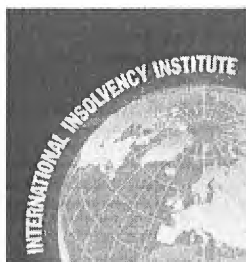


# INTERNATIONAL INSOLVENCY INSTITUTE

## *Breaking Away: Local Priorities and Global Assets*

**Jay L. Westbrook**

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International Insolvency Institute
PMB 112
10332 Main Street
Fairfax, Virginia 22030-2410
USA
Email: *info@iiiglobal.org*

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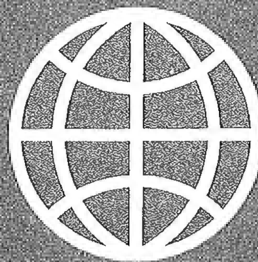

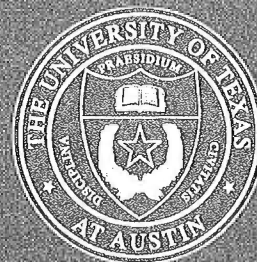


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# Breaking Away: Local Priorities and Global Assets


*Jay Lawrence Westbrook*



THE UNIVERSITY OF TEXAS SCHOOL OF LAW

# Breaking Away: Local Priorities and Global Assets

JAY LAWRENCE WESTBROOK*

*"There are no grounds of justice or policy which require this country to insist upon distributing an Australian company's assets according to [English] priorities only because they happen to have been situated in this country at the time of the appointment of the provisional liquidators."*[1]

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* Benno C. Schmidt Chair of Business Law, The University of Texas School of Law. I am grateful to the other participants in this symposium for their insightful comments and responses to this paper. I also thank Jamie France, Texas '11, and Jeff Quilici, Texas '12 for their help in the research.

1. McGrath v. Riddell (*In re* HIH Cas.& Gen. Ins., Ltd.), [2008] UKHL 21, [36], 1 W.L.R. 852 (H.L.) 863 (Lord Hoffmann) (appeal taken from Eng.).

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## I. INTRODUCTION

Like an adolescent struggling with clothes that no longer fit, the growing field of international insolvency has not so far put aside the old notion that local priorities must always be applied in distributing local assets. Yet the great variation in the distribution rules from one nation to another means that application of local priorities creates a serious obstacle to multinational cooperation, puts both maximization and fairness at risk, and exacerbates the likelihood of forum stashing.

The problem of conflicting distribution rules is part of the larger discourse pitting territorialism against universalism in the insolvency proceedings of multinational corporations.[2] That aspect of territorialism that would apply local priority rules to locally seized assets may be called "localism." If fully realized, localism would create a separate pool of the assets seized in each jurisdiction and distribute its value under local priority rules, while universalism would create a single global asset pool and distribute its value worldwide under a single set of rules. Some of the authors in this symposium believe localism is the inevitable rule, while others incline toward universalism.[3] Professor Edward Janger has advocated a form of localism that would mitigate its more glaring defects through a choice of law rule that would permit some less parochial results.[4] I share his sense that any general rule we might adopt requires exceptions, but I think there are compelling arguments against adopting a territorial rule as the general rule in multinational cases. I would propose a universalist rule with some exceptions that recognize legitimate local expectations. But an approach from such a different beginning has a quite different ending as well. That is, to start with a central rule and make exceptions produces results different from a regime that has no central rule at all.

Two crucial points underlie the argument. First, localism does not favor local creditors per se, but rather privileges the application of local rules that might often benefit foreign multinationals as much or more than the local contractor. Thus

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2. *See* A.L.I., PRINCIPLES OF COOPERATION AMONG THE NAFTA COUNTRIES 8 (2003) [hereinafter PRINCIPLES] (explaining the traditional dichotomy between the distribution rules of territorialism versus universalism).

3. Lord Hoffmann has described universalism as a "golden thread running through English cross-border insolvency law since the eighteenth century." *McGrath*, [2008] UKHL 21,[30] 1 W.L.R. at 861. He would not claim, any more than I would, that the common law of England or the law of any other jurisdiction has adopted universalism in its purest form. Leonard Hoffmann, Baron, Keynote Address at the University of Texas School of Law International Insolvency Symposium: The Priority Dilemma (May 11, 2010).

4. *See* Edward J. Janger, *Virtual Territoriality*, 48 COLUM. J. TRANSNAT'L L. 401, 422–40 (2010) (advocating decentralized priority rules through a system of "universal proceduralism"). His contribution to this symposium seems to emphasize a choice of law rule focusing on the territory where a claim arose. *See generally* Edward J. Janger, *Reciprocal Comity*, 46 TEX. INT'L L.J. 441 (2011) [hereinafter Janger, *Reciprocal Comity*].

localism cannot be justified by protection of local creditors, leaving aside the difficulty of defining that category in a globalizing world.

The second point is that localism would apply local rules to all locally controlled assets whether or not those assets bear any significant relationship to the claims given priority under local law. Absent such a relationship, a creditor has no legitimate expectation that these assets will be distributed under local rules. It follows that the application of local rules to those assets is often adventitious and unprincipled, because it is not related to legitimate expectations. For these reasons, the proper general rule is universalist, with local rules to be applied only where there is a substantial connection to specific assets and therefore arguably a legitimate reliance on local rules. These instances are not necessarily rare. They would include workers' reliance on the assets associated with their workplace and customers' reliance on funds required by regulators to be maintained in local accounts. Certain taxes and secured claims might also be exceptions for similar reasons, although this article does not work through those two important categories of claims. Thus there is room in a universalist regime for a choice of law rule based on the existence of such expectations, permitting local assets to be distributed under local rules where appropriate.

Given its difficulties, why does localism survive? The primary overt justification seems to be a claim that it satisfies commercial expectations, although that claim is unproven and highly questionable. An underlying proposition that may be more important is that localism is unavoidable politically and is supported by a commitment to special local values. I will suggest that except for the three Great Priorities which are found nearly everywhere—wages, security, and taxes[5]—it seems unlikely that either politics or widely shared national values strongly support most of the remaining grants of priority. Taking all in all, neither legislators nor judges are apt to be deeply committed to their vindication. If the Great Priorities could be managed, the rest would be of limited concern.

These policy arguments admittedly leave unaddressed the argument that all local priorities—and for that matter the very principle of *pari passu* distribution—are imposed by the terms of statutes[6] and therefore must be enforced absent an international treaty. I divide possible solutions of the difficulty into two parts. First, a choice of law approach applies the law of the main proceeding as the law with the most significant connection to the distribution overall, but identifies some claims as so associated with particular assets as to justify application of local distribution rules. The second approach uses choice of forum as a method of centralizing choice of law, subject once again to exceptions for certain kinds of claims. I offer the United States and the United Kingdom as examples of the use of this approach.

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5. I ignore a fourth priority that may be even more universal, the priority for administrative expenses of the proceeding. In the United States, for example, that would be found in section 507(a)(2) of the Bankruptcy Code. 11 U.S.C. § 507(a)(2) (2006), *amended by* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub.L. No. 111-203, § 1101(b), 124 Stat. 1376, 2115 (2010). That priority must be granted in each jurisdiction where local official action is needed, along the lines suggested by the old adage that someone in the circus parade has to clean up after the elephants.

6. *See, e.g.*, Alan L. Gropper, *The Payment of Priority Claims in Cross-Border Insolvency Cases*, 46 TEX. INT'L L. J. 559, 560–61 (2011) (describing the system of priorities imposed by Section 507 of the U.S. Bankruptcy Code).

## II. THE CASE FOR LOCALISM

Given all its flaws, why do observers still cling to localism, often reluctantly?[7] Although others in this symposium present various arguments for favoring a local rule for local assets, I think it is fair to say that there are three grounds typically advanced in defense of localism. The first is that this rule is the traditional approach and current law in many jurisdictions. The second is that nationalism compels localism. The third is that local expectations and values should be vindicated. The first two arguments are importantly wrong. The last is valid, but only to a limited extent.

As to the fact that localism is the traditional rule, "[I]t is revolting to have no better reason for a rule of law than that so it was laid down in the time of Henry IV."[8] If the rule of localized distribution—a legacy of territorialism or "the grab rule"—has no justification except its existence, it should not detain us long except insofar as it may bind local judges despite their appreciation for its defects, a point addressed below.

The second argument for local distribution is one of *realpolitik*. It has two branches: refusal and resistance. The first branch is the claim that local judges will never be willing to permit local assets to slip away when local creditors would benefit from a local rule. We know that is wrong, because there are too many contrary examples.[9] Whether parochialism might prevail more often than not remains to be

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7. To a significant extent, the arguments for localism overlap those supporting territorialism and opposing universalism. *See generally* Benjamin J. Christenson, *Best Let Sleeping Presumptions Lie: Interpretation of "Center of Main Interest" Under Chapter 15 of the Bankruptcy Code and an Appeal for Additional Judicial Complacency*, 2010 U. ILL. L. REV. 1565 (arguing that U.S. courts under universalism have too much discretion in locating the single appropriate forum); John J. Chung, *The New Chapter 15 of The Bankruptcy Code: A Step Toward Erosion of National Sovereignty*, 27 NW. J. INT'L L. & BUS. 89 (2006) (proposing that universalism threatens national sovereignty and incentivizes forum shopping, with only theoretical economic benefits); Lynn M. LoPucki, *Cooperation in International Bankruptcy: A Post-Universalist Approach*, 84 CORNELL L. REV. 696 (1999) [hereinafter LoPucki, *Post-Universalist Approach*] (arguing that territoriality lays the best foundation for international cooperation while universalism leads to unpredictable results); Lynn M. LoPucki, *The Case for Cooperative Territoriality in International Bankruptcy*, 98 MICH. L. REV. 2216 (2000) [hereinafter LoPucki, *Cooperative Territoriality*] (outlining the inherent weaknesses in attempting to define "home country" under a universalist approach); Frederick Tung, *Fear of Commitment in International Bankruptcy*, 33 GEO. WASH. INT'L L. REV. 555 (2001) (listing various factors that make states reluctant to adopt universalism); Symposium, *Bankruptcy in the Global Village: The Second Decade*, 32 BROOK. J. INT'L L. 753 (2007) (exploring the complexity of substantive coordination of cross-border insolvency cases); Edward S. Adams & Jason Fincke, *Coordinating Cross-Border Bankruptcy: How Territorialism Saves Universalism*, 15 COLUM. J. EUR. L. 43 (2008) (suggesting that territorialist aspects of the Model Law protect domestic interests of creditors and stakeholders while universalism does not); Nigel John Howcroft, *Universal vs. Territorial Models for Cross-Border Insolvency: The Theory, the Practice, and the Reality that Universalism Prevails*, 8 U.C. DAVIS BUS. L.J. 366 (2008) (summarizing localist models, including territoriality and cooperative territoriality).

8. Oliver Wendell Holmes, Jr., *The Path of the Law*, 10 HARV. L. REV. 457, 469 (1897).

9. *See, e.g.*, McGrath v. Riddell (*In re* HIH Cas.& Gen. Ins., Ltd.), [2008] UKHL 21, 1 W.L.R.852 (H.L.) (appeal taken from Eng.) (applying Australian bankruptcy law in the United Kingdom despite negative effects on local creditors); *see also* Maxwell Commc'n Corp. v. Soc'y Gen. (*In re* Maxwell Commc'n Corp.), 93 F.3d 1036 (1996) (applying English avoidance rules in Chapter 11 and accepting a worldwide plan); JP Morgan Chase Bank v. Altos Hornos de Mex., S.A. de C.V., 412 F.3d 418 (2d Cir. 2005) (deferring to Mexican bankruptcy court in proceedings brought by lending bank against foreign borrower regarding funds in the bank's possession); *In re* Compañía de Alimentos Fargo, S.A., 376 B.R. 427 (Bankr. S.D.N.Y. 2007) (dismissing an involuntary Chapter 11 case in discretion where no good reason

fully tested, but the tide is flowing toward cooperation and universalism, and every jurisdiction responding positively is an addition to the community of coordination, so there seems every reason to press on.[10] Defenders of the localist position counter with the second branch of this argument, which is that insistence on global distribution will prevent cooperation while the embrace of nationalism will encourage it. In fact, the opposite is likely to be true.[11]

Another argument for localism is based on a concern to protect localized expectations, an assertion that is unsupported and doubtful.[12] An underlying proposition is that localism is politically unavoidable because it is supported by a commitment to special local values.[13] I have suggested that after the three Great Priorities which are found nearly everywhere—wages, security, and taxes—it seems unlikely that either politics or widely shared national values strongly support most of the remaining grants of priority.

Having said that, the argument for local rules of priority does have some validity, as to certain sorts of rules under certain circumstances, a point addressed in section IV.

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existed for a United States proceeding and the insolvency should be resolved in Argentina); *In re* Bd. of Dirs. of Telecom Arg. S.A., 2005 WL 3098934 (S.D.N.Y. 2005) (deferring to bankruptcy court decision that claimants' rights were sufficiently similar to United States provisions to justify deference); *In re* Bd. of Dirs. of Multicanal S.A., 307 B.R. 384 (Bankr. S.D.N.Y. 2004) (dismissing claim that the Trust Indenture Act prohibited impairment of company members' rights by recognition of foreign insolvency proceedings in the United States); *In re* Condor Ins. Ltd., 601 F.3d 319 (5th Cir. 2010) (applying foreign avoidance law in Chapter 15 proceeding). *But see In re* Globo Comunicacoes e Participacoes, S.A., 317 B.R. 235 (S.D.N.Y. 2004) (stating that an involuntary petition in the United States should not be dismissed in deference to Brazilian main proceeding unless dismissal benefits both creditors and debtor).

10. Leonard Hoffmann, Baron, Keynote Address at the University of Texas School of Law International Insolvency Symposium: The Priority Dilemma (May 11, 2010) ("[H]istory shows that it may be necessary to cast one's bread upon the waters, even though it is many days before one can find the reward in the form of enactments like the Model Law.").

11. *See infra* Part III.C.

12. *See* Adams & Fincke, *supra* note 7, at 57–58 (noting that protection of creditor expectations is one of the four main advantages that proponents of territorialism claim); LoPucki, *Post-Universalist Approach*, *supra* note 7, at 747 (arguing that a territorialist regime will better match unsophisticated creditors' expectations); *cf.* LoPucki, *Cooperative Territoriality*, *supra* note 7, at 2223 ("[T]he workers in a Chrysler plant in Detroit do not expect to have to claim their wages and benefits in a German bankruptcy court . . . .").

13. *See* Adams &Fincke, *supra* note 7, at 71–72 (arguing that it is unrealistic to expect judges to resist domestic political pressure in bankruptcies, especially high-profile cases). Professor Tung described how various political pressures acting on local politicians work to defeat universalism:

> In general, a state's preference for its own bankruptcy law and reluctance to recognize foreign bankruptcy proceedings may arise from the desire of domestic political actors to defend the policies implicit in their domestic laws. This may include the preservation of any perquisites that redound to particular groups under those laws. The complexities of a state's bankruptcy regime reflect myriad policy decisions and political trade-offs. These trade-offs might enhance the public interest or merely the interests of the victors in domestic rent seeking contests. Regardless of which, political actors will wish to preserve the balance struck in their domestic bankruptcy rules. They will generally resist recognition of foreign bankruptcy proceedings that would upset this careful balance.

Frederick Tung, *Is International Bankruptcy Possible?*, 23 MICH. J. INT'L L. 31, 55 (2001) (footnotes omitted).

## III. THE TROUBLE WITH LOCALISM

The reason that localism is so subversive of the benefits of universalism is that distribution of value is a core function of bankruptcy proceedings. To adopt a territorial approach to distribution is to attempt to carve out the central idea of territorialism—the claim that creditors have vested interests in local assets based on local law—and then graft that idea upon universalism. The result is something like Professor LoPucki's cooperative territorialism, but not much like universalism, even in its pragmatic, modified version.[14] Choosing priority law on a territorial basis makes this fundamental mistake and there remains only the struggle to ameliorate its inevitable anomalies and inefficiencies in a global economy.

Localism has five primary defects. The first is that its effects are arbitrary and unprincipled, normatively and economically, and therefore little related to its goals because it does not rest upon any relevant connection to particular local assets and cannot be used to benefit local creditors over others. The second is that there is little evidence for the assumption that locally claiming creditors legitimately expect to be paid from local assets. The third is that localism is harmful to the prospects for any international cooperation. The fourth is that it will encourage forum stashing, the transfer of assets for the purpose of exploiting local rules that favor a debtor's purposes rather than the rights of creditors and other stakeholders. The fifth, addressed in Section IV, is that it is far too broad a response to local expectations and local values. In those instances where the case for applying local rules to local assets is persuasive, that result can be achieved by a nuanced choice of law rule within a global regime.

### A. *The Lack of Connection Between Claimants and Assets*

Localism does not protect local interests because there is no necessary connection between the assets captured by the local courts and the creditors who will be benefited by a local distribution. Thus, there is no principled connection between the claimants and the local assets on which to rest a preference. For example, applying local insolvency law may grant a priority to local civil contractors in the distribution of the proceeds of a company airplane that happened to be landing at the airport at the moment of filing or in the proceeds of sale of a local patent on a product unrelated to any local activity.[15] The proceeds of inventory seized locally might be distributed to local employees although the inventory was produced and marketed by employees in another country and is destined for sale elsewhere.

The lottery flavor of localism is especially great in the case of intangibles. In the Lehman case we learned of the infamous $8 billion that was transferred through its cash management system from London to New York over the weekend before

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14. *See generally* LoPucki, *Cooperative Territoriality*, *supra* note 6 (advocating application of principles of sovereignty-territoriality in cross-border bankruptcy cases).

15. This difficulty is the one that Professor Janger attempts to meet with his choice of local law rules, an approach that I applaud, although we disagree about where to start and how to proceed. *See* Janger, *Reciprocal Comity*, *supra* note 4, at 449. For the difficulty of harmonizing choice of law rules, *see* Hannah L. Buxbaum, *Rethinking International Insolvency: The Neglected Role of Choice-of-Law Rules and Theory*, 36STAN. J. INT'L L. 23, 54–55 (2000).

Lehman filed insolvency proceedings in both jurisdictions.[16] There has been no suggestion that employees, pensioners, or lenders on Wall Street or the Upper West Side had any greater relationship to this wandering treasure than their counterparts in the City or the East End. Similar cash management systems in thousands of large corporations loft huge sums from continent to continent every night. As to bank accounts generally, the answer to the question "where is a bank account located for legal purposes?" is "it depends."[17]

The lack of a connection between claimants and assets is found at both ends of localism, because it does not actually serve local creditors. Built into many discussions of localism is the implicit notion that it favors locals. I believe that this unstated assumption causes many judges and lawyers to assert that it is unthinkable that local judges would transfer assets without first satisfying local priorities, because the implication is that local creditors (and voters) would be favored.[18] Yet nowadays, in virtually all jurisdictions with substantial economies, there is no statutory discrimination against foreign creditors.[19] If Colossal Transnational Construction Company is owed millions of dollars by the debtor, it will claim in a local bankruptcy right alongside the local contractors and the electric utility and will share proportionately in any distribution of the value of the seized assets.[20] So, under a

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16. Landon Thomas, Jr., *Funds Try to Lose Ties to Lehman*, N.Y. TIMES, Oct. 1, 2008, *available at* http://www.nytimes.com/2008/10/02/business/02lehman.html.

17. *See, e.g.*, Citibank, N.A. v. Wells Fargo Asia Ltd., 495 U.S. 660 (1990) (reflecting the ambiguity surrounding the question of account location). A recent case in France illustrates the possibilities. There the creditor sought and obtained attachment of a bank account opened and maintained in Monaco by an action against the bank's French branch. Gilles Cunniberti, *International Reach of French Attachments*, CONFLICT OF LAWS .NET (Mar. 2, 2008), http://conflictoflaws.net/2008/international-reach-of-french-attachments.

18. This mental block is found even among the outstanding expert participants in this symposium. José M. Garrido, *No Two Snowflakes the Same: The Distributional Question in International Bankruptcies*, 46 TEX. INT'L. L. J. 459, 479 (2011) (quoting an inartful reference in the Guide to the Model Law concerning "local" creditors); *id.* at 485 (protecting local creditors over foreigners); John A.E. Pottow, *A New Role for Secondary Proceedings in International Bankruptcies*, 46 TEX. INT'L L. J. 579, 580 (2011) ("[t]he purpose of a secondary proceeding is to allow *local creditors* of a foreign debtor the opportunity to open a bankruptcy case in *their native country*, chiefly to enjoy the benefit of *local bankruptcy law*") (emphasis added); Gropper, *supra* note 6, at 563 (arguing that it is unfair to "impos[e] a foreign distribution scheme and depriv[e] a worker of the substantial priority claim be would have in *his home jurisdiction*," and that "it cannot be realistically expected that the authorities in a jurisdiction where assets are located will surrender those assets to a foreign court when the interests of *local creditors* will be adversely affected") (emphasis added). Even Professor Fletcher is ambiguous in this regard. Ian Fletcher, "L'enfer, c'est les autres"*: Evolving Approaches to the Treatment of Security Rights in Cross-Border Insolvency*, 46 TEX. INT'L L. J. 489, 491 (2011) ("This [public policy choice concerning priority rules] becomes a factor that is likely to color the approach by the courts of that country when reviewing any request to authorize the transmission of assets from their own jurisdiction to that of a different state under whose insolvency law the said assets will be subject to a different order of distribution.").

19. *See* Jay Lawrence Westbrook, *Universal Participation in Transnational Bankruptcies*, *in* MAKING COMMERCIAL LAW: ESSAYS IN HONOUR OF ROY GOODE 419, 436–37 (Ross Cranston ed., 1997) [hereinafter *Universal Participation*] (arguing that the assumption that local priorities benefit local creditors has not been enshrined in local statutes); Jay Lawrence Westbrook, *Universal Priorities*, 33 TEX. INT'L L.J. 27, 31 (1998) [hereinafter *Universal Priorities*]; *see also* Model Law on Cross-Border Insolvency, G.A. Res. 52/158, U.N. Doc. A/RES/52/158, art.13, para.2 (Jan. 30, 1998) [hereinafter Model Law] (prohibiting discrimination against foreign creditors). Of course, local creditors have the usual "home team" advantage, as is true in all international litigation.

20. Concerning their right to share in local priorities that come ahead of general unsecured creditors, *see infra* Part V.A.