important change took place during the course of the proceedings, though, which undoubtedly had an effect. When the

[5] Reported as McGrath v Riddell [2008] B.C.C. 349

proceedings started there were these special priorities in Australia, whereas there was no special priority in England. During the progress of this case, which went slowly up through the English courts, the English position completely changed. The European Union passed a directive[6] on the reorganization and winding-up of insurance undertakings, which was then promptly implemented in England. As a result of the enactment of the directive into English law, direct policy holders were given precedence over all other creditors. Therefore the direct policy holders' interests were given precedence over those of reinsurance creditors and ordinary creditors such as lenders. This was an even more radical change of priorities than the priorities that prevailed in Australia. It was a fundamental departure from the former *pari passu* principles.

What happened in the HIH case was that the distribution was not going to take place in a liquidation proceeding but in a statutory composition called a scheme of arrangement. However, the scheme of arrangement was drafted in such a way that the exact mode of distribution depended on what would have happened if there had been a liquidation proceeding. The issue that arose before the English courts was: if a liquidation proceeding had governed the distribution, would the English courts have sent the assets and claims from England to Australia to be dealt with in the main liquidation?

In first instance, the judge rejected this idea and said that there was no jurisdiction in the English Court to send assets to be dealt with in a foreign liquidation in a way that is completely inconsistent with the mandatory statutory priorities in England. In order to understand this, one has to take a little step back in time.

In a case called BCCI[7] there was a lot of interesting litigation, and a lot of interesting case law arose from this major scandal. One of the interesting parts of the BCCI case dealt with this area of ancillary and main liquidation. Prior to the BCCI case there had never been any fundamental clashes of priorities in applying the ancillary liquidation doctrine, just local differences in the priorities of preferential creditors. BCCI was something new on the horizon, because there were main liquidation proceedings in Luxemburg whereas the centre of main interests (as we would now call it) was actually in London. The business was run from London; the head office functions were located in London. Everything was located in London, except for the place of registration and, unfortunately, the place of supervision at the time. BCCI turned out to be a gigantic international fraud. Although BCCI officially was short for Bank of Credit and Commerce International some have called it the Bank of Crooks and Criminals International, which perhaps was a better description. The interesting aspect was that the English ancillary liquidation doctrine allowed in principle that all assets and claims (net of costs and preferential creditors) would be sent over to Luxemburg to be distributed under Luxemburg law. For the first time the priorities were completely different, though, because under Luxemburg law there is very little set-off allowed and set-off was a big issue for a number of creditors. Under English insolvency law, automatic self-executing set-off takes place at the start of the liquidation proceedings. So any cross-claims, of whatever nature, are all merged into one net debt. Under Luxemburg law, as mentioned earlier, very little set-off is allowed. Therefore, the creditors in England complained that if all the assets were to be sent to Luxemburg they would be deprived of their right of set-off, which would cost them a great deal of money. In the first instance they managed to persuade the judge that he should retain sufficient money in the English liquidation for special distribution to protect those creditors that would lose out significantly in Luxemburg. This was the first time that such a problem arose. The principle the judge used to solve this case was the idea that the distribution mechanism, in particular set-off, was mandatory in the statute in England. One could therefore not contradict this mandatory system by sending the assets

[6] Directive 2001/17/EC on the reorganisation and winding-up of insurance undertakings of 19 March 2001

[7] Re Bank of Credit and Commerce International SA (in liq.). [1996] BCC 980

to Luxemburg. In the HIH case the judge in first instance followed the same sort of approach, i.e. that it would be a contradiction of the mandatory rules of distribution and priority in English law to send the assets to Australia to be dealt with in a way that was radically different from the distribution of priorities in England. Of course the liquidators in the Australian insolvency proceedings appealed this decision. They went up to the Court of Appeal, which ruled that there was jurisdiction to contradict the mandatory statute of provisions in England because of the judge-made doctrine of ancillary and main liquidations. This means that if assets are moved to another country they in fact never really become subject to the English distribution mechanism and the English mandatory distribution of priorities. The Court of Appeal nevertheless rejected the remittance to Australia because, although it was allowed to do so as a matter of jurisdiction, it could not be done - despite the word 'shall' in Section 426 - because it was not proper to do so. But when does one know when it's proper or not? In this instance the Court of Appeal said that it wasn't proper simply because the distribution mechanism was radically different from the *pari passu* principle applied in England.

Eventually this decision was appealed and the HIH case went up to the House of Lords. The House of Lords ruled that not only is there jurisdiction, supporting the Court of Appeal in that aspect of its decision, but that it is also proper to send all assets and claims to Australia to have them dealt with in one universal insolvency proceeding. Some people suspect that the fundamental change in English law must have had some influence on the decision reached by the House of Lords. They reason that at the start of the proceedings there was a fundamental difference between the English *pari passu* system on one hand and the special priority system in Australia on the other. By the time the HIH case got to the House of Lords, however, English law had broken more radically with the *pari passu* principle than Australian law had. It would now be impossible to say that it wasn't proper to send the assets to Australia because Australians do not have *pari passu*, the Court of Appeal had reasoned. Some have thus referred to the fact that it would be strange to tell the Australians that something was not proper when English law now went even further than theirs. This, therefore, is a really important factor for understanding the House of Lords' decision. What is very interesting analytically and conceptually is that although all five members of the House of Lords came to the same conclusion they used two radically different approaches to solve this problem.

There were two strands of thought, the first of which was that of Lord Hoffman. He said that the correct analysis of this case was to be found within the doctrine of ancillary liquidation, which I touched upon earlier. In the HIH case there was an ancillary liquidation or secondary proceeding in England and a principal liquidation in Australia. So the general principle was that all the assets and liabilities should be sent to Australia unless there was a very good reason not to do so. Lord Hoffman believed that Section 426 was only a kind of reinforcement for that. It gave extra strength, if you like, to the request from Australia.

The actual correct analytical principle, according to Lord Hoffman, was the judge-made case law discretionary ancillary liquidation principle. He described this as a kind of modified universalism. The Regulation itself was also a form of modified universalism, because it was a compromise between main and secondary proceedings. The same applied to the English ancillary liquidation doctrine, which goes back to about a hundred years before the Regulation. Although it has a universal principle it should be seen as modified in substance by the claims of local creditors where hardship or injustice would be brought upon them. Where the actual and exact boundaries lie of this ancillary liquidation doctrine is quite difficult to tell and has to be clarified by case law. Very interestingly, Lord Hoffman has pointed out that historically the main liquidation has always been done in the place of registration, which is taken as the place of domicile. He raised the question, though, if one should change to the COMI standard adopted by the

Regulation. In the HIH case obviously this would have made no difference, because then the liquidation would still take place in Australia. The reason that this remark is very interesting is because all of these other English law based countries at the moment use the registered office standard. The Cayman Islands, Australia, New Zealand, Canada, Bermuda and the British Virgin Islands currently all use this standard and not the COMI standard.

But where does the discretion of English judges stop? In other words: when is it right to remit and send the actual assets and liabilities and when isn't it? This is the actual question in the HIH case that needs to be considered. Lord Hoffman said that there were two things that could prevent remittance of assets and liabilities, which were justice and public policy.

Public policy is the easy one to deal with because, like Article 26 of the Regulation, public policy is a very narrowly defined issue. It is very difficult for an English lawyer to prove a breach of public policy. It usually would require something like, for example, discrimination on national or ethnic grounds or lack of proper procedure or procedural safeguards. Public policy is very rarely going to apply and this is particularly true when it concerns Australia. Nearly all of the top Australian judges were educated at British universities. They have a similar system of law and a similar judiciary system, so the chances of ever finding that an Australian court is running something contrary to public policy are very slim.

Of the two things that, according to Lord Hoffman, could prevent remittance of assets and liabilities, justice is the really difficult one. How do you know when it is not just to send assets and liabilities? This resembles the Section 426 question: how do you know when it's proper and when it's not? It's a similar sort of dilemma. Here Lord Hoffman only gives one real example, based on the previously mentioned BCCI case. Lord Hoffman did not except the reasoning in the BCCI case. He believed, like the Court of Appeal, that there was discretion to send the assets and liabilities and that this therefore would not be a breach of mandatory rules for distribution. However, Lord Hoffman accepted the end result in the BCCI case that there was a retention needed, but on the basis that it would have been unjust to those creditors who had the best set-off rights in England in the liquidation in the BCCI case. It would have been unjust, because the claims of debts in BCCI were very closely connected with the English jurisdiction. As mentioned earlier BCCI was actually run from London, all the business was done in London. Luxemburg was only a kind of nominal brass plate aspect of BCCI. So that is the one example of justice Lord Hoffman gives us, i.e. that in the BCCI case it would have been unjust to those creditors not to retain some assets to protect their set-off rights because in substance these set-off rights belonged in England and not in Luxemburg.

The other strand of thought in the HIH case was based of the concept of mandatory English law rules. This strand of thought was based on a fundamental misconception, though. The two Lords who followed this approach both seemed to think that the English statute of the Insolvency Act 1986 was some kind of code of insolvency law. They believed that if you needed to find insolvency law you would find it in the statute. Of course anybody in the field would agree that this is wrong. Throughout the entire English insolvency law, there have always been parallel judge-made rules that have made important provisions next to and separate from the statutory provisions. The assumption that any statute will have all the answers is completely wrong and has been disproved by history. So this is a classic mistake of not analysing this problem in terms of the ancillary liquidation doctrine, where it belongs, but to keep thinking that the answer can be found somewhere in Section 426. When one looks at Section 426 it does not say anything about remitting assets to another jurisdiction nor does it say anything about main or secondary proceedings or about ancillary liquidation. The basis of Section 426 is the old Bankruptcy

Act of 1914 for individuals and essentially extends its scope to companies. Unfortunately this strand of thought is just completely unhistorical and misguided in terms of the failure to analyse the actual state of insolvency law based on the thought that Section 426 gave jurisdiction for remittance, even though there is no part of Section 426 that touches on this subject at all.

With regard to the question of the 'shall' the Lords of course accepted that, as the Court of Appeal said, somewhat confusingly and in a contradictory way, this sometimes does and sometimes doesn't actually mean 'shall', depending on whether it's proper or not. So this issue relating to Section 426 (when is it proper to assist and when isn't it?) resembles the question under the ancillary liquidation doctrine: when is it just to remit and when isn't it? However, it is an equally elusive question: how do you decide whether or not something is just? The Lords decided that the fact that Australian distribution priorities are completely different does not make remittance unjust. One could wonder why, though. Why is it *not* proper to deprive English creditors of English law set-off rights, whereas it *is* deemed proper to put them under Australian law distribution rules that give priorities that are completely different from those under English law at the relevant time? Why should a creditor who does not benefit from the special priority regarding the insurance recovery lose out?

Chapter 15 U.S. Bankruptcy Code

My final remarks relate to the Bear Stearns case in the USA in the context of Chapter 15 of the U.S. Bankruptcy Code, which replaced Section 304 of the U.S. Bankruptcy Code. Under the old Section 304 there was a general ability to have what is called an ancillary proceeding. Obviously, this was originally derived from the English ancillary liquidation for assisting in foreign insolvency proceedings. However, this was a somewhat more modern version in a way.

The Americans actually had a very good system and the only thing you had to show in practice was that insolvency or reorganisation proceedings were taking place and that American creditors were not discriminated against. You were then pretty much home and dry and would receive a lot of assistance from what was a pro-debtor court, a very refreshing phenomenon for somebody from England where the courts are mostly pro-creditor. Unfortunately this is history now, because of the adoption by the United States of America (USA) of the UNICITRAL Model Law on Cross-Border Insolvency.[8] Generally speaking this law was adopted quite well in the USA, apart from one aspect.

There is one fundamental problem that was felt immediately in case law. For this, one has to look at Article 7 of the Model Law and its accompanying Guide of Enactment, which makes clear that the intention of getting countries to enact the Model Law is to *widen* the ability for giving assistance in insolvency proceedings. In most countries in the world, unlike the USA, the continental EU member states or the United Kingdom, there was - or still is - no good system in place for assisting in foreign insolvencies, or at least not a clear statutory system that is simple to use. Even the UK lacked a clear statutory basis except in relation to Section 426 countries and the Regulation's EU member states.

The Model Law is meant to be a universal model statute, which does not only apply in the European Union (EU) but can also be applied to insolvency proceedings in the rest of the world. Bear in mind that the rest of the world at this stage still used the registered office standard and not the COMI standard. What the Model Law does, as Article 7 expressly states, is provide an *additional* way of assisting in foreign insolvency

[8] The UNCITRAL Model Law on Cross-Border Insolvency 1997 inspired the drafters of Chapter 15 US Bankruptcy Code, which came into legal effect in October 2005.

proceedings. Therefore it is assumed that in most countries there is, prior to the adoption of the Model law, no or very little assistance or it is either very complicated or requires some extra or special procedures that make it quite difficult. The Model Law introduces a new additional procedure based on the notions of 'COMI' and 'establishment', which are borrowed from the Regulation. These were known concepts here in Europe but new to the Americans. However, instead of getting the Model Law to act as an additional way of assisting in foreign insolvency proceedings the Americans chose it to be the only (at least statutory) mode of assisting. In doing so, almost everybody in the USA seems to have overlooked the fact that its scope of action would be more limited than that of the old Section 304. If the foreign proceedings were started in a place that was not a company's COMI or where it did not have an establishment, then assistance could not be given by the USA under the enacted version of the Model Law.

There had been a long history under Section 304 of assisting in foreign liquidation proceedings, not only those from substantial countries like the UK and other European states but also those from offshore jurisdictions that over the years have become more and more important. For example, Bermuda is currently one of the main places for reinsurance and the Cayman Islands are one of the largest centres for hedge funds in the world. These were exactly the kind of places where jurisdiction could only be based upon the registered office approach to main proceedings. These proceedings were fairly automatically and routinely being recognised and assisted under Section 304.

When the new Chapter 15 was written, as is clear from the papers in the House of Congress, everybody thought that things would stay pretty much the same as they were under the old Section 304. Nobody mentioned the new rules and nobody realised that in fact what they were doing was shutting out a major area in which the old Section 304 had worked. And, as it appears, this actually was not an accident. Chapter 15, the USA enactment of the Model Law, was drafted by Professor Westbrook and a Boston lawyer called Daniel Glosband. Professor Westbrook has a particular history with offshore jurisdictions, though. Both professor Westbrook and I were involved in a case called National Warranty[9] some years ago. National Warranty was an American business giving warranties on consumer products and was incorporated in the Cayman Islands. However, it operated exclusively in the USA. If one were to look at head office functions, the centre of main interests would obviously be in the USA. Unfortunately National Warranty went bust and liquidation proceedings were opened in the Cayman Islands, where its place of incorporation was and therefore its place of main jurisdiction under Cayman law.

The real issue was whether or not ancillary proceedings should be opened under the old Section 304 to assist in the Cayman liquidation proceedings. Both professor Westbrook and I attempted to persuade the American bankruptcy court to switch over to the COMI standard. Therefore, we both argued that there should be a substantive main proceeding in the USA because that is were the COMI of National Warranty was located and not in the Cayman Islands, which was only its place of registration. Moreover, recognition of or even assisting in the Cayman liquidation proceedings should be out of the question. This attempt failed miserably. Westbrook, who also acted as one of the lawyers in the case, was particular annoyed when his plea was completely rejected by the judge in the National Warranty case.

Since then professor Westbrook has spoken and written very critically about offshore jurisdictions. So we had someone drafting Chapter 15 who doesn't like nameplate companies, doesn't like any kind of offshore incorporation, doesn't like shelf companies and so on. Professor Westbrook believes that the main proceedings should be opened where the centre of main interests is or where there is at least a proper establishment, a

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9 In re Nat'l Warranty Ins Risk Retention Group, 306 B.R. 614, (B.A.P. 8th 2004)

proper base of business, a place of operations. Therefore he drafted Chapter 15 in statutory terms based only on the concepts of COMI and establishment. The COMI is where the main proceedings are held and the place of establishment is the location of the non-main proceedings.

Pretty soon there was a Cayman liquidation that sparked the first real debate or discussion about how Chapter 15 had changed the position in relation to the old Section 304. It concerned the SphinX case[10], which was decided upon by a bankruptcy judge of the United States Bankruptcy Court Southern District of New York. SPhinX was a typical Cayman hedge fund, but this case had some special characteristics. It was a completely abusive application under Chapter 15 and it was designed to achieve a collateral purpose to upset a different bankruptcy proceeding. It could and should have been rejected on the basis that it was completely abusive. However, the bankruptcy judge in this case could not stop himself from saying one or two things about the COMI, which included a notion that is very odd to Europeans. This bankruptcy judge said that if all creditors decide that the COMI should be in the Cayman Islands, that this is where the COMI indeed would be. Obviously that is very convenient but above all a very pragmatic and strange interpretation of the statute, which obviously is completely out of line with the origins, history and context of the whole concept of the centre of main interests. Not surprisingly, this part of his judgement received some harsh criticism.

A few years later, two of Bear Stearns' hedge funds became insolvent. Again these were Cayman hedge funds, which were treated as such. This time, though, one has to bear in mind that a certain amount of suspicion surrounded Bear Stearns before Bear Stearns itself became insolvent. These two hedge funds defaulted very early in the sub-prime mortgage crisis and some say that they were even one of the first signs of the sub-prime mortgage collapse. The suspicion surrounding Bear Stearns had to do with the efforts by Bear Stearns in keeping this case offshore. The bankers of Bear Stearns preferred that no one back home in the USA would take a really close look at it. Some had the feeling that Bear Stearns was trying at the time to bury some really bad news in the Caribbean. Apparently these hedge funds were registered in the Cayman Islands for regular tax reasons. However, these funds never had any connection with the Cayman Islands except for their formal registration and auditing, which consisted mainly of basic bookkeeping and so on. Basically everything else happened in the USA, though. Therefore, in many ways the situation in the Bear Stearns case resembled that of SPhinX.

However, what happened was that the liquidators of the Cayman insolvency proceedings relied upon the presumption of the registered office due to the fact that there was no formal opposition in first instance. On the basis of the absence of opposition and the presumption of the registered office, the Cayman liquidators requested relief under Chapter 15. The bankruptcy judge rejected this request, though. Referring to the evidence that had been put before him, he said that he believed that there was no real connection with the Cayman Islands except for the funds' registration. Therefore he believed that the COMI of these Bear Stearns hedge funds could not be located in the Cayman Islands, but could probably be found in the USA. Also, no evidence had been put forward that there was an establishment in the Caymans due to the fact that no operations were taking place in the Caymans.
In fact, the bankruptcy judge said that if one looked at these hedge funds they were what Cayman law calls 'exempt companies'. Under Cayman law you can either operate a type of company that performs activities in the Caymans or a company can be incorporated that essentially performs activities elsewhere. This greatly resembles the situation in the Eurofood case. These hedge funds were exempt companies, which meant that they could

[10] In re SPhinX, Ltd., 351 B.R. 103 (Bankr. S.D.N.Y.2006) ('SPhinX I') and In re SPhinX, Ltd., 371 B.R. 10 (S.D.N.Y.2007) ('SPhinX II')

only perform activities elsewhere, outside of the Cayman Islands. They could only perform activities in the Caymans for the purpose of performing activities somewhere else. However, they could not perform activities in the Caymans for the sole purpose of performing activities in the Caymans.

The bankruptcy judge relied on the fact that it concerned exempt companies and basically said that it did not matter that nobody objected or if there was a presumption. In the USA this presumption is treated quite lightly and not given any great weight, unlike perhaps in the Eurofood case. On this basis, the bankruptcy judge rejected the Chapter 15 relief that was requested by the Cayman liquidators.

Subsequently, I advised the Cayman liquidators on an informal basis and told them that the facts just did not match. There was no COMI applicable in this case nor could it be suggested that there was an establishment. My reading of the case was that the bankruptcy judge was not going to accept that Chapter 15 applied, although the Cayman liquidators were trying to appeal his decision at the time. I suggested going back to the bankruptcy judge and telling him that there was another way in which he could help. There was a perfectly good liquidation in the Caymans, all of the investors were contracted under Cayman law, there was no creditor who did not like Cayman law, there was no issue about distributions or priorities under Cayman law, there was no question about Cayman law being more expensive than US law, or any question that the Caymans would not act swifter than the US. Therefore, what on earth was all the fuss about? Reference should be made to the residual common law jurisdiction where one could avail of a discretionary stay under judge-made principles instead of having mandatory recognition under Chapter 15.

The Cayman liquidators informally mentioned this to the judge in order to get some indication if he would be receptive to this kind of argument. However, the judge did not seem to be receptive at all, so in the end they backed off and never used this argument. Oddly enough, in his judgement in the Bear Stearns case, the bankruptcy judge identified himself as one of the co-drafters of Chapter 15. In England it would be considered very strange that a judge drafts a law and then interprets the same law, but apparently in America they do not think that this is odd. I wonder whether the judge was indeed one of the drafters or whether Chapter 15 was actually only the work of Westbrook and Glosband.

Basically, the Cayman liquidators had no chance unless they tried my argument on the residual common law discretion. Unfortunately the lawyers did not argue this in the first instance. Furthermore, in America it is common practice that no new facts and arguments can be brought upon appeal. At the appeal the Cayman liquidators tried to produce some more facts, but none of these facts really helped. The District judge who was responsible for the appeal said that, first of all, he did not allow the new facts because they were presented too late and, secondly, that if he had allowed them they wouldn’t have made any difference. Indeed, if you look at them objectively those new facts did not amount to either a COMI or establishment. There was just nothing in the Caymans except for a place of registration. There were a couple of local directors, but in reality the local directors in the Cayman Islands did not do anything except what they were told to do by the non-Cayman directors. These new facts did not really add substance to the matter.

Through this way of enacting the Model Law, which was contrary to the terms of the Model Law and the Guide to Enactment, the Americans unfortunately have made COMI/establishment the only bases for requesting statutory assistance for foreign insolvency proceedings and have effectively shut out a whole series of cases. But what can be done about this? A short answer to this question is that one must change the facts if the facts do not fit the criteria of Chapter 15. This is exactly what was done in a case involving a group of companies that were mostly registered in the British Virgin Islands (BVI). The objective was to get recognition in the USA, but this group of companies was arguably run from Europe. The group had hostile creditors in America under American law, but the directors of these companies found out that BVI had to be the centre of main interests in order to get recognition and assistance in the USA. They found that BVI had really good weather in the winter although they were European and used to the cold. So the directors set up camp in the BVI, got an office there, hired an employee and were now running their empire from the BVI indefinitely. They then started reorganization proceedings in the BVI and got recognition in the USA in the bankruptcy court. The answer to the US problem therefore is that one will have to change the facts to fit the criteria; then it can be done.