

**Submission for the  
2016 Prize in International Insolvency Studies**

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**Navigating Scylla and Charybdis:  
International Arbitration and National Insolvency**

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## **Navigating Scylla and Charybdis: International Arbitration and National Insolvency**

### **I. Introduction**

This paper will assess the intersection of arbitration and insolvency in international dispute resolution. In brief, insolvency concerns the centralization of debt claims by multiple creditors against the insolvent party; whilst international arbitration provides the mechanism by which parties to a contract are able to select the means of dispute resolution for themselves.

At the theoretical level, international arbitration is concerned with the efficient design of a tailor-made legal infrastructure for dispute resolution, binding only in as much as the parties to the arbitration agreement have consented to be bound: in practice, this manifests in the parties' choice of the court of arbitration and the procedural and material rules for the court to apply. Arbitration has become pivotal for the settling of international disputes where the parties consider national courts to lack the necessary speed, cost-efficiency, competency, pragmatism, or predictability.

The primary justification for insolvency proceedings, on the other hand, is the efficient design of a collective debt collection mechanism which should result in an as high as possible and equal satisfaction of creditors' claims. While there is some possibility for forum shopping in insolvency, the free choice of governing insolvency law is understandably limited in order to mitigate the danger that an insolvency regime is chosen not to increase the value of firm's assets but to favour the party, or parties, authorized to choose the governing law.<sup>1</sup> Insolvency proceedings are governed by legislation which prescribe when and how insolvency proceedings may be brought against a debtor. Due to the fact that insolvency proceedings are set out in national legislation, it is less easy to describe a single practice of insolvency law; however, the principles that are found across jurisdictions, such as that of *pari passu* (*lit.* side by side) by which creditors with equal claims are to be treated equally, illustrate the primarily

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<sup>1</sup> For an analysis of forum shopping in insolvency see: Gerhard McCormack, *Jurisdictional Competition and Forum Shopping in Insolvency Proceedings* 68 (1) *Cambridge Law Journal* 169 (2009); Wolf-Georg Ringe, *Forum shopping under the EU Insolvency Regulation* 9 *European Business Organization Law Review* 579 (2008); David Skeel, *European Implications of Bankruptcy Venue Shopping in the US* 54 *Buffalo Law Review* 439 (2006).

distributive function of insolvency proceedings.<sup>2</sup> However, collective debt collection and distribution is not the only aim: many jurisdictions allow for a period of administration in order to restructure the debt of an insolvent company to maximise asset value before distributing this value amongst the creditors; and if the insolvent company is not dissolved, many jurisdictions provide measures for financial rehabilitation within their insolvency law. Insolvency law itself can be defined as a coercive and collective style of dispute resolution.

The reconciliation of these two areas of dispute resolution presents a number of complex questions of equity and efficiency: the aim of this paper is to comparatively analyse how different jurisdictions deal with the conflict of two so seemingly different areas of law in case that one party to an arbitration agreement becomes insolvent. The titular reference to the opposing sea-hazards of the Strait of Messina seeks to illustrate both the opposing nature of these legal proceedings, and the possibility that a wrong choice between them may lead to suboptimal results. Just as Homer's Odysseus was forced to choose between Scylla, the many-headed monster that picked away at his crew, and Charybdis, the whirlpool that threatened to take his entire ship in one fell swoop; creditors and debtors are faced with the choice between concurrent arbitration proceedings which threaten to pick away at a debtor's assets to the detriment of the body of creditors, and centralized insolvency operations which threaten to eliminate the surplus of private ordering dispute resolution. Thus, the questions to be asked are how can international arbitration fit into national insolvency law; and how should the conflict between contract and coercion be resolved so as to approach an efficient solution? Alternatively, to carry on the previous metaphor, is there an optimum distance to navigate between the Scylla of arbitration, and the Charybdis of insolvency proceedings?

In order to answer that question, this paper will first positively analyse the principles, main legal resources, and economic rationale for international arbitration in section II. It will then be necessary to provide a positive analysis of insolvency within the context of different legal systems in section III. In section IV., the comparative model which will later be applied to the country-specific analysis in the US, England, and Russia will be presented. A comparative analysis of the US, England, and Russia promises some especially valuable insights: The US and England have each a quite different approach to deal with distressed debt against the background of a traditionally contrasting lending structure, but they both apply a rather open

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<sup>2</sup> And even the *pari passu* (common law) or *par conditio creditorum* (civil law) (lit. side by side) is subject to multiple exceptions/violations in different jurisdictions where the public ordering law-maker may ascribe a re-distributive function to the insolvency law. See III. 5.

policy in arbitration. Russia has a young insolvency law which suffers from being partly overshadowed by informal rules; a typical transition economy problem. The room for arbitration in insolvency is significantly limited in Russia. In section V., the principles of limitations on international arbitration in insolvency will be evaluated for (i) the validity of the arbitration agreement, and (ii) the enforcement of the arbitration award for the US, England, and Russia. In this context, the questions of arbitrability and public policy will be discussed. In sections VI. 2.1, 3.1, and 4.1, three distinct models for the management of distressed debt in the US, England, and Russia are analysed; this is crucial in order to work out the policy considerations which will be reflected in a per-country analysis of the question which matters of dispute in insolvency are arbitrable or non-arbitrable in sections VI. 2.2 (US), VI. 3.2 (England), and VI. 4.2 (Russia). Section VII., eventually, shall close the circle in a comparative review of the previous findings.

## **II. Contract: International Arbitration**

### **1. The Rationale for International Arbitration**

For the purpose of this paper, the benefits of arbitration will be discussed in relation to litigation in national courts. A recent survey by White & Case and Queen Mary University<sup>3</sup> reports that 90% of respondents choose international arbitration as their preferred method of dispute resolution over dispute resolution in the forum of national courts, either alone or alongside other forms of alternative dispute resolution. The question thus arises as to why this should be the case. The predominant benefits in the eyes of the client, as reported in the survey, are those of: enforceability (as per 65% of respondents), the avoidance of national courts (64%), flexibility (38%), the ability to select arbitrators (38%), confidentiality (33%), neutrality (25%), finality (18%), speed (10%), and cost (2%).

*Enforceability:* In some jurisdictions the enforcement of foreign judicial decisions are possible: an example of this is England, where the common law tradition will enforce a foreign judicial decision unless the defendant is able to successfully challenge the decision on such grounds as fraud. Russia presents an example of a civil law jurisdiction that enforces foreign judicial decisions, drawing on the basis of judicial comity. Other possible routes for the enforcement of foreign decisions may be found in bilateral treaties, such as that between Belgium and France;<sup>4</sup> and in multilateral treaties, such as the Hague Convention on Foreign Judgments in Civil and Commercial Matters. Whilst the enforcement of foreign judicial decisions is not impossible, it is far from assured in many cases: it is notable that the Hague Convention on Foreign Judgments has only been ratified by three countries—Cyprus, The Netherlands, and Portugal. By contrast, the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards has 156 parties: a party thus stands a better chance of enforcing an arbitral award in a foreign jurisdiction than of enforcing a decision made by a national court. Further to this, due to the supranational nature of international arbitration, it may even be possible to enforce an award that has been set aside in its jurisdiction of origin:

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<sup>3</sup> White and Case, *2015 International Arbitration Survey: Improvements and Innovations in International Arbitration*, accessible at <http://www.arbitration.qmul.ac.uk/docs/164761.pdf>. The methodology of the study is explained at page 51.

<sup>4</sup> Convention between Belgium and France on Jurisdiction and the Validity and Enforcement of Judgments, Arbitration Awards and Authentic Instruments, signed at Paris on 8 July 1899

notable in this regard is the line of cases in France, starting with *The Norsolor*,<sup>5</sup> where the French courts upheld arbitral decisions that had been set aside.

*Flexibility and the Selection of Arbitrators:* In contrast to litigation proceedings, which are carried under the authority vested in the courts of a State, arbitration proceedings are carried out under the principles of party autonomy and *pacta sunt servanda* (lit. agreements are to be kept); a corollary of this is that where litigation takes place one must follow the procedural rules of the relevant State, whilst arbitration agreements are bound to the procedure set out in the relevant arbitration agreement. One aspect of this is that the agreement is able to prescribe not only the number of arbitrators to handle disputes, but the manner in which arbitrators are to be selected: this can range from the prescription of a mutually agreed sole arbitrator to a panel of five arbitrators, with each party selecting two and leaving the choice of the final arbitrator to the four party-chosen arbitrators. This flexibility is not restricted to the selection of arbitrators, but extends to the place of arbitration, and the choice of law for each aspect of the arbitration procedures. Though there are limitations to practicability,<sup>6</sup> theoretically speaking the parties to an arbitration agreement are free to create a custom legal system for the resolution of disputes.

*Avoidance of National Courts and Neutrality:* The desire to avoid national courts often relates to the desire for neutrality: the reasoning for this is that the fear of adverse partiality can be a reason for foreign parties avoiding the national courts of their contractual counterparty. An example of contracts that often provide for such considerations is that of oil and gas contracts: foreign oil companies often fear that political pressure may lead to bias in national courts. Taking as example the Azerbaijan Joint Development and Production Sharing Contract, the arbitration agreement provides that disputes under the contract are to be arbitrated in Stockholm under three arbitrators.<sup>7</sup> However, fear of court partiality is only one factor in a party's choice to avoid a certain court system: the fear of their counterparty having a 'home-court advantage', along with other more jurisdiction-specific considerations play a large role in the choice of a arbitration agreement. Further to this, many States have incorporated

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<sup>5</sup> *Société Pablak Ticaret Limited Sirketi v Norsolor S.A.* / 83-11.355 (1984).

<sup>6</sup> See Kerr LJ in *Naviera Amazonica Peruana SA v. Cia Internacional de Seguros del Peru* [1998] 1 Lloyd's Rep. 116

<sup>7</sup> Agreement on the joint Development and Production Sharing For the Azeri and Chirag Fields and the Deep Water Portion of the Gunashli Field in the Azerbaijan Sector of the Caspian Sea Among the State Oil Company of the Azerbaijan Republic and Amoco Caspian Sea Petroleum Ltd et al. Appendix VI on Arbitration

provisions into their legislature by which courts are obliged to stay proceedings in favour of arbitral proceedings: in England this is provided by s.9 of the Arbitration Act 1996.

However, in the survey lack of effective sanctions during the arbitral process ranks as the second worst aspect of arbitration, with 46% of respondents complaining. One of the reasons for this is that an arbitral tribunal is not empowered to award interim measures. As has been succinctly expressed by Professor Weil, '[t]he principle of *pacta sunt servanda* and that of party autonomy do not float in space; a system of law is necessary to give them legal effect'. Thus, arbitration does not provide for the avoidance of national courts altogether; parties are nonetheless able to choose which country will be the seat of the arbitration, thus choosing which country's courts will have jurisdiction.

*Finality and Speed:* The finality of arbitral awards is a crucial component in the time-saving function of international arbitration. The average time for arbitration procedures under the London Court of International Arbitration is reported as 16 months<sup>8</sup>. Though this may not necessarily be faster than first-instance judgments in some of the more time-efficient court system, international arbitration may still afford a relative time-efficiency when jurisdiction would otherwise lie with a slower court system, such as India where the average case is reported to take 15 years for resolution<sup>9</sup>. Further to this, arbitral awards are immune from most grounds for appeal, with the London Court of International Arbitration (hereafter LCIA) rules precluding appeal altogether<sup>10</sup>: in preventing extended appellate hearings arbitration is often immune to the delay that might otherwise forestall dispute resolution. However, with 36% of respondents to the survey complaining of a lack of speed, and only 10% asserting speed as a reason to choose arbitration, the time-efficiency rationale for arbitration seems outdated in those countries where the alternative forum is a time-efficiently working judiciary.

*Cost:* Apart from time-efficiency, the other traditional rationale for arbitration is cost-efficiency. However, as reflected in the survey, only 2% of respondents claim cost as a reason for arbitration; in contrast to this, 68% of respondents claiming costs as a deterrent from arbitration, placing it at the top of the most complained aspects of international arbitration.

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<sup>8</sup> Accessed at: <http://www.lcia.org/News/lcia-releases-costs-and-duration-data.aspx>

<sup>9</sup> The Times of India, New Delhi – Monday August 17, 2009. In Europe, the “Italian Torpedo” is a well known strategy to delay an unfavourable judgement. See: David Kenny and Rosemary Hennigan, *Choice of Court Agreements, the Italian Torpedo, and the Brussels I Regulation* 64 (1) *International and Comparative Law Quarterly* 197 (2015).

<sup>10</sup> LCIA Arbitration Rules (1998), Art. 29(2)



Allowing for roughly equal lawyers' fees in arbitration and litigation, the combined cost of institutional and arbitrators' fees is unlikely to undercut court costs by much, if at all. There is *ad hoc* arbitration, by which the parties agree to arbitrate without an arbitral institution, avoiding institutional fees; however, parties may forfeit the benefits of easier recognition and enforceability and time-management that come with institutional administration. Similarly, one can reduce arbitrators' fees by providing for a sole arbitrator; however, this may adversely affect the predictability of the arbitration, as any misunderstanding or prejudice of the arbitrator will manifest in the arbitral award. Generally speaking, if a party is willing to pay for arbitration, they had better be willing to pay to win: cutting corners in arbitration, as in litigation, is likely to lose a party the benefits of arbitration.

*Confidentiality:* As confirmed by the survey, confidentiality plays an important role in commercial arbitration, and will likely continue to do so for the foreseeable future. The reasons for this are manifold, though there are common features: parties intending to maintain their commercial relationship may wish to present a unified front on the market so as not to adversely affect consumer or investor confidence; or parties may be required to disclose trade secrets within the arbitration procedure. Though investor-state arbitration has recently come under scrutiny for lack of transparency and thus public accountability, the recent TTIP protests being a notable example; confidentiality in commercial arbitration has seen more modest changes. The traditional view of confidentiality was reflected in the English High Court decision of *Hassneh Insurance Co of Israel v Mew*<sup>11</sup>, where the private nature of arbitral proceedings lead to the finding of an implied term of confidentiality with regard to submissions and documents; though the English Court of Appeal has pointed out that any duty of confidentiality may be restricted in a number of circumstances, including where justice, or possibly public interest, demands<sup>12</sup>. Recent trends in the US have shown that American courts have little sympathy for implied terms of confidentiality and will find in favour of disclosure where the parties have not expressly stated otherwise in the arbitration agreement<sup>13</sup>.

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<sup>11</sup> *Hassneh Insurance Co of Israel v Mew* [1993], 2 Lloyd's Rep 243

<sup>12</sup> *John Forster Emmott v Michael Wilson & Partners Ltd* [2008] EWCA Civ 184

<sup>13</sup> *United States v Panhandle Eastern Corporation* 118 FRD 346 (D. Del. 1998).

## **2. The Legal Framework for International Arbitration**

### **2.1 Preliminary Considerations**

Over the course of its life, an arbitration procedure may be subject to up to five systems of law: the law governing the agreement to arbitrate (section 2.2); the law governing the arbitral procedure (*lex arbitri* 2.3.2 and curial law 2.3.3); the substantive law chosen to apply to the dispute (section 2.3); and the law governing recognition and enforcement (section 2.4).

### **2.2 Law Governing the Agreement to Arbitrate**

An arbitration agreement, unlike other terms in a contract, constitutes a stand-alone agreement. This is referred to as the doctrine of separability, by which the arbitration agreement's validity is self-contained: this principle has been found even to apply in situations where the main contract is alleged to be invalid.<sup>14</sup> Parties will thus be unable to frustrate their agreement to arbitrate disputes under a contract by making the validity of the contract itself the subject of dispute. However, a corollary of the doctrine of separability is that the law governing the arbitration agreement will not necessarily be the same as that governing the main contract. Parties are thus free to provide for a specific law to govern the arbitration agreement; though where parties fail to do so, it will fall to the courts of the seat of arbitration to apply their conflict of laws rules<sup>15</sup>. As the basis of jurisdiction for an arbitral tribunal, the validity of the arbitration clause under its governing law decides whether courts must stay proceedings in favour of arbitration, and whether the arbitrators are empowered to handle disputes. The importance of the law governing the agreement is made explicit in the New York Convention on the Recognition of International Arbitral Awards<sup>16</sup>, which provides grounds for the refusal to recognize and enforce an arbitral award where 'the said agreement is not valid under the law of the country to which the parties have subject it or, failing any indication thereon, under the law of the country where the award was made'<sup>17</sup>.

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<sup>14</sup> See *Fiona Trust Holdings v Privalov* [2007] UKHL 40, where the English House of Lords found that the doctrine of separability bound parties to arbitration in settling a dispute over the validity of the main contract, the contract having been obtained by bribery

<sup>15</sup> The Rome Convention and the Rome I Regulations are not applicable to arbitration agreements: Rome Convention Art.1(2)(d), Rome I Regulation Art.1(2)(e)

<sup>16</sup> Hereon referred to as 'The New York Convention'

<sup>17</sup> Art. V(1)(a), New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards

## **2.3 Law Governing the Arbitral Procedure**

### **2.3.1 Preliminary Considerations**

The law governing the arbitral procedural is a combination of the seat of arbitration's laws governing arbitration and the laws chosen by the parties in their arbitration agreement. It is the legal system that governs, *inter alia*, interim measures, the courts' ability to supervise arbitration (e.g. removing an arbitrator for misconduct), and the availability of grounds for appeal of arbitral awards. In order to better define the scope of party autonomy in shaping the *lex arbitri*, the *lex arbitri* will be broken down into mandatory provisions<sup>18</sup> and non-mandatory provisions<sup>19</sup>.

### **2.3.2 Lex Arbitri**

The *lex arbitri* is composed of the laws of the seat of arbitration: specifically it is composed of the provisions out of which parties may not contract when forming an arbitration agreement. Due to the State-specific nature of any given provision of *lex arbitri*, it is inadvisable to generalize; however, there is a valid distinction to be drawn between States that have adopted the UNCITRAL Model Law on International Commercial Arbitration<sup>20</sup>, and those States that have retained their own legislation for international arbitration.

As it is made apparent in its preamble, the Model Law on Arbitration was motivated by harmonization in the area of international arbitration; and though some States have not adopted the Model Law on Arbitration, many of these States have taken it as a model for the modernization of their own legislation. Of the States included for analysis in this paper, Russia has adopted a law that closely follows the Model Law on Arbitration. The Arbitration Act 1996 brought the legislation of England, Wales, and Northern Ireland much closer to the Model Law on Arbitration; one of the remaining major differences is that the Act is not limited to international commercial arbitration. The United States has both a federal law on arbitration, the Federal Arbitration Act, as well as individual State laws: whilst the Model Law on Arbitration has not been adopted at the federal level, it has been adopted by a number of States, including California and Florida.

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<sup>18</sup> Hereon referred to as '*lex arbitri*' (lit. the law of arbitration)

<sup>19</sup> Hereon referred to as 'curial law'

<sup>20</sup> Hereon referred to as the 'Model Law on Arbitration'

The Model Law on Arbitration occupies one end of the spectrum, allowing for a high degree of party autonomy in the selection of procedure for arbitration: the comments on the inadequacy of domestic laws found in the explanatory notes to the Model Law on Arbitration explain how party expectations are frustrated by mandatory provisions. The Model Law was thus in part an attempt to overcome these ‘[u]nexpected and undesired restrictions found in national laws’. Article 19 on the determination of rules of procedure simply states that ‘[s]ubject to the provisions of this Law, the parties are free to agree on the procedure to be followed by the arbitral tribunal in conducting the proceedings’<sup>21</sup>, and that ‘[f]ailing such agreement, the arbitral tribunal may, subject to the provision of this Law, conduct the arbitration in such manner as it considers appropriate’<sup>22</sup>.

The English Arbitration Act 1996 lists its mandatory provisions in Schedule 1, which pursuant to s.4(1) ‘have effect notwithstanding any agreement to the contrary’; whilst s.4(2) provides that provisions not listed in Schedule 1 ‘allow the parties to make their own arrangements by agreement but provide rules which apply in the absence of such agreement’. The majority of the provisions listed in Schedule 1 relate to the obligations of the courts to support arbitration proceedings or to the administration costs and lawyers fees; of more procedural import are ss.67 and 68, which state the applicable grounds for appeal of an arbitral award handed down in England.

In the United States, on the other hand, the Federal Arbitration Act<sup>23</sup> is not explicit about whether any of its provisions are mandatory or not: thus it has fallen to courts to rule on whether certain provisions are permissive or mandatory. The courts, however, have been inconsistent in finding for or against the mandatory nature of certain provisions: in *Cortez Byrd Chips Inc. v Bill Harbert Construction Co.* the Supreme Court overturned the first-instance and appellate findings that the Federal Act’s venue provisions are mandatory<sup>24</sup>; in *Hall Street Associates, L.L.C. v. Mattel Inc* the Supreme Court ruled that parties were unable to provide for grounds for appeal against an arbitral award that are not present in the Act.

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<sup>21</sup> Art. 19(1), Model Law on Arbitration

<sup>22</sup> Art. 19(2), Model Law on Arbitration

<sup>23</sup> Hereon referred to as the ‘FAA’

<sup>24</sup> See Darynne L. O’Neal, *Clarifying the Intent of Congress: Are the Federal Arbitration Act’s Venue Provisions Permissive or Mandatory - Cortez Byrd Chips, Inc. v. Bill Harbert Construction Co.*, 2001 J. Disp. Resol. (2001) Available at: <http://scholarship.law.missouri.edu/jdr/vol2001/iss1/11>

Though the provisions in the Federal Act take precedence over State laws on arbitration, where the federal act is silent, the provisions of State law are valid: thus in response to questions about the *lex arbitri* in the United States, the answer is unsatisfactory in that the situation not only varies from State to State, but is capable of court revision even at the federal level.

### **2.3.3 Curial Law**

Much like the relationship between the United States Federal Act and the subordinate State Arbitration Acts, by which State legislation is allowed to fill in the gaps; the curial law in arbitration is allowed to fill in the gaps left by the *lex arbitri*. As a result, the scope of the procedure left to the curial law will vary between States: the above-discussed *lex arbitri* and curial law represent the degree of central authority and party autonomy in arbitration respectively. Parties wishing to exercise maximum autonomy may wish to opt for *ad hoc* arbitration, creating their own curial law without having to work within the pre-existing rules of an arbitral institution.

However, parties to arbitration rarely wish to throw themselves into a legal void, building their own comprehensive procedural system for disputes; even in *ad hoc* arbitration, it is not uncommon to find the prescription of an arbitral institution's rules to be applied by the arbitrator(s). In practice, parties will often resort to the existing corpus of procedure contained in the rules of the various arbitral institutions. The Queen Mary survey reports that over the last five years, clients of international arbitration have named the International Chamber of Commerce (ICC) (according to 68% of respondents), the London Court of International Arbitration (LCIA) (37%), the Hong Kong International Arbitration Centre (HKIAC) (28%), and the Singapore International Arbitration Centre (SIAC) (21%) as their preferred institutions. Each institution will have its own body of procedural rules that parties submit themselves to in choosing that institution: for example under Rule 35.1 of the SIAC, both the parties and the tribunal are at all time bound to confidentiality with regard to proceedings and awards; by contrast, Arts. 30.1 and 33 of the LCIA determine that the parties and the LCIA are bound to confidentiality in the absence of any contrary, express agreement by the parties; finally, the ICC rules have no provision on confidentiality, though Art.6 of the Statute of the International Court of Arbitration (i.e. the division within the ICC that handles international arbitration) states that the work of the Court is confidential in nature.

Beside these client favourites, the China International Economic and Trade Arbitration Commission (CIETAC) will be relevant for any discussions of arbitration in China due to the mandatory provisions on the selection of arbitral institutions. The CIETAC rules have recently undergone a number of revisions in terms of the institutions structure, its handling of multiple contracts and parties, its ability to provide emergency arbitrators, and the dispute amount threshold for summary proceedings; with regard to the changes in the treatment of multiple contract and parties, the revisions to the rules have brought CIETAC closer to ICC practice.

## **2.4 Law Governing the Dispute**

The law governing the dispute is the legal system chosen by the parties to be applied by the tribunal in resolving the dispute. Parties are free to choose the legal system best adapted to their needs, and are even able to choose legal systems other than those associated with a particular State: under freedom to contract, parties may stipulate transnational legal systems such as Shari'ah law, the UNIDROIT Principles, or *lex mercatoria*. Further to this, where national legal systems may be too customized to the requirements of any given nation and transnational systems may not be sufficiently fleshed out to comprehensively cover all foreseeable disputes, it is possible to combine the two: an example of such a choice of law would be, 'the tribunal is to apply the laws of Austria, in so far as those laws are in accordance with public international law'. However, party autonomy is not absolute in this regard, and mandatory rules may restrict the party's capacity to choose their own legal system: Art.126 of the Contract Law of the People's Republic of China discussed above is an example of this; similarly, in one case the English Court of Appeal refused to enforce an arbitral award where the parties had chosen to Jewish law to govern the dispute so that the illegal nature of the main contract would not affect the parties' rights under it<sup>25</sup>.

## **2.5 Laws Applicable to Enforcement and Recognition**

Once an arbitral tribunal has issued an award, unless the losing party voluntarily undertakes performance of the award, it will still require enforcement in a national court. A number of

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<sup>25</sup> *Soleimany v Soleimany* [1999] QB 785.

treaties have been drafted for this purpose in order to better facilitate international arbitration as a viable means of dispute resolution in the face of globalization.

Arguably the most important of these treaties is the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, which has replaced the Geneva Protocol in those states that have ratified it<sup>26</sup>. For the purposes of this paper, all the relevant States are parties to the New York Convention. Art. 3 of the New York Convention provides that ‘[e]ach Contracting State shall recognize arbitral awards as binding and enforce them in accordance with the rules of procedure of the territory where the award is relied upon’<sup>27</sup>, before setting out the formalities required in Art. 4. However, even where formalities have been complied with, a losing party in arbitration may be able to prevent enforcement of the award if they are able to prove in a national court any of the elements listed in Art. 5. For the purpose of this paper the major provisions for refusing enforcement are Arts. 5(2)(a) and (b): the grounds of unarbitrability and public order respectively. By contrast, the other major treaty on the recognition and enforcement of arbitral awards, the International Committee for the Settlement Investment Disputes Convention, provides for no grounds for review by national courts; this relative rigidity in the enforcement of award has led to reaction in Latin America, with Bolivia, Ecuador, and Venezuela withdrawing from the Convention, and Argentina that enforcement is not automatic<sup>28</sup>.

Aside from these international treaties, there are a number of regional treaties governing the enforcement and recognition of arbitral awards. The Moscow Convention applied to the countries of the former Council for Mutual Economic Assistance; though now that the German Democratic Republic has ceased to be, and Poland, Czech Republic, Hungary, and Poland have withdrawn, the Convention only applies to Bulgaria, Cuba, Mongolia, Romania, and Russia. Currently, the Convention seems to have fallen into disuse. Of more relevance to the enforcement of arbitral awards in practice is the Panama Convention, which has been ratified by 16 Latin American States.

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<sup>26</sup> Art. 7(2), New York Convention.

<sup>27</sup> Though the Convention seems to conflate the two, there is a distinction between enforcement and recognition: recognition is a defensive action, used by parties facing claims in national courts, by which parties can use the arbitral award either for issue estoppel or for setting off the claims that they face; enforcement, on the other hand, is a request for national courts to take the necessary actions to fulfil an arbitral award

<sup>28</sup> This argument has become famous under the name of the ‘Rosatti doctrine’, after the former Argentine Minister of Justice who espoused it.

### **III. Coercion: Insolvency**

#### **1. Preliminary Considerations**

Section III will explore the theory of insolvency: Since the national law-maker and the national courts refer to their distinct insolvency policy when they decide the conflict between arbitration and insolvency, it is insightful to get to go back to the roots in order to better understand the functional role that insolvency plays. In section IV., a country-specific analysis of this question will follow.

#### **2. The Common Pool: An Original Conflict**

In insolvency we find an archetypal example of an original conflict: once a debtor is insolvent, it becomes clear that all creditors will not be paid on time and in full. Thus the common pool problem arises in most insolvency cases, though not all.<sup>29</sup> The common pool problem can be best explained by the example of the tragedy of the commons: a group of villagers share common-owned land to pasture cattle. Given the limited capacity of the land, the common good is defeated by self-interest: though the most efficient use of the commons is achieved by moderate use by each of the villagers, allowing for the villagers as a group to derive the most benefit; individually, it is in each villager's interest to use the commons to maximum capacity, as each individual derives only a fraction of the benefit created by restrained use. Every villager will make use of the common pool until it is destroyed.<sup>30</sup> As with the commons, so with the debtor's balance sheet: a core resource presents the individual with the possibility of harvesting a variable sum of fruits, here the debtor's assets. If the core resource is not protected from overuse by individuals it will eventually become barren: in the case of the commons, overuse will leave the land incapable of bearing grass; in the case of insolvency, if the firm's assets are fragmented and disposed of in fire sales, the surplus gain from the going-concern value or a package sale will be lost<sup>31</sup>. Just as the villagers work on the basis of individual benefit, ignoring the more efficient group benefit, creditors seek fast and full satisfaction of their claims over coordinated value realization. In both cases, the common

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<sup>29</sup> Susan Block-Lieb, *Fishing in Muddy Waters: Clarifying the Common Pool Analogy as Applied to the Standard for Commencement of a Bankruptcy Case* 42 *The American University Law Review* 337 (1993). Block-Lieb relaxes the analysis of the creditor's bargaining theory by showing the limitations of the common pool problem to balance-sheet insolvent debtors.

<sup>30</sup> Garret Hardin, *The Tragedy of the Commons* 162 (3859) *Science* 1243 (1968); William Lloyd, *Two Lectures on the Checks to Population* (1833) reprinted in 6 (3) *Population and Development Review* 473 (1980).

<sup>31</sup> Lynn LoPucki and Joseph Doherty, *Bankruptcy Fire Sales* 106 (1) *Michigan Law Review* 1 (2007).



resource is diminished in value, and each individual's right to benefit is subordinated to a first-come-first-served system.<sup>32</sup>

Suboptimal outcomes in the tragedy of the commons can be avoided where a formal or informal<sup>33</sup> regulatory regime in public or private ordering is established (i) with a fence against opportunistic overuse for the preservation of the common pool property, and (ii) with a pre-defined access-key for the distribution of its benefits. Informal rules work under the condition that the village community is small enough to actively monitor and sanction individual misbehaviour. Similarly, to overcome the common pool problem in insolvency the relevant authority often enacts an insolvency regime with:

- i. A fence - i.e. a stay on individual enforcement for the preservation of the common pool, and an external management or incentive-regime for debtor-in-possession management in order to maximize value.
- ii. An access key - i.e. distribution system that allows for all claimholders to benefit from the assets. The most prominent theoretical account of this idea is the creditor's bargaining theory put forward by Douglas Baird and Thomas Jackson. The creditor's bargaining theory postulates that creditors, being uncertain about future states of solvency and insolvency and aware of the inefficiencies that come with a common pool, would contract to stay individual action and opt for collective debt-management and debt-collection action in distress.<sup>34</sup>

The pendulum swings between a defensive stay for all secured and unsecured creditors with a protection against *ipso facto* (lit. by the fact itself) modifications of contracts upon the event of insolvency, and a *vis attractiva concursus* (lit. concentration power of insolvency) for the centralization of judicial power on the one hand and a merely strict restriction on the collection of unsecured debts on the other hand. The distribution order might reflect the pre-

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<sup>32</sup> Albert Tucker, *A Two-Person Dilemma* (memo 1950) reprinted in 14 (3) *The Two-Year College Mathematics Journal* 228 (1983).

<sup>33</sup> Elinor Ostrom, Joanna Burger, Christopher Field, Richard Norgaard, and David Policansky, *Revisiting the Commons: Local Lessons, Global Challenges* 284 (5412) *Science* 278 (1999).

<sup>34</sup> Douglas Baird and Thomas Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy* 51 (1) *The University of Chicago Law Review* 97 (1984); Thomas Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditor's Bargain* 91 *Yale Law Journal* 857 (1982); Thomas Jackson, *The Logic and Limits of Bankruptcy* (Beard Books 2001).

insolvency ranking of claims, it might give preference on the basis of efficiency by setting incentives,<sup>35</sup> or it might improve the situation of seemingly weak creditors for social reasons.

Because the parties want to avoid the direct and indirect costs associated with the public ordering insolvency procedure,<sup>36</sup> private ordering negotiations take place in the shadow of the public ordering insolvency law.<sup>37</sup> Negotiations fail where collective action problems, such as information and coordination problems with a fragmented body of unrelated creditors, and prisoner's dilemmas hinder an efficient bargaining outcome. A culture of strong inter-creditor lending relations, such as in syndicated bank lending, will enable a private ordering solution in which unity is enforced by the threat of excluding free riders from future business in the syndicates.<sup>38</sup> As with the villagers, this requires a small number of interrelated creditors. Where the body of creditors is dispersed and anonymous, collective action problems will make an informal arrangement almost always impossible. Formal private ordering solutions, such as contracts that mimic a public ordering insolvency regime, can then help to achieve an efficient outcome.<sup>39</sup> As for the relation between insolvency and international arbitration, the question is whether private solutions can succeed, public ordering remaining the last resort; or if private debt-management is inhibited by public ordering rules.

### 3. Incentivizing the Captain

Insolvency is often labelled as being debtor- or creditor-friendly;<sup>40</sup> though such a classification is seldom helpful and often inaccurate. If an insolvency regime favours one party over the other, this is regularly for the reason of value maximisation in the interest of all

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<sup>35</sup> See the discussion in II. 3.

<sup>36</sup> For indirect insolvency costs see: Gregor Andrade and Steven Kaplan, *How Costly is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions that Became Economically Distressed* 53 (5) *Journal of Finance* 1443 (1998). For direct insolvency costs see: Lawrence Weiss, *Bankruptcy resolution – Direct costs and violation of priority of claims* 27 *Journal of Financial Economics* 285, 285 – 290 (1990).

<sup>37</sup> Obert Mnookin and Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce* 88 (5) *The Yale Law Journal* 950 (1979).

<sup>38</sup> The London Approach is a supreme example for private ordering coordination out-of-insolvency. See: John Armour and Simon Deakin, *Norms in private insolvency: the 'London Approach' to the resolution of financial distress* 1 *Journal of Corporate Law Studies* 21(2001).

<sup>39</sup> David Ehmke, *Publicly Offered Debt in the Shadow of Insolvency* 16 (1) *European Business Organization Law Review* 63 (2015).

<sup>40</sup> A differential analysis is provided by: Sefa Franken, *Creditor- and Debtor-Oriented Corporate Bankruptcy Regimes Revisited* 5 *European Business Organization Law Review* 645 (2004).

parties concerned by way of incentivizing the captain, which is an investment into the ex ante and/or ex post debt management.<sup>41</sup> Privilege is not graciously bestowed, but rewards might be earned. David Skeel brings this differentiation to the point when he distinguishes ex ante from ex post oriented regimes in corporate and insolvency law. Ex post oriented regimes are characterized by a dispersed lending and ownership-structure, powerful managers who are threatened by an active hostile takeover market and incentivised by a so-called ‘debtor-friendly’ insolvency regime for their collaboration in distress. In ex ante oriented regimes, the ownership and lending structure is concentrated. The takeover market is not very aggressive. Controlling owners and lenders can influence the course of business, and have a strong incentive to monitor the business activities diligently. Insolvency constitutes a last-resort threat for the debtor who misbehaves. Directors are regularly replaced in insolvency, external management is the rule, and equity-holders are ‘out of the money’.<sup>42</sup>

An ex post oriented regime is characterised by: institutional preference for debtor-in-possession reorganisation over external management or liquidation; a defensive stay; an exclusivity period for the debtor to guide the firm through rough waters; and the chance to depart from the strict application of the absolute priority principle.<sup>43</sup> In contrast, an ex ante oriented regime is characterised by strong enforcement and control rights for creditors, especially secured creditors; external management; an unquestioned priority in either liquidation or restructuring that grants creditors the highest possible return with appropriate interest for any time that they were hindered in exercising their legal rights. Pre-insolvency entitlements are maintained whilst transferred to a collective procedure.

Where the lending structure is dispersed, short-term oriented, and/or anonymous, it is unlikely that creditors will make investments into diligent monitoring and ex ante debt management. If the debtor saw insolvency as a loss-option, the debtor would try any desperate rescue option with an overall negative net present value if only the debtor’s distinct net present value calculation would yield a positive return.<sup>44</sup> Creditor loss would be ignored, and perverse

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<sup>41</sup> On carrot and stick-strategies see: Simon Gächter, *Carrot or stick?* 483 *Nature* 39 (2012)

<sup>42</sup> David Skeel, *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy* 51 *Vanderbilt Law Review* 1325 (1998).

<sup>43</sup> For the importance of managerial incentives see: Michelle White, *The Costs of Corporate Bankruptcy: A U.S.-European Comparison*, in Jagdeep Bhandari and Lawrence Weiss (eds) *Corporate Bankruptcy – Economic and Legal Perspectives* 467 (Cambridge University Press 1996).

<sup>44</sup> Example: Assume a debtor trades at the brink of insolvency. Within short time the debtor will be cash-flow insolvent. Its assets are sufficient to pay its creditors in full without that a residual will be left for the

strategies such as underinvestment, asset substitution, and asset withdrawal would dominate.<sup>45</sup> In order to give the debtor an incentive to enter the procedure sufficiently early, the expected return of insolvency must be positive for debtors. It is the incentive for the captain. The privileges given to the debtor ex post in cases of distress are paid by the savings the creditors receive by not needing to monitor and control the debtor ex ante.

Ex ante oriented regimes, in contrast, empower creditors to chart the firm's journey from the brink of extinction. They must rely on a concentrated and coordinated lending structure. Where there is primarily one major creditor, or where creditors coordinate on a mutually beneficial course of action by informal or formal agreements, the ex ante debt management has an excellent prospect to succeed. In such a regulatory environment banks would have an incentive to monitor the debtor diligently, to share the costs of monitoring in the syndicate, and to take coordinated action once the debtor approaches a situation where the creditor's satisfaction is at risk.<sup>46</sup> Active ex ante debt management by creditors has proven to add value to the firm's assets.<sup>47</sup>

#### 4. The Legal Transplant Problem

A problem emerges where reformers change the law in order to mimic the success of a different regulatory regime while ignoring the fact that the re-modelled law is no longer consistent with the underlying extra-legal circumstances. For instance, they might empower a debtor in a concentrated lending structure, thus awarding the debtor an unearned privilege as

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equityholders. In insolvency, the directors will lose their job and the firm will be dissolved. The directors have one investment option on the table. They can liquidate a  $0.8X$  of their assets ( $X$ ) and invest into a new adventurous product line. The market prognosis is that the project will either fail with a probability of ( $P$ )  $0.8$  and a payoff of  $0$  or that the project will be a roaring success with a payoff of  $2.4X$ . If the firm were financially healthy, the directors would reject the project, since it has a negative Net Present Value (NPV), i.e.,  $0.8X > 0.2 * 2.4X$ . However, since the directors see no prospect in insolvency, they will re-consider: Since the debtors distinct NPV is positive, i.e.,  $0 < 0.2 * (2.4X - X)$ , they will play the risky. The risk is born by the creditors, i.e.,  $X > 0.8 * 0.2 + 0.2 * X$ . If the creditors do not monitor and control the debtor, the debtor must be given a chance to collect a share in insolvency. Otherwise, the debtor will substitute low risk assets for high risk assets, even were the NPV for the firm is negative.

<sup>45</sup> Paul Davies, *Director's Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency* 7 (1) European Business Organization Law Review 301 (2006).

<sup>46</sup> See Julian Franks and Oren Sussman, *Financial distress and bank restructuring of small to medium size UK companies* 9 Review of Finance 65 (2005).

<sup>47</sup> Sudip Datta, Mai Iskandar-Datta, Ajay Patel, *Bank monitoring and the pricing of corporate public debt* 51 (3) Journal of Financial Economics 435 (1999); Takeo Hoshi, Anil Kashyap, and David Scharfstein, *Bank Monitoring and Investment: Evidence from the Changing Structure of Japanese Corporate Banking Relationships* 105, in Glenn Hubbard (ed) *Asymmetric Information, Corporate Finance, and Investment* (University of Chicago Press 1990); Dianna Preece and Donald Mullineaux, *Monitoring, loan renegotiably, and firm value: The role of lending syndicates* 20 (3) Journal of Banking and Finance 577 (1996).

the unlucky side-effect of a well intended but poorly implemented reform.<sup>48</sup> By the same token, changing circumstances and an outdated law create problems. If, for instance, the lending structure becomes more and more dispersed while the law gives the debtor no incentives to enter the insolvency procedure sufficiently early, a storm will sink the firm's assets. Corporate law, insolvency law, and informal rules in response to extra-legal circumstances complement each other, and must be balanced for each to work efficiently.<sup>49</sup> It is therefore understandable but misleading when insolvency lawyers take a pathological view on the law and want to resolve all conflicts of distress in insolvency. If the recovery rates and the satisfaction quota in insolvency are low, and liquidation is the common route, this will not necessarily call for reform. It might also be that insolvency is the ultimate exit route for a procedure that has already begun in the shadows of the law.<sup>50</sup>

## **5. Distribution and Concentration: A Matter of Public Policy**

The question of re-distribution and concentration in the public insolvency procedure becomes a matter of policy-based exemptions in international arbitration. Exemptions from the general rule of contractual freedom in enforcing an arbitration agreement and recognition in enforcing an arbitral award vary where policy concerns in insolvency prevail. The differences between different insolvency regimes can be attributed to the differences in distribution and concentration.

Re-distribution in insolvency may take place for two entirely distinct goals:

- i. To favour the 'weak'

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<sup>48</sup> Daniel Berkowitz, Katharina Pistor, and Jean-Francois Richard, *The Transplant Effect* 51 (1) *The American Journal of Comparative Law* 163 (2003); Christian Kirchner and David Ehmke, 'Staat und Recht' in Rainer Kollmorgen, Wolfgang Merkel, and Hans-Jürgen Wagener (eds) *Handbuch für Transformationsforschung* 455 (Springer VS 2015).

<sup>49</sup> The idea of complementarities in legal and extra-legal structures is prominently presented by Peter Hall and David Soskice, *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford University Press 2001); David Soskice, *Divergent Production Regimes: Coordinated and Uncoordinated Market Economies in the 1980s and 1990s*, in Herbert Kitschelt, Peter Lange, Gary Marks, and John Stephens (eds) *Continuity and Change in Contemporary Capitalism* 101 (Cambridge University Press 1999).

<sup>50</sup> The concern that the lack of impartial oversight out of insolvency would allow controlling shareholders to increase their share does not consequently mean that other creditors will suffer. If indirect and direct insolvency costs shrink the pie of assets available for distribution, creditors without control might recover an 'equal' but comparatively smaller share of the pie. In John Armour, Audrey Hsu, and Adrian Walters, *Corporate Insolvency in the United Kingdom: The Impact of the Enterprise Act 2002* 5 (2) *European Company and Financial Law Review* 148 (2008), the authors show empirically that the change from administrative receivership, a procedure controlled by the major secured creditors, to administration, a procedure conducted for the equal benefit of all creditors, has brought higher recovery rates, which are, however, used to pay for correspondingly higher insolvency costs.

- ii. To set the right incentives for value maximisation.

Both goals may be considered as policy concerns in disfavour of international arbitration.<sup>51</sup> From an economic perspective, insolvency is not the right place for social concerns, i.e., to realise the (i) goal: the welfare costs of subsidising inefficient ventures regularly outnumber the benefits transferred to the beneficiaries.<sup>52</sup> While social policy concerns in insolvency are often the product of political opportunism, they nevertheless form part of the policy-related exceptions in international arbitration. Setting the right incentives for value maximisation, i.e., realising the (ii) goal, does not actually lead to a wealth transfer. A creditor-friendly regime consequently compensates the (secured) creditors for their monitoring and debt management effort before the commencement of formal insolvency procedures, while the debtor's incentives in a debtor-friendly regime make the extended monitoring and debt management efforts of creditors unnecessary.<sup>53</sup> Another re-distribution for social but at the same time for efficiency reasons can be a preferential ranking of employees' claims arising within a limited time before the insolvency procedure (and with a cap in value). If there were no such preferential ranking, the danger would increase that employees jump the ship once the distress of the debtor becomes known to them.

Generally, the concentration of legal action in a collective regime, and therewith the relation of insolvency to international arbitration is linked to the question of an ex ante or ex post-oriented insolvency regime. An ex post-oriented regime typically works with a strong

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<sup>51</sup> See section II. 2.4.

<sup>52</sup> They, moreover, often miss the goal to favour the weak whom they instead factually disfavour if seen from a bird's-eye view: If an insolvency regime bails-in creditors to rescue a troubled firm for the sake of securing jobs, or for the purpose of preventing damage to the public community, even though the debtor might be economically distressed, this will negatively effect the cost and opportunities of debt capital acquisition and inefficiently lock up capital, when it could be put to better use in a different venture; the result being less ventures realised and less jobs created in the first place. A strong proponent of substantial policies in insolvency is Elizabeth Warren. See Elizabeth Warren, *Bankruptcy Policy* 54 (3) *The University of Chicago Law Review* 775 (1987) and Elizabeth Warren, *Bankruptcy Policy Making in an Imperfect World* 92 (2) *Michigan Law Review* 336 (1993). For a critical review of Elizabeth Warren's concept of substantial policies see: Douglas Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren* 54 (3) *The University of Chicago Law Review* 815 (1987). For social policies in insolvency from a contract theory perspective see: Donald Korobkin, *Contractarianism and the Normative Foundations of Bankruptcy Law* 71 *Texas Law Review* 541 (1993); Donald Korobkin, *The Role of Normative Theory in Bankruptcy Debates* 82 *Iowa Law Review* 75 (1996).

<sup>53</sup> In the abovementioned creditor's bargaining theory, any re-distribution was rejected as creating the perverse incentive to access the procedure not for reasons of value maximising but for the reason of a wealth transfer. See Baird and Jackson 101–104 (1984), 109 – 114; Jackson 868 – 871(1982). In the risk-sharing theory, Thomas Jackson and Robert Scott extended that notion with the exception that ex post re-distribution can be efficient if it is done so as to compensate the captain of the ship for effort and unbiased decisions, which likely create extra value. See: Thomas Jackson and Robert Scott, *An Essay on Bankruptcy Sharing and the Creditors' Bargain* 72 (2) *Virginia Law Review* 155 (1989); Robert Scott, *Through Bankruptcy with the Creditors' Bargain Heuristic* 53 (2) *The University of Chicago Law Review* 690 (1986).

concentration of individual action in a collective procedure under the special jurisdiction of a bankruptcy court, regularly initiated and carried-out by the debtor-in-possession; on the other hand, an ex-ante oriented regime, especially where secured creditors maintain a controlling position, is characterized by less concentration, the honour of pre-insolvency entitlements, and thus of pre-insolvency arbitration agreements. Neither the debtor nor the creditor, in fear of the outcome of the arbitration dispute, should rush into insolvency so as to alter the rules of the game. Moreover, where restructuring agreements are made in the shadow of the law rather than in a formal procedure, as is more likely in ex-ante oriented regimes, international arbitration and out-of-court restructuring negotiations do not, in reality, conflict at all.

## **IV. The Comparative Project**

### **2. Introduction**

The value of comparative legal analysis is a better understanding of the development and function of legal rules by way of comparison with a focus on similarities and differences in context of similar and/or different extra-legal and legal conditions.<sup>54</sup> This chapter builds on the abstract analysis of arbitration in section II. and insolvency in section III. Following the functional approach, first the value, i.e., the variable surplus of arbitration as a dispute resolution model alternative to dispute resolution in the forum of national courts shall be discussed in section IV. 2. In section IV. 3., the points of conflict between arbitration and insolvency shall be identified. While the operating mechanism of international arbitration as discussed in section II. follows a transnational concept, the limitations on arbitration in insolvency differs by country, and, as one might assume, differ with the distinct national approach of dealing with distressed debt.

### **2. National Courts v International Arbitration Tribunals: A Variable Surplus**

The surplus of international arbitration in the individual case is dependent on the variable factor of the national jurisdictional infrastructure. As far as the commencement of formal insolvency procedures forecloses international arbitration (concerning specific matters of dispute), the parties to the arbitration agreement, i.e., the insiders, have to resolve their dispute in the forum of national courts. The loss for insiders depends on the efficiency and suitability of the national judicial infrastructure for their individual case. The economic rationale of international arbitration has been discussed in section II.1. Of particular importance for the calculation of costs which result from a limitation on arbitral dispute resolution in favour of dispute resolution in the forum of national courts, and which one can expect to vary the most between different national courts, are: neutrality, competence, speed, and cost.<sup>55</sup> When international arbitration is ruled out, the size of the cost for the insiders will depend on the relative inefficiency of the national judicial infrastructure.

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<sup>54</sup> For a discussion of the functional method in comparative law see: Ralf Michels, 'The Functional Method in Comparative Law', in Mathias Reimann and Reinhard Zimmermann (eds) *The Oxford Handbook of Comparative Law* 339 (OUP 2006).

<sup>55</sup> See section II. 1 for a more in-depth discussion of these factors.



The parties might have chosen international arbitration because they expected that national courts would not uphold their contractual agreement, and that the courts would lack the neutrality to honour both parties' interest. This is in particular a transition economy problem. Political opportunism, corruption, and a patriotic judiciary can be associated with a prevalent nexus of informal rules which supersede the law in the books.<sup>56</sup> Courts dealing with the demands of foreign creditors against a domestic debtor might be inclined to 'protect' the debtor and to bail-in foreign creditors to revive a debtor as employer, taxpayer, and link in a production or service chain valuable for the national economy. Such a policy, from an unbiased economic perspective, is likely to have negative ex ante reflections which exceed the short-term ex post benefit. However, short-term political needs, in particular in countries with a judiciary dependent on political directives, are likely to work contrary to the expectations of a win-win-agreement between the parties to a contract if accounting for ex ante and ex post effects. The less neutral the national judicial infrastructure is, the higher is the surplus of international arbitration.

International arbitration is often the preferred dispute resolution mechanism because the parties expect the arbitrators nominated by them to be particularly competent to decide the problems that may arise in their commercial relation. This is likely to be the case where the case not only involves a complex legal but also a complex business judgement. National courts with a long history of business case dispute resolution have a substantial institutional advantage over transition economies whose judiciaries have just entered the challenge. A rich collection of precedent cases to be applied to the case by arbitrators of an institutional seat can enhance a dispute resolution in competent and timely manner. The less competent the national judiciary is, the higher is the surplus of international arbitration.

A related question is the speed of international arbitration in comparison to the relevant national judicial infrastructure. This equally applies to the cost of procedure and the confidentiality of the national court. Questions of speed and cost depend on the competence of the judges and the equipment of the judicial infrastructure. The longer a national court procedure takes, the more unnecessary costs it produces, the less able or willing the judge is to prevent the leakage of information: in each scenario the surplus offered by international arbitration will proportionately increase. The point of costs has to be considered in another

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<sup>56</sup> For an in-depth analysis of this problem in context of transition economies and legal reform see: Christian Kirchner and David Ehmke, 'Staat und Recht' in Rainer Kollmorgen, Wolfgang Merkel, and Hans-Jürgen Wagener (eds) *Handbuch für Transformationsforschung* 455 (Springer VS 2015).

context as well. It might very well be that an arbitral tribunal has already decided the case, an award has been granted; or that the arbitral tribunal has made considerable progress in analysing the issue. In such cases, the commencement of insolvency would require the parties to start from scratch with all investments in arbitration gone

We can assume—and will investigate further in the country-specific analyses, that the higher the surplus of international arbitration is, the less effective will be the national insolvency regime in public ordering. If the national judicial infrastructure is weak and corrupt, the faults in dispute resolution will occur across all forms of administrative and judicial resolution, including cases involving financial distress. The necessity for a reform of the insolvency regime will be correspondingly high in case of a high surplus of international arbitration in a country with a dominant public-ordering regime for the resolution of financial distress.

### **3. Major Points of Conflict and the Goal of Institutional Consistency**

There are several points of conflict between insolvency and international arbitration. The consistency of the system of national law in relation to international arbitration depends on how stark the conflict between contract and coercion, between Scylla and Charybdis is. The five major points of conflict discussed in this section are: private v public ordering, ex ante v ex post orientation, substantive re-distributive policies v party autonomy, concentration v decentralization, and certainty v equity.

*Private v Public Ordering:* Arbitration is, by definition, a form of private ordering. While it may be enforced with the assistance of a court order in public ordering; the dispute is resolved according to and in the forum agreed upon by the parties ex ante in private ordering.

Insolvency, in contrast, tends to either private or public ordering. If the problems associated with financial distress are generally resolved out-of-insolvency, pre-determined by contract or within the framework of informal rules, the regime of financial distress resolution can be characterised as private ordering dominant. This is likely in case of well-established inter-creditor relations with concentrated and repeated debt lending. The more the credit structure is dispersed, the more likely is that financial distress dispute resolution is concentrated in a public ordering procedure under court or administrative supervision if not contractual arrangements provide an alternative scheme. The starker is the contrast of insolvency to international arbitration.

*Ex Ante v Ex Post Orientation:* An ex ante oriented insolvency regime is characterized by an institutional preference for private ordering, out-of-court resolution of financial distress under the control and guidance of strong creditors, and debt management regulation by way of contract. It is the institutional twin of international arbitration which is itself a procedure of private dispute resolution pre-determined by contract.

An ex post oriented insolvency regime is built on the assumption that financial distress is not effectively resolved by contract and creditor control. A dominant debtor is assumed to have perverse incentives in the face of insolvency, leading to the creation of insolvency proceedings that are designed to regulate by stick and carrot. Conflict resolution in arbitration can, potentially, undermine the incentive mechanism created by an ex post oriented insolvency regime.

*Substantive Re-distributive Policies v Party Autonomy:* Different from an ex post oriented regime with the goal to promote efficiency, an insolvency regime might be designed to realise substantive re-distributive policies. As such, employees, the tax authority, or the public community can receive special treatment in insolvency (i.e., a disproportional share in insolvency in relation to their pre-insolvency entitlement).

A social privilege, i.e., re-distribution for social but not efficiency goals, as it may be a component of insolvency, conflicts with the concept of party autonomy which is paramount for international arbitration. International arbitration threatens to pick away at the assets, which should be preserved for the benefit of privileged parties.

*Concentration v Decentralization:* If seen from the common pool perspective in insolvency arbitration is a decentralised procedure. A strong concentration in insolvency might be the law-maker's choice in order to bring effect to its policy goals of an (ex ante or) ex post oriented insolvency regime (efficiency considerations), or to protect selected parties according to a social policy agenda (substantive re-distribution). Decentralisation in international arbitration threatens the desired concentration as a mean to accomplish the full realisation of either efficiency or social goals in insolvency.

*Certainty v Equity*: Many reasons to choose international arbitration over dispute resolution in the forum of national courts can be linked to certainty: the private ordering concept of choosing the material and procedural rules to apply to the dispute and of the judges to decide the case offer the certainty that only such a tailor-made system could. An added benefit are to be found in the ‘stabilization clauses’, by which parties are able to govern the contract not only with the law of a specific jurisdiction, but also of a specific time. International arbitration agreements can limit the exposure to changes in the law, which would otherwise apply to the contracting parties: they are aimed to secure certainty and to allow the parties an as accurate as possible ex ante calculation to set the price and terms of their transaction.

Outcomes in insolvency should be predictable as well. As far as pre-insolvency entitlements are perfectly mirrored on a pro rata basis, the ex ante expectations about ex post outcomes are met to the highest possible degree. Insolvency is, however, often subject to substantive policies. The harsher is the effect of insolvency on pre-insolvency arrangements, the less predictable is the ex ante calculation for price and terms of the commercial agreement.

Importantly, if insolvency has a substantial effect on the contractual arrangements, including the means of dispute resolution, this will mean the choice to enter a public ordering insolvency procedure will be at risk of motivation by strategic concerns. Assume that one party to a commercial contract of high value trades in the zone of financial distress. It is known that the acceleration of insolvency procedures will shift the dispute resolution power to the national courts: the arbitral procedure will be halted, suspended, or the arbitral award will become (temporarily) unenforceable. The near-insolvent party will now calculate as to whether it can benefit from entering insolvency and thereby put itself in a better position. If this is a realistic prospect, for instance, because the national courts are supposed to rescue the troubled debtor at any price, the near-insolvent party will have the perverse incentive to enter an inefficient insolvency procedure for the purpose of increasing its chances to benefit most. The distorted incentive to accelerate insolvency in order to evade arbitration will exist whenever the arbitration procedure is likely to produce an ex post unfavourable result for the near-insolvent party. This is forum-shopping by declaration of insolvency.

#### **4. A Conflict between Insiders and Outsiders**

Unless there is a stark asymmetry of power and/or information, the rational assumption in the case of a commercial contract with an arbitration clause is that it is in each party's interest that the arbitration agreement shall prevail. Naturally, one party to the agreement will articulate a different position if it becomes foreseeable that the case will be decided in the other party's favour: in such a situation ousting international arbitration may be advocated as the 'best solution' by the losing party. From an ex ante perspective, under the veil of uncertainty about future situations, the parties, however, will design a dispute resolution regime in their mutual favour so that it is fair to say that it is in the insiders' interest that arbitration as agreed ex ante should be unaffected by insolvency.

The outsiders' calculation is tricky. Generally, those who are not part of the commercial contract for which international arbitration has been agreed, are not affected unless their debtor is part to this agreement and is near-insolvent. In this case, the outsider to the contract becomes an insider by way of the common pool dilemma; not out of choice, but by coincidence. Since the surplus of arbitration will account positively to the debtor's firm value, the outsiders can benefit indirectly from an arbitration agreement.

However, the national insolvency law is the transparent projection for creditors' calculation about the probability of and the possible outcome in insolvency. The nature of the insolvency law is the decisive factor in measuring the pro and cons of a limitation on international arbitration with the commencement of insolvency procedures. Only when international arbitration does not undermine the insolvency system itself, outsiders will not be harmed. In consequence, the outsiders preference is a coherent nexus of mutually supportive and complementary rules, i.e, institutional consistency.

## **V. Limitations on International Arbitration Involving an Insolvent Party**

### **1. Introduction**

To consider the interrelation of insolvency and arbitral proceedings it is necessary to consider two distinct scenarios:

1. Two companies, A and B, have entered into a contract containing a valid agreement to arbitrate. Subsequently A becomes insolvent, and there is a breach of contract.
2. B has received an arbitral award against A for damages of breach of contract. Before B is able to take the award for enforcement in a national court, A becomes insolvent.

At these points (before, and after proceedings) the effect of insolvency raises different questions: in the first case the question is whether the arbitration agreement entered into between the parties remains valid; in the second case, the question is whether the national courts where either enforcement or recognition is sought against an insolvent party has the discretion, or the duty, to refuse<sup>57</sup>

### **2. The Validity of the Arbitration Agreement**

#### **2.1 Preliminary Considerations**

Strictly speaking there are two means of binding oneself to arbitrate a dispute, though the distinction is purely a temporal one: an agreement to arbitrate binds the parties in relation to future disputes; whilst a submission agreement is entered into with respect to disputes that have already arisen under a contract. For the purpose of simplicity only the ‘arbitration agreement’ will be referenced to.

In initiating arbitral proceedings on the basis of an agreement to arbitrate, party B is invoking the principles of *pacta sunt servanda* and party autonomy in order to bypass the default option

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<sup>57</sup> A third possible scenario to consider is where during arbitral proceedings A becomes insolvent. This scenario has not been considered on the basis that much the same considerations go into the court’s supervision of the initiation of arbitral proceedings after the initiation of insolvency proceedings as go into the supervision of ongoing arbitral proceedings. Further to this, the situation where a separate analysis would prove useful (where the law governing the arbitration agreement and the *lex arbitri* are different) raises complex issues of arbitration law that are beyond the scope of this paper.

of dispute resolution in a national court. Despite the importance of these principles in private law, there are principles of public law that may take precedence where insolvency is involved. Whilst arbitration is efficient in the resolution of bilateral disputes; States are unlikely to give free rein to an arbitral tribunal to involve itself matters of insolvency, where the interests of the insolvent parties' creditors, employees, and possibly the local economy are likely to be affected.

For each jurisdiction it is necessary to determine the legal position on the validity of an agreement to arbitrate where one party is insolvent. As discussed before, the arbitration agreement is separate from the contract, the disputes under which the agreement compels to arbitration. However, as in cases of *ab initio* illegality<sup>58</sup> under English law, there are cases where a single cause taints both the contract and the agreement to arbitrate. Further to this, there is the possibility that should the contract survive, any disputes under it will need to be attached to centralized insolvency proceedings, precluding arbitration as a means of resolution. Thus it will be necessary to consider the position of the contract and the arbitration agreement both separately and together.

## **2.2 The United States**

Ss. 2-4 of the FAA define the scope of court supervision of arbitration agreements. S. 2 provides the formal requirements for an arbitration agreement. S. 3 holds that where there is a valid arbitration clause any proceedings brought in a US court will be stayed. S. 4 holds that, upon application, the court will compel the parties to arbitration. No explicit provision is made for the initiation of insolvency procedures; however, s.3 provides that a stay shall only be granted with respect to issues referable to arbitration. The question of arbitrability is raised by § 362 of the Bankruptcy Code, which provides an automatic stay for the commencement of proceedings against a party after a petition has been submitted. Thus whilst the underlying principles applicable to the agreement to arbitrate in cases where one party has become insolvent are no different from those in any other circumstances; the question of the arbitrability of the dispute in insolvency becomes the focus.

Arbitrability is not defined in the FAA, and it has been left to courts to determine the scope within which parties may submit their disputes to arbitration. Formerly American courts took

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<sup>58</sup> See *O'Callaghan v Coral Racing Ltd.* (1998) WL 1044030 (CA)

a hostile approach to arbitration, ruling a number of statutory claims such as securities, anti-trust, and RICO claims an unarbitrable. However, following the accession of the United States to the New York Convention in 1970, in 1974 the case of *Fritz Scherk v Alberto-Culver Co*<sup>59</sup> marked a turning point: it was held that ‘it will be necessary for national courts to subordinate domestic notions of arbitrability to the international policy favoring commercial arbitration’. This pro-arbitration sentiment was further expressed in *Moses H. Cone Memorial Hospital v. Mercury Construction Corp*<sup>60</sup>, in 1983 when the Supreme Court held that ‘as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favour of arbitration’; and in 1985 in *Mitsubishi Motors Corp v Soler Chrysler-Plymouth Inc*<sup>61</sup>, where the Supreme Court expanded upon the international sentiment expressed in *Scherk*, by stating that arbitrability would be interpreted more broadly in the context of international arbitration than in domestic cases. In 1987, with direct reference to both *Moses* and *Mitsubishi*, the Supreme Court in *Shearson/American Express Inc v. McMahon* ruled for the arbitrability of statutory claims under the 1934 Exchange Act: supporting the pro-arbitration policy, the Court held that the burden of asserting inarbitrability was on the party resisting arbitration, and the requirement was to show by reference to another statute’s text, legislative history, or underlying purpose that Congress has intended to preclude arbitration of such disputes.<sup>62</sup>

One of the decisions in the earlier pro-arbitration period was *Zimmerman v Continental Airlines*<sup>63</sup> decided a few months later than *Mitsubishi*: here the Third Circuit Court of Appeals, applying the 1978 Bankruptcy Reform Act, held that the arbitrability of a case involving an insolvent party should be ‘left to the sound discretion of the bankruptcy judge’. The basis for the court’s decision in *Zimmerman* was the argument that the underlying purposes of bankruptcy legislation ‘impliedly modify’ the policies behind the FAA. This argument, however was later explicitly rejected in 1989, in *Hays & Company v Merrill Lynch, Pierce, Fenner and Smith*<sup>64</sup> where the Third Circuit Court of Appeals, applying the test from

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<sup>59</sup>*Fritz Scherk v Alberto-Culver Co.* 417 U.S. 506 (1974)

<sup>60</sup>*Moses H. Cone Memorial Hospital v. Mercury Construction Corp* 460 U.S. 1 (1983); affirmatively cited by the Supreme Court in 2012, *CompuCredit Corp v Greenwood*, 615 F. 3d 1204 (2012), stating that the FAA would reveal the law-maker’s intent of “a liberal policy favoring arbitration” in the Syllabus, in reference also to *Dean Witter Reynolds Inc. v Byrd*, 470 U.S. 213 (1983).

<sup>61</sup> *Mitsubishi Motors Corp v Soler Chrysler-Plymouth Inc.*, 473 U.S. 614 (1985).

<sup>62</sup> *Shearson/American Express Inc v. McMahon*, 483 U.S. 220 (1987) at 226.

<sup>63</sup> *Zimmerman v Continental Airlines*, 712 F.2d 55 (1983).

<sup>64</sup> *Hays & Company v Merrill Lynch, Pierce, Fenner and Smith*, 885 F. 2d 1149 (1989).



*Shearson/American Express* held that there was insufficient evidence that bankruptcy legislation showed Congressional intent to oust the arbitrability of “non-core” matters in the case of insolvency. Under *Hays* the situation becomes clearer, with the bankruptcy court having no discretion to stay arbitration with respect to non-core matters. However, the current situation remains uncertain, with different courts dealing with *Hays*: whilst some court have followed *Hays*, others, such as the New York bankruptcy court in *In re WM. S. Newman Brewing Co., Inc*<sup>65</sup>, holding *Hays* as no more that persuasive as opposed to a ‘new controlling authority’. The prevalent view, however, seems to be that *Hays* is good law. In *In re U.S. Lines, Inc.*<sup>66</sup>, the Second Circuit Court of Appeals, cites *Hays*, before continuing to suggest that bankruptcy courts have discretion whether to permit arbitrability with respect to core, in contrast to non-core, matters depending on the underlying policy, or Congressional intent, behind the provision in question.<sup>67</sup> More recently, in 2015, *Hays* has been positively cited and discussed in *In re Lehman Bros. Holdings, Inc.*<sup>68</sup>, and *Moses v Cashcall Inc.*<sup>69</sup>.

The origin of this concept of core/non-core bankruptcy proceedings came in the wake of the ruling in *Northern Pipeline Construction Co. v Marathon Pipe Line Co*<sup>70</sup>, where the Supreme Court found the current bankruptcy law unconstitutional on the basis that ‘[c]ongress may not vest in a non-Article III court the power to adjudicate, render final judgment, and issue binding orders in a traditional contract action arising under state law, without consent of the litigants, and subject only to ordinary appellate review’<sup>71</sup>. On the basis of the Supreme Court judgement in Northern Pipeline, Congress inserted § 157(b)(2) into the Bankruptcy Code so as to set out which proceedings are core to the process of insolvency and, thus, which matters should only be arbitrable upon the bankruptcy court’s discretion. With respect to non-core proceedings, the bankruptcy court may only make recommendations, subject to review by the district court. The concept of core and non-core and consequently of arbitrable and non-arbitrable matters in insolvency in the United States will be discussed in section VI. 2.2.

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<sup>65</sup> *In re WM. S. Newman Brewing Co., Inc* 87 B.R. 236 (1988).

<sup>66</sup> *In re U.S. Lines, Inc.*, 97 F.3d 631 (1999).

<sup>67</sup> See also *Re Crysen/Montenay Energy Co.* 226 F.3d 160 (2000), especially 165–166.

<sup>68</sup> *In re Lehman Bros. Holdings, Inc* 2015 WL 5729645

<sup>69</sup> *Moses v Cashcall Inc.*, 781 F. 3d 63 (2015).

<sup>70</sup> *Northern Pipeline Construction Co.. v Marathon Pipe Line Co.*, 458 U.S. 50 (1982).

<sup>71</sup> *Thomas v Union Carbide Agricultural Products Co.*, 473 U.S. 568 (1985).

## 2.3 England

The default position for the enforcement of arbitration agreements is to be found in s.9(1) of the Arbitration Act 1996. This section provides that in as much as a dispute is subject to an arbitration agreement, the courts will stay any other proceedings taken to resolve the dispute. The grounds for refusing a stay are contained in s.9(4) of the Arbitration Act 1996, and are limited to situations where the court is satisfied that the arbitration agreement is ‘null and void, inoperative, or incapable of being performed’ by the court.

The court is not only empowered to issue a stay of domestic proceedings, but also to issue anti-suit injunctions against foreign proceedings.<sup>72</sup> A distinction must be made here that in domestic cases, the court is obliged to issue a stay under the Arbitration Act 1996; whilst in issuing an anti-suit injunction the courts act at their discretion. In such cases, the courts take the same approach to an agreement to arbitrate as to an exclusive jurisdiction clause; as a consequence this is subject to the condition that there be no strong reasons against granting the injunction<sup>73</sup>. An exception to this rule is found in cases with a European dimension, in which the ECJ has ruled against the permissibility of granting anti-suit injunctions against the courts of EU Member States to preclude them from assessing the validity of the arbitration agreement<sup>74</sup>.

Where one of the parties has become insolvent, the effect on the arbitration clause will depend on the form of insolvency procedure applied. For example, in cases of voluntary winding up, there is no automatic stay of procedures. Where an insolvent party has instead been put into administration, the AA Sch. 3 s.46 amends the Insolvency Act 1986 s.349 to provide that if the trustee in bankruptcy adopts the relevant contract then he is subrogated to the position of the insolvent party, and will be bound by the arbitration agreement. The law in this regard has been held to be the same in both situations where a foreign party has been declared insolvent, and where the insolvent party is domestic<sup>75</sup>. In situations where the contract has not been adopted, the court, on the application of an interested party, has discretion whether to enforce

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<sup>72</sup>See *The Angelic Grace* [1995] 1 Lloyd’s Rep. 87

<sup>73</sup> See *Donohue v Armco* [2002] 1 Lloyd’s Rep. 425

<sup>74</sup> See *The Front Comor* Case C-185/07 [2009] 1 Lloyd’s Rep. 413

<sup>75</sup> See *Bannai v Erez* [2013] EWHC 3689 (Comm), where Burton J refused the appeal against of anti-suit injunction against a trustee-in-insolvency from bringing proceedings in an Israeli court. This was in spite of the fact that the respondent did not intend to initiate arbitration proceedings, but merely to prevent proceedings in the Israeli courts.

the arbitration agreement. The question of arbitrability of dispute matters in insolvency and of the procedure for the application to the court for a delegation to arbitration will be discussed further in section VI. 3.2.

## **2.4 Russia**

The requirements for the validity of an arbitration agreement, and the consequences of such an agreement are found in Chapter 2 of the Russian Law on Arbitration. Art. 7 defines both an arbitration agreement, and the formal requirements for an arbitration agreement. Art. 8(1) states that where a valid arbitration agreement is found, upon application by a party, the court shall stay any domestic proceedings in relation to a dispute governed by the arbitration clause, and refer the parties to arbitration. Art. 8(1) continues by stating that the court may refuse to refer the parties to arbitration if it is satisfied that the agreement is null and void, inoperative, or incapable of being performed. Further to this, the Commercial Court Code art. 148<sup>76</sup> reinforces art. 8(1) of the Russian Law on Arbitration, by stating that commercial courts shall stay any proceedings with the same subject-matter as any disputes currently under consideration by an arbitral tribunal, or subject to an arbitration clause unless that clause is null and void, inoperative, or incapable of being performed. Similar provision can also be found in arts. 220 and 222 of the Civil Procedure Code.

There is no provision on the validity of the arbitration agreement in respect of the initiation of bankruptcy proceedings: as such, the arbitration agreement will survive the initiation of bankruptcy proceedings. A further consideration, however, is the definition of an arbitration agreement in the New York Convention art. II(1): this provision, unlike the Russian Law on Arbitration, links the concept of arbitrability to the validity of the arbitration agreement. Art.15(4) of the Russian Constitution states that where the rules of a foreign treaty stipulate rules other than those of Russian law, the treaty is to take precedence: this is echoed specifically in the context of arbitration in Art.1(5) of the Russian Law on Arbitration. On this reading, it might be possible to hold the arbitration agreement as invalid depending on the question of arbitrability; however, the general rule is nonetheless that tribunals are to decide on their jurisdiction as set out in art. 16(1), though such a decision may subsequently be challenged in a Russian court if the requirements of art. 16(3) are met.

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<sup>76</sup> This provision has been declared to be mandatory by previous the Supreme Commercial Court in clause 2 of the Letter of the Presidium of the Supreme Commercial Court 25/12/96 No.10 (An Overview of Practice in Resolving Dispute Cases involving Foreign Entities examined by Commercial Courts after 1/07/1995).

In practice, however, courts in Russia sometimes incorrectly combine the question of arbitrability with that of the validity of the arbitration agreement. In one case<sup>77</sup> concerning a claim of unjust enrichment in relation to taxation rates, the court stated that the arbitrability defence found in art. V of the New York Convention could be applied by analogy in finding the arbitration agreement to be inoperable<sup>78</sup>.

### **3, The Enforcement of an Arbitral Award**

#### **3.1 Preliminary Considerations**

A major hurdle to a party seeking to enforce an arbitral award against an insolvent party will be the issue of arbitrability. The issue of arbitrability is raised repeatedly in the New York Convention: Article II(1) provides that contracting States need only give effect to arbitration agreements ‘concerning a subject matter capable of settlement by arbitration; and Article V (2)(a) provides for where the dispute is not capable of settlement under the relevant law.

Further to this, of relevance in disputes involving an insolvent party, Article V(1)(a) provides a defence against enforcement in situations where the parties are incapacitated under the relevant law. We are thus faced with two forms of arbitrability: that which is dependent on the nature of the dispute itself; and that which is dependent on the nature of a party, or parties, to a dispute. These two forms of arbitrability have been termed ‘objective’ and ‘subjective’ arbitrability respectively<sup>79</sup>.

Depending on the approach in each jurisdiction it may be that arbitration involving an insolvent party is strictly prohibited, or on possible subject to certain qualifications. Similarly, the legal status of the dispute in each jurisdiction may mean that any dispute involving an insolvent party is not arbitrable; however it may be that only disputes over the core matters of

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<sup>77</sup> Постановление Федерального арбитражного суда Северо- Западного округа от 30 октября 2009 г. по делу Арбитражного суда Мурманской области № А42-6966/2008; Постановление Федерального арбитражного Северо- Западного округа от 4 декабря 2009 г. по делу № А42-6967/2008.

<sup>78</sup> Karabelnikov argues that not only was the court incorrect in conflating the questions of arbitrability and the validity of the arbitration agreement, but that the court was wrong to rule the dispute itself to be non-arbitrable. He argues this on the basis that there is no explicit statement in any other laws to preclude settlement of such disputes by arbitration, required by art. 11 of the Civil Code in combination with the art.1(2) of the Russian Law on Arbitration.

<sup>79</sup> Julian Lew, Loukas Mistelis, and Stefan Kröll, *Comparative International Commercial Arbitration*, 187 (2003).

arbitration fall within the scope of Articles V(2)(a) and II(2), leaving other matters within the jurisdiction of an arbitral tribunal.

A further factor to consider is the public policy defense found in Article V(2)(b). National courts have great leeway in deciding whether an award is contrary to the public policy of the relevant country. Though there is significant overlap between arbitrability and public policy, as public policy plays an important role in determining which disputes may be settled by a private tribunal; public policy is arguably wider, encompassing situations where courts may refuse enforcement not due to the nature of the dispute, but on more general grounds such as public morals.

The question of whether party B will be able to successfully enforce or have recognized an award will revolve around the approach of the legislation and the judiciary of the relevant jurisdiction. In such a politicized areas as enforcement, in order to understand the decisions reached by the national courts it is necessary to consider the methodology employed when delineating arbitrability: national courts may employ any of a range of approaches, such as a socio-economical, purely economical, or purely social approach. The methodology and the application will vary between cases, but nonetheless some degree of uniformity has been achieved within most jurisdictions.

### **3.2 The United States**

Ss.9-11 of the FAA deal with the degree of court supervision of the award. S.9 states that unless an award has been modified or corrected as set out in ss.10 and 11, the court is under an obligation to enforce the award under the New York Convention as per s.201 in Chapter 2 of the FAA. Apart from procedures for the setting aside of the award where the United States provides the *lex arbitri*, the only defences to the enforcement of an award are those found in the New York Convention. For the present paper, the most relevant provisions are those in arts. V(2)(a) and (b), which the court may assess *ex officio*, arbitrability and public policy.

*Arbitrability:* For a full discussion of the American position on arbitrability, see the above section on the validity of the arbitration agreement in cases of insolvency in section VI. 2.2.1, and especially section V. 2..2. For a discussion of the arbitrable and non-arbitrable dispute matters in insolvency see section VI. 2.2.

*Public Policy*: In the context of the United States, the line between arbitrability and public policy is even more blurred than in other jurisdictions: the active weighing of conflicting public policy arguments in defining the scope of arbitrability leads to the pre-emption of an argument of public policy. However, the two concepts still maintain independence in American law on the matter. The principle of public policy has been raised in a number of cases, which involved breaches of foreign law in the enforcement of the award<sup>80</sup>. American courts have been reluctant to accept this argument, and have held that national interest and international relations do not amount to public policy for the purposes of the New York Convention; and it has been held that ‘the showing required to avoid summary confirmation [of an arbitral award] is high’<sup>81</sup>. The result is that the defense under Art.V(2)(b) of the New York Convention is to be applicable ‘only where enforcement would violate the forum state’s most basic notions of morality and justice’<sup>82</sup>. An example of these principles in application is the case history of *Lagstein v Certain Underwriters at Lloyd’s*<sup>83</sup>: at first instance it was held that ‘together, the size and scope of the awards shock the Court’s conscience and contravene public policy’; however this ruling was subsequently reversed in part<sup>84</sup>, remanded<sup>85</sup>, and finally affirmed in part, and reversed and remanded in part<sup>86</sup>. It is clear that shocking the conscience of the court does not meet the stringent requirements; though whether this might attract other forms of judicial intervention will depend on the circumstances. In the 2012 case of *Changzhou AMEC Eastern Tools and Equipment Co. Ltd v Eastern Tools & Equipment*<sup>87</sup> the district court could find no previous case of a district court refusing enforcement on the basis of public policy<sup>88</sup>; but went on to suggest the potential examples given in *Ameropa AG v Haci Ocean Co. LLC*<sup>89</sup> where ‘the defendant’s due process rights had been violated—for

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<sup>80</sup> See, for example, *Northrop Corporation v Triad International Marketing S.A.*, 842 F. 2d 1154 (1988); *Parsons & Whittemore Overseas Co., Inc. v RAKTA*, 508 F. 2d 969 (1974).

<sup>81</sup> *Ottley v Schwartzzberg*, 819 F. 2d 373 (1987); cited in *Yusuf Ahmed Alghanim & Sons v Toys “R” Us, Inc.*, 126 F. 3d 15 (1997) and *Calbex Mineral Ltd v ACC Resources Co.*, 90 F.Supp. 3d 442 (2015).

<sup>82</sup> *Parsons & Whittemore Overseas Co. v RAKTA*, 508 F. 2d 969 (1974).

<sup>83</sup> *Lagstein v Certain Underwriters at Lloyd’s* 2007 WL 2363871 (2007).

<sup>84</sup> *Lagstein v Certain Underwriters at Lloyd’s* 607 F. 3d 634 (2010).

<sup>85</sup> *Lagstein v Certain Underwriters at Lloyd’s* 2011 WL 4356517 (2011).

<sup>86</sup> *Lagstein v Certain Underwriters at Lloyd’s* 725 F. 3d 1050 (2013).

<sup>87</sup> *Changzhou AMEC Eastern Tools and Equipment Co. Ltd v Eastern Tools & Equipment* 2012 WL 3106620 (2012).

<sup>88</sup> Whether *Lagstein* was not considered, or was rejected as an example on the basis of the results of the appeals is unknown

<sup>89</sup> *Ameropa AG v Haci Ocean Co. LLC* 2011 WL 570130 (2011).

example, if defendant had been subject to coercion or any part of the agreement had been the result of duress'. However, these scenarios are arguably covered by Arts. V(1)(a) and (b), which would preclude enforcement where an arbitration agreement is invalid (as for example as a result of duress), and where a party has not been given reasonable chance to present his case (as in the case where general due process has not been followed). An analysis of the case law shows that the threshold for a successful defense of public policy is so high as to offer so few successful cases as to be able to draw a clear line in the sand.

In the context of statutory claims, and thus cases involving insolvency, there may be slightly lower threshold. This stems from the ruling in *Mitsubishi*, in which the court applied what has become known as the 'second look doctrine'<sup>90</sup>. In *Mitsubishi*, the court ruled that it 'would have little hesitation in condemning the agreement as against public policy' where the choice-of-forum and choice-of-law clauses operate to preclude statutory remedies of an anti-trust claim, commenting on a possible situation where the arbitral tribunal had ignored the relevant American legislation. The doctrine presents a gap in the otherwise near-impregnable wall separating a claimant from a successful defense of public policy: if a tribunal, applying the law elected in the arbitration agreement, fails to consider the Bankruptcy Code, the award may be refused enforcement on the grounds of public policy. Unfortunately, there is no more precise definition of the arbitral tribunal's duties, and '[i]t is uncertain if the second look involves a broad examination of whether the arbitrator properly applied the law, or merely involved a mechanical examination of whether the arbitrator in fact considered the American Statute'<sup>91</sup>. Further to this, there is a strong suggestion that bankruptcy matters may elicit a less exacting requirement for public policy: in contrast to *Northrop* and *Parsons*, where contravention of foreign law did not give rise to a defense of public policy; in *Victrix Steamship Co., S.A. v Salen Dry Cargo A.B.* the Second Circuit Court of Appeals refused the enforcement of an award on the basis that it might prejudice the centralized bankruptcy proceedings of a Swedish company.

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<sup>90</sup> For an in-depth analysis of the case with respect to the doctrine, see: . Park, 'National Law and Commercial Justice: Safeguarding Procedural Integrity in International Arbitration', 63 Tul. L. Rev (1989).

<sup>91</sup> *Ibid*

### 3.3 England

As stated by Lord Denning in *Blackburn v Attorney General*<sup>92</sup>, English courts ‘take no notice of treaties until they are embodied in laws enacted by Parliament’. Unlike many other jurisdictions, including those that have adopted the UNCITRAL Model Law on International Arbitration, the AA does not merely adopt the provisions set out in the New York Convention, but expands upon the defences to enforcement by adding ss. 67-68 challenges on the basis of lack of substantive jurisdiction, and serious procedural irregularity respectively. Otherwise s.66(4) affirms the enforcement of qualifying awards in accordance with the Convention. Despite the additional defences provided by the AA, the above-mentioned defences under the New York Convention remain the primary obstacle to the enforcement of an award against an insolvent party.

*Arbitrability*: Whilst the Arbitration Act 1996 has codified a number of areas previously been governed by common law case law<sup>93</sup>; unfortunately arbitrability is not one such area, s. 81 stating that the Arbitration Act 1996 shall not change the common law position on arbitrability. The situation is none-the-clearer, and, due to the sensitive nature of this area of law, there is unlikely to be an exhaustive list or bright line test for the foreseeable future. With respect to subjective to the concept of arbitrability in England see section V. 2.3 and for a discussion of subjective and objective arbitrability concerning core and non-core, or arbitrable and non-arbitrable dispute matters in insolvency in England see section VI. 3.2.

*Public Policy*: The House of Lords has public policy has been defined as ‘that principle of law which holds that no subject can lawfully do that which has a tendency to be injurious to the public or against the public good’<sup>94</sup>. Definitions have remained vague, the Court of Appeal more recently issuing a similar formula, though adding that an element of illegality might suffice<sup>95</sup>. Whilst the exact definition of public policy has remained elusive in English case law, certain categories have been explicitly excluded: in particular, it has been made clear that an award is not to be set aside on the basis that the court would have decided the

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<sup>92</sup> *Blackburn v Attorney General* [1971] 2 All ER 1380

<sup>93</sup> E.g. kompetenz-kompetenz, the principle by which an arbitral tribunal may rule on its own jurisdiction, found in case law from 1942<sup>93</sup>, is now covered by s.30 AA

<sup>94</sup> *Egerton v Brownlow* (1853) 4 HLC 1

<sup>95</sup> *DST v Rakoil* (1990) 1 A.C. 295



matter differently. In *Omnium de Traitement et de Valorisation SA v Hilmarton Ltd*<sup>96</sup> it was held that ‘it is relevant that the English court is considering the enforcement of an award, and not the underlying contract.... It is entitled to take the view that such domestic public policy considerations as there may be, have been considered by the Arbitral Tribunal’. This has been affirmed in the recent case of *Pencil Hill Limited v US Citta Di Palermo S.p.a*<sup>97</sup>, where it was held that an arbitral award, which gave effect to a penalty clause that would be ineffective under English law, was enforceable in England. However, the case of *Soleimany v Soleimany*<sup>98</sup> illustrates that the benefit of the doubt will not always be given to the arbitral tribunal in situations where arbitration is being used to circumvent English law, holding that ‘an enforcement judge, if there is prima facie evidence from one side that the award is based on an illegal contract, should inquire further to some extent’. The courts display a tendency to presume enforceability of awards, only raising the question of a public policy defence in cases of prima facie illegality. In the case of insolvency, it is unlikely that an award defining the relationship between creditor and insolvent party will prima facie offend public morals to draw the attention of an enforcement judge. Due to the public interest in managing an insolvent company there is a risk that where the award is intended to undermine the claims of other creditors, or would undermine the possibility of keeping the company as a going concern, the court may intervene on the basis of public policy. However, in all but the most extreme cases public policy is unlikely to prove a barrier to enforcement: in the words of Borrough J, public policy is something of a last resort, and ‘is never argued but where other points fail’<sup>99</sup>.

### **3.4 Russia**

The relevant provisions on the enforcement of international arbitral award in Russia are Artt. 35 and 36 of the Russian Law on Arbitration. Art. 35(1) provides that an arbitral award is to be recognized and enforced, irrespective of the award’s country of origin, subject to the ground for a refusal set out in art.36. The grounds provided under art.36 are a repetition of the grounds provided under the New York Convention Art.V. Of interest for present purposes are

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<sup>96</sup> *Omnium de Traitement et de Valorisation SA v Hilmarton Ltd* (1999) 2 All ER (Comm) 146

<sup>97</sup> *Pencil Hill Limited v US Citta Di Palermo S.p.a* (2016) WL 212897

<sup>98</sup> *Soleimany v Soleimany* (1998) 3 W.L.R. 811

<sup>99</sup> *Richardson v Melish* (1824) 2 Bing 229

the defenses of arbitrability and public policy, which, as under the New York Convention art. V(2)(a) and (b), the court may examine *ex officio*.

*Arbitrability*: Art.1(2) of the Russian Law on Arbitration sets broad guidelines for arbitrability in Russian law: it deems arbitrable those disputes resulting from contractual and other civil law relationships arising in the course of foreign trade and other forms of international economic relations, provided that the place of business of at least one of the parties is situated abroad, disputes arising between enterprises with foreign investment, international associations and organizations established in the territory of the Russian Federation, disputes the participants of such entities, and disputes between such entities and other subject of Russian law. Art. 1(4) states that art.1(2) shall not affect any other law, which explicitly prohibits the submission of certain disputes to arbitration. Further to this, a similar provision can be found in art. 4(6) of the Commercial Court Procedural Code, requiring the explicit exclusion of a dispute from submission to an arbitral tribunal.

The only law to explicitly prohibit the arbitration of certain disputes is the Federal Law on Insolvency (Bankruptcy) art. 33(3), which explicitly states bankruptcy issues may not be submitted to an arbitral tribunal. Whilst this narrows the scope of the role that arbitration may play in arbitration where one party is insolvent, this provision does not totally preclude arbitration. Rather the question turns on when the bankruptcy proceedings are initiated in relation to the stage that the arbitral proceedings have reached. Where at the time of the initiation of bankruptcy proceedings, the court has already made the referral to arbitration, the arbitral tribunal will retain jurisdiction to decide the dispute<sup>100</sup>. Similarly, where the arbitral award has already been delivered by the time that one of the parties is declared insolvent, the subsequent insolvency of the party will not necessarily render an award unenforceable for inarbitrability. An arbitral award may be registered alongside the claims of other creditors as long as this is done before the relevant deadline. A relevant consideration in this respect is that Russian insolvency procedures tend to move at a rapid pace: if the arbitral proceedings are at a relatively late stage at the time of the initiation of insolvency procedures, it may be worth seeing arbitration through; however, if the arbitral procedures are at an early stage, it may be wise to re-file the claim with the court overseeing the bankruptcy proceedings

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<sup>100</sup> См . Решения МКАС при ТПП РФ от 24 января 2000 г . по делу № 417/1998, от 17 сентября 2002 г . по делу № 38/2002 и от 11 ноября 2002 г . по делу № 52/2002.

pursuant to art. 63(1) of the Federal Law on Insolvency (Bankruptcy)<sup>101</sup>. The initiation of arbitration after a declaration of bankruptcy, on the other hand, would likely prove futile: even were the tribunal to hand down an award against the insolvent party, it would be unenforceable in Russia.

*Public Policy:* Public policy is not defined in the Russian Law on Arbitration; and in Procedural Code of the Commercial Court the only expansion on the concept is the use of the synonymous phrase ‘fundamental principles of Russian law’<sup>102</sup> in arts. 233 and 239. Thus it has fallen largely to the courts to develop the concept of public policy within the context of international arbitration.

In a review of the 30 enforcement decisions between 2002, when the commercial courts gained exclusive jurisdiction of such matters, to 2008, Karabelnikov and Pellew identified the misuse of the public policy defense as a recurring theme<sup>103</sup>. More recently, White and Case published that of the 43 foreign arbitral awards refused in Russia between 2008 and October 2015, 24 of these were refused on the ground of public policy<sup>104</sup>. Further to this, of the 89 cases mentioned in the 2015 IBA Russian review of the public policy defense<sup>105</sup> by Artur Zurabyan and Andrey Panov, in 42 cases the court refused enforcement. Whilst these statistics may seem disheartening for a potential claimant at first, there is a clear demarcation between cases decided before 2013, and those decided after: the reported cases for 2012 show 2 cases in favour of enforcement, and 10 cases in favour of refusal; 2013 shows 6 cases in favour of enforcement, and 8 cases in favour of refusal; and 2014 shows 8 cases in favour of enforcement, and 6 cases in favour of refusal.

A major reason for this change in the rate of enforcement are the two informational letters, Nos. 96 and 156, by the Presidium of the Supreme Commercial Courts dating from 2005 and 2013 respectively. In the former letter, the Presidium gives confusing direction, seemingly

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<sup>101</sup> See further: Roman Khodykin, Insolvency and International Commercial Arbitration in 'International Commercial Arbitration Review, 2010, issue 1, p21-22

<sup>102</sup> Original Russian: основополагающие принципы российского права'

<sup>103</sup> Boris Karabelnikov and Dominic Pellew, Enforcement of International Arbitral Awards in Russia – Still a Mixed Picture, ICC International Court of Arbitration Bulletin – Vol. 19/No. 1, 2008, pp. 65-85

<sup>104</sup> White and Case, Statistics on Recognition and Enforcement of Foreign Arbitral Awards in Russia (20 Oct 2015)

<sup>105</sup> Accessible at: <http://www.ibanet.org/Document/Default.aspx?DocumentUid=DE3F83FA-02C0-4010-AB85-DF9583DE6668>

setting different standards of review for domestic and international arbitration: the two cases cited in support of prohibiting a review on the merits in considering public policy are domestic arbitration cases; on the other hand, paragraphs 29 and 30, which cite cases of international arbitration, refer to public policy as based on the equality of parties within civil law relations, on good faith in the parties' conduct, and the proportionality of civil liability in cases of breach, taking account of the parties' fault. In setting public policy in such terms, the Presidium created a test that necessitates an examination of the merits by courts in considering the public policy defense. In particular, the citation of the case in paragraph 29 explicitly states that the court reviewed the matter afresh in refusing enforcement<sup>106</sup>.

The latter informational letter, No 156 of 26 February 2013, starts by directly contradicting the previous letter. The headline of paragraph 1 states that no court may review the subject-matter of a foreign arbitral award in considering the defence of public policy. Later in paragraph 1, the letter sets out the description public policy given by the court in the case cited: 'the court pointed out that by public order... is understood the fundamental legal roots (principles) of the utmost imperative nature, universality, which are of particular social and public significance, and which form the foundation of the economic, political, and legal system of the state'<sup>107</sup>. The cited case further linked the concept of public policy to meta-mandatory norms of Russian law, as described in art. 1192 of the Civil Code where otherwise there would be damage to the sovereignty or safety of the state, where the interests of large social groups are concerned, and where constitutional rights and freedoms of individuals would be infringed. Paragraph 2 adds that the relevant question is not whether the arbitral award contravenes public policy, but whether the effect of enforcing it would do so. Though it predates informational letter No. 156, an example of where these principles have been correctly applied within the framework of bankruptcy is decision of the Federal Commercial Court of Western Siberia of 10 April 2008<sup>108</sup>. In this case the court refused the enforcement of an arbitral award for the payment of a debt by an insolvent party: the court stated that this

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<sup>106</sup> Original Russian: При новом рассмотрении дела и после исследования поставленных вопросов арбитражный суд отказал в признании и приведении в исполнение арбитражного решения, поскольку последствия исполнения подобного решения противоречат публичному порядку Российской Федерации, основанному на принципах равенства сторон гражданско-правовых отношений, добросовестности их поведения, соразмерности мер гражданско-правовой ответственности последствиям правонарушения с учетом вины

<sup>107</sup> Original Russian: суд указал, что под публичным порядком... понимаются фундаментальные правовые начала (принципы), которые обладают высшей императивностью, универсальностью, особой общественной и публичной значимостью, составляют основу построения экономической, политической, правовой системы государства

<sup>108</sup> No Ф04-2401/2008(3600-A45-12)

would undermine the principles underlying bankruptcy proceedings, in particular that of *pari passu*, and thus that the enforcement of the award would contravene public policy.

It is, however, important to qualify this legal position for two reasons. Firstly informational letter No.96 may still inform some court decisions in as much as there is more case law decided on this basis than under the newer informational letter No.156. As a result, counsel for parties still try to invoke interpretations under the previous letter when disputing arbitral awards, and judges less experienced in arbitration law are still swayed by such arguments. The second reason for the possible instability of the current legal position of public policy in Russia is that both informational letters were issued by the former Supreme Commercial Court: in August 2014 the Supreme Commercial Court and the Supreme Court of Russia were merged into a single Supreme Court. Practitioners have noted that many of the Supreme Commercial Court judges have not been transferred to the new unified Supreme Court. As a result, the judges who issued informational letter No. 156 are not the same judges that currently sit in the Supreme Court; rather the Supreme Court is populated by judges who are less experienced with dealing commercial law, including arbitration.

## **VI. Insolvency and Arbitration: The Clash of Contract and Coercion in Practice**

### **1. Introduction**

Based on the analysis of insolvency in section III. and the comparative-approach presented in section IV., the national legal and extra-legal framework for distressed debt management for the United States in section VI. 2, for England in section V.3, and for Russia in section VI. 4 shall be discussed in this chapter. Since the benchmark test for the question of the arbitrability of dispute matters in insolvency is linked to the policy of the national insolvency system, such a bird-eye analysis of the insolvency systems in the jurisdictions of investigations is decisive. Subsequently, in sections VI. 2.2., VI. 2.3, and VI. 2.4 the question of the arbitrability of dispute matters in insolvency shall be discussed for the United States, England, and Russia, respectively. The analysis in sections VI. 2.2, VI. 2.3, VI. 2.4 is based on section V., in which the concept of arbitration was discussed per country. It answers to the specific question which insolvency matters may be subject to dispute resolution in the forum of an arbitral tribunal and which matters will have to be decided in the forum of the insolvency court instead. In section VII. the approach of insolvency and limitations on arbitrability involving insolvent parties will be comparatively discussed.

### **2. The United States**

#### **2.1 The Concept of Distressed Debt Management in the United States**

The US is often referred to as the textbook example of a debtor-friendly insolvency regime, with labels attached to the US approach in dealing with distressed debt such as “second chance” or “fresh start”. This is in particular the case since the Bankruptcy Reform Act of 1978. Most adequately, the US insolvency approach can be identified as an ex post oriented regime, with the extra-legal lending structure and the legal insolvency and restructuring framework traditionally corresponding with the characteristics of ex post debt management.<sup>109</sup> Some significant changes in the law and the patterns of lending behaviour call into question the consistency of the current legal design for ex post debt management.

Traditionally, the US has been a country where debtors, and this is in particular true for large enterprises, have sought funds on the debt capital markets by public bond offerings. Bank debt financing has always played a minor role if compared with bond debt financing for the

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<sup>109</sup> See section III. 3.

after WW II period; and the trend continues. The major concern has thus been that creditors, each of them with a relatively small debt share and with no long-term business relation to the debtor and amongst each other, would stand in a poor position to effectively monitor and control the debtor. In the vicinity of insolvency, this leads to major problems of value-destruction. Reasoning that the creditors could not manage the debt and navigate the debtor's firm in their own interest, it was crucial to find a reliable captain instead who would make value-maximising decisions. Chapter X of the pre-1978 Bankruptcy Code placed the reorganisation procedure under the powerful oversight of a bankruptcy judge. Chapter 11 of the current Bankruptcy Code 1978 follows another approach and has prominently shaped the impression of the US as the paragon of a debtor-/reorganisation-friendly insolvency law, the uncontested saviour of the struggling firm being the troubled debtor itself. This approach is grounded on the assumption that, first, the firm's struggle is not necessarily related to the debtor's mismanagement but that it can also be the result of external factors, that second, the debtor's supreme firm-specific knowledge should be used for the rescue mission, and that eventually, it should be in the debtor's own interest to facilitate a rescue procedure which is expected to create value to be shared by the debtor and its creditors.

In order to make the reorganisation procedure the first best option in the debtor's interest, the US insolvency law design protects and empowers the debtor. With the rare exception of external management by a trustee,<sup>110</sup> the debtor remains in charge of running the business.<sup>111</sup> A defensive stay allows the debtor to conduct its affairs without being torn apart by creditors collecting their debt.<sup>112</sup> Contracts which would be terminated or modified<sup>113</sup> or which would foresee the transfer of the debtor's property<sup>114</sup> upon the event of insolvency—typically to the debtor's and the body of creditor's ex post disadvantage—are invalid. A preferred ranking for debtor-in-possession financing secures the inflow of fresh capital.<sup>115</sup> The debtor is not only the manager of its business but has the exclusive right to propose a restructuring plan within the first 120 days to 18 months.<sup>116</sup> This plan may grant the debtor itself a share of the estate even though its creditors will not receive full satisfaction. The approval by two-third in value

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<sup>110</sup> § 1104, Chapter 11, 11 U.S. Code.

<sup>111</sup> § 1107, Chapter 11, 11 U.S. Code.

<sup>112</sup> § 362, Chapter 3, 11 U.S. Code.

<sup>113</sup> § 365(e), Chapter 3, 11 U.S. Code.

<sup>114</sup> § 541(c)1(B) Chapter 5, 11 U.S. Code.

<sup>115</sup> § 364 (a)–(d) Chapter 3, 11. U.S. Code.

<sup>116</sup> § 1121(b), Chapter 11, 11 U.S. Code.

and half in number of creditors of one class binds all creditors within the respective class of creditors holding impaired claims.<sup>117</sup> A cram-down approval by court order can take place where at least one impaired class voted in favour of the plan and where the plan does not ‘discriminate unfairly’ and is ‘fair and equitable’.<sup>118</sup> The public ordering response to distressed debt puts the debtor in a quite strong position.

The public ordering solution is, however, not only the first best option because of its institutional strength but because of a factual monopoly for cases of severe distress created by public ordering regulation. A viable alternative to the public ordering procedure would be a private ordering debt restructuring. Because of the typically dispersed body of creditors in the US, such a solution would require an institutional design by contract that would encompass a binding majority voting option. This alternative does not exist because of sec 316(b) Trust Indenture Act 1939 which prohibits a binding vote on payment terms.<sup>119</sup> The long practiced side-step strategy of the exit consent is called into question with recent decisions in *Marblegate II*<sup>120</sup> and *Ceasers*.<sup>121</sup> In the exit consent strategy, consenting creditors traded their bonds for new titles with reduced principal and/or interest in consideration for their approval of the amendment of the original bonds’ protective non-payment terms in disfavour of the holdouts so as to incentivize cooperation. This restriction on private ordering restructuring solutions in context of the dispersed lending structure has led to a stark concentration in the public ordering procedure for cases which make a debt reduction necessary.

The concept of a consequent ex post oriented insolvency regime, however, is challenged by changing extra-legal and legal circumstances. While creditors still tend to abstain from coordinating for investments into value-creating ex ante debt management, certain creditors, namely large institutional investors, tend to assume a more proactive role once the debtor is in distress. While creditor activism itself can be a substitute, equally or even more effective strategy if compared to a debtor-oriented model, this is only the case as long as creditors monitor and control ex ante and ex post. If, however, creditors first claim responsibility and control when the debtor’s distress becomes public while they abstain from action and

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<sup>117</sup> § 1126(b), Chapter 11, 11 U.S. Code.

<sup>118</sup> § 1129(b) Chapter 11, 11 U.S. Code.

<sup>119</sup> For a discussion see Mark Roe, *The voting prohibition in bond workouts* 97 Yale Law Journal 232 (1987).

<sup>120</sup> *Marblegate Asset Management LLC. v Education Management Corporation*, No 14 CIV. 8584 (KPF) 2015 WL 3867643 (Bankr. S.D.N.Y. June 23, 2015).

<sup>121</sup> *Meehancombs Global Credit Opportunities Master Fund, LP et al v Ceasers Entertainment et al*, No. 14-CV-7091 (SAS) (S.D.N.Y. January 15, 2015).



monitoring investment for as long as they believe the debtor to be solvent, this will often rather worsen than mitigate the problem. The legal design of the ex post oriented regime works on the assumption that the debtor is given a strong incentive to choose the cooperative insolvency option over risky and, in an expected value calculation, value-destroying turn-around manoeuvres. If the cooperative insolvency option becomes less attractive for the debtor because active and powerful creditors threaten the debtor's privilege, the debtor will try to disguise the signs of distress and delay insolvency. In the absence of similar developed creditor activism in monitoring and ex ante debt management, the rise of ex post creditor activism is neither in the interest of the debtor nor of the body of creditors. The instrument by which such institutional investors extend their influence over the debtor are the DIP financing contracts. In exchange for funds, they request tight control and protective covenants with which they can keep the debtor on a short leash.<sup>122</sup> The extension of safe harbour provisions for qualified financial contracts which will be exempt from the automatic stay, the ipso facto protection, and avoidance powers in the interest of reducing systematic risks and increasing the tradability of financial products<sup>123</sup> and the reduction of the exclusivity period to a maximum of 18 months with the Bankruptcy Abuse Protection and Consumer Protection Act 2005<sup>124</sup> have further contributed to a weakening of the ex post attractiveness of insolvency as a debtor's choice.

In a nutshell, the US framework for dealing with distressed debt could be described as traditionally ex post oriented, with a stark concentration in the public ordering procedure, and with pre-insolvency entitlements being impaired for the policy goal of setting the right incentives for the captain.<sup>125</sup> The aforementioned legal and extra-legal developments have on the one hand weakened the consequent ex post orientation and at the same time reduced the scope for workable private ordering alternatives.

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<sup>122</sup> On the problem of DIP-financing see: David Skeel, *The Past, Present and Future of Debtor-in-Possession Financing* 25 *Cardozo Law Review* 1905 (2004).

<sup>123</sup> For a critical analysis of safe harbour privileges see: Steven Schwarcz, *Derivatives and Collateral: Balancing Remedies and Systematic Risk* 2 *University of Illinois Law Review* 699 (2015); Steven Schwarcz, *The Bankruptcy Law Safe Harbor for Derivatives: A Path Dependence Analysis* 71 (3) *Washington and Lee Law Review* 1715 (2014).

<sup>124</sup> Section 411 Bankruptcy Abuse Protection and Consumer Protection Act 2005.

<sup>125</sup> Re-distribution, partly for efficiency (employee claims) and partly for social reasons, takes place in favour of employee claims and tax claims. See therefore: § 507 (1)(a) 1121(b), Chapter 5, 11 U.S. Code.

## 2.2 The Arbitraribility of Dispute Matters in Insolvency in the United States

The question where to draw the line, how to distinguish core from non-core matters, and subsequently how to distinguish arbitrable from non-arbitrable matters in insolvency shall be answered in this section. In *Hayes*, the court defined a core proceeding as a proceeding involving “a right created by federal bankruptcy law, or [...] one which would only arise in bankruptcy”.<sup>126</sup> In *In Re Winstar Communications Inc.*, the Delaware Bankruptcy Court stated, in reference to *In Re Slipped Disc Inc.*<sup>127</sup> and *In Re Barney's, Inc.*,<sup>128</sup> that the court shall only restrict arbitration concerning a core proceeding where a conflict with the policies underlying the Bankruptcy Code or a conflict with the rights created by the Bankruptcy Code itself would arise.<sup>129</sup> The court will, hence, take two steps. First, the court will determine as to whether a matter of dispute is a core issue or not. If it is not, the matter is, according to the prevalent view in case law, arbitrable, so that arbitration survives. Importantly, in this context, § 157(b) (2) US Bankruptcy Code provides a non-exhaustive list of core matters in bankruptcy; the extent to which any non-listed matter can be considered core is crucial. If a matter, however, constitutes a core proceeding, the court will have to decide in a second step as to whether the authorisation of individual dispute resolution in arbitration would conflict with and essentially undermine (i) the US bankruptcy policy, and/or (ii) the rights especially created by the Bankruptcy Code.

The point to be further investigated, accordingly, is not only what is a core proceeding, but what is a core proceeding which is likely to be non-arbitrable because the conflict of arbitration and insolvency has to be decided in favour of (i) the US bankruptcy policy or (ii) the rights especially created by the Bankruptcy Code. The second point of conflict (ii) is related to the definition of core issues itself, but it goes further, since it is the purpose of the second step to analyse as to whether arbitration instead of a bankruptcy court dispute resolution would jeopardise the purpose of insolvency. Courts have been eager to stress the individuality of the constellation of facts in any given dispute so as to decide if a non-listed matter can be considered core and if the matter has to be decided by the bankruptcy court therefore, or as to whether a matter which is core can be delegated to arbitration because it

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<sup>126</sup> *Hays & Company v Merrill Lynch, Pierce, Fenner and Smith*, 885 F. 2d 1149 (1989) at footnote 9.

<sup>127</sup> *In re Slipped Disc Inc.*, 245 B.R. 342 (2002).

<sup>128</sup> *In re Barney's, Inc.*, 206 B.R. 336 (1997).

<sup>129</sup> *In re Winstar Communications Inc.*, 335 B.R. 556 (2005).

does not have to be decided in the bankruptcy forum. Some flexibility might be crucial for the purpose of an ex post efficient outcome, i.e., the rescue of the firm and the value-maximisation for the distribution to creditors. Certainty, however, is important from an ex ante perspective.

In order to bring some light into the dark and to answer the forenamed question what are core proceedings which are likely to be non-arbitrable, one can resort to three sources: First, even though § 157(b)(2) US Bankruptcy Code is non-exhaustive, it can illuminate the law-maker's intention. If the core issues named in § 157(b)(2) US Bankruptcy Code are systematically analysed, one can deduce general principles for the identification of further core-issues. If analysed in connection to case law, where courts ruled that matters are core and non-arbitrable, or, as a test of the opposite, that they are arbitrable and/or non-core, these principles can be confirmed. Eventually, a recourse to section VI. 2.1, i.e., to the policy of the US approach towards debt crisis resolution/insolvency provides an analytically important source for this part. A discussion of the US bankruptcy policy in respect to core proceedings of insolvency may be of at least as much value as the discussion of specific case law. As the court in *In Re Farmland Industries Inc.* held, the reference to analogous cases in which, for instance, it was decided that a specified core-matter would be non-arbitrable, has no exclusive authority, and cannot be taken as a guarantee that a court will, in the future, declare an analogous dispute question to be arbitrable or non-arbitrable. The court must decide with regard to the underlying bankruptcy policy in application to the individual case,<sup>130</sup> e.g., with regard to the policy goal of a collective and centralized procedure in contrast to piecemeal liquidation.<sup>131</sup> In consequence, the court has to concentrate, most importantly, on the underlying policy decisions of the Bankruptcy Code when making a balancing decision in favour or disfavour of the arbitrability of a matter of dispute in insolvency.<sup>132</sup> From the suggested 'three source analysis' the following categories can be deduced:

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<sup>130</sup> *In Re Farmland Industries Inc* 309 B.R. 14 (2004) at footnote 20. As a side-note, in *Re Farmland Industries*, the court held that the dispute resolution of the present core issue would not endanger the US Bankruptcy policy, as the facts in this specific case were presented. And since it would also be a US policy goal to support arbitration where possible, the court allowed the dispute to be decided in arbitration.

<sup>131</sup> *In Re Gandy*, 299 F.3d 489 (2002) at 500.

<sup>132</sup> In this line, also the Eleventh Circuit Court of Appeal, in *Re Electric Machinery* 479 F.3d 791 (2007) at 796., held that it would be decisive for the question if an arbitration tribunal could rule on a matter of dispute involving an insolvent party to "examine whether an inherent conflict exists between arbitration and the underlying purposes of the Bankruptcy Code." The court applied the *McMahon* test to investigate the law-makers intention and focusing on the underlying purpose of the statute. For the *McMahon* test see: *Shearson/American Express Inc v. McMahon* 483 U.S. 220 (1987) at 226. A very diligent case law analysis, discussing various pre-2008 cases, which are also analysed in this paper, and several more, is provided by Mark

(1) *Matters concerning the collective decision-making process (restructuring)*: Key stone of the Bankruptcy Code after its reform in 1978 become the collective voting process<sup>133</sup>—with less court supervision in case that all classes would approve the plan by the required majority and a substantive court revision in case of a cram-down approval. The purpose of the voting process is to create a collective decision process. The individual creditor has to take a step back and subordinate his unconditional contractual claim to the result of a binding majority vote to which he may contribute but which he has to accept as binding even though he voted differently than the majority. An arbitration tribunal can, thus, not revise a matter concerning the collective decision proceeding, since such a proceeding is inherently based on a right of the body of creditors arising from the Bankruptcy Code which would not be a matter of dispute out of insolvency. Consequently, 157(b)(2) stipulates in (B)<sup>134</sup> and (L)<sup>135</sup> that the allowance of claims for the vote and the confirmation of the plan are core to insolvency, these matters those the policy decision of the law-maker to transfer individual contractual choice into a collective procedure.

(2) *Matters concerning the going-concern of the debtor (reorganisation / restructuring)*: The major and distinguishing characteristic of the US approach to deal with distressed debt, as outlined in V. 2., is that the debtor gets a second chance to turn-around its business. Importantly, the debtor can do so as a debtor-in-possession with trustee-powers and special powers which the debtor would not have outside of insolvency, i.e., with privileges arising from the Bankruptcy Code

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Salzberg and Gary Zinkgraf, *When Worlds Collide: The Enforceability of Arbitration Agreements in Bankruptcy* 37 (1) Franchise Law Journal (2007). Salzberg and Zinkgraf distinguish in their analysis by court circuit.

<sup>133</sup> Before the 1978 reform, the court extended its substantive review also to cases where all classes approved the plan under then Chapter X.

<sup>134</sup> See § 157(b)(2)(B) Chapter 1, 11 U.S. Code. “allowance or disallowance of claims against the estate or exemptions from property of the estate, and estimation of claims or interests for the purposes of confirming a plan under chapter 11, 12, or 13 of title 11 but not the liquidation or estimation of contingent or unliquidated personal injury tort or wrongful death claims against the estate for purposes of distribution in a case under title 11”. See also § 157(b)(2)(C) Chapter 1, 11 U.S. Code. “counterclaims by the estate against persons filing claims against the estate“. In respect to § 157(b) Chapter 1, 11 U.S. Code it is to note the Supreme Court’s decision in *Stern v Marshall* 564 U.S. 2 (2011) that a bankruptcy court may not decide in a final judgement a counterclaim which would not arise as a matter of insolvency law, since this would be a matter to be decided by a Article-III judge (a life-time appointed judge; bankruptcy judges are appointed for 14 years instead). Recently, the Supreme Court clarified in *Wellness International Network v Sharif*, 135 S.Ct. 1932 (2015), that the parties can, however, consent that the case may be decided by the bankruptcy judge.

<sup>135</sup> See § 157(b)(2)(L) Chapter 1, 11 U.S. Code. “confirmations of plans”.

itself (and not from contract). These privileges are the provisions logically corresponding to an ex post oriented approach to deal with distressed debt. It is the law-makers policy decision to grant special rights, so that the debtor has a good chance to rescue the business and to maximise the value of the assets in the interest of all parties concerned, and similarly important, that the debtor has an incentive to enter the procedure sufficiently early. If an arbitration tribunal could decide to cancel the debtor's "bankruptcy privileges" which the debtor received so as to realise its second chance, this would not only question a special right conferred to the debtor by the Bankruptcy Code, but it would significantly undermine the law-maker's policy decision to create an ex post oriented public ordering law. Hence, sec 157(b)(2) regulates that "matters concerning the administration of the estate"<sup>136</sup> and "orders in respect to obtaining credit"<sup>137</sup> and "motions to terminate, annul, or modify the automatic stay"<sup>138</sup> are core proceedings. As a matter Also, the recognition of foreign proceedings and other matters under chapter 15 of title 11" affects the way the insolvency procedure is conducted in relation to foreign jurisdictions and is, thus, a matter of the collective procedure and not a matter of contract.<sup>139</sup> If a debtor shall be given the chance of a re-birth, the discharge of debts in insolvency will be core matter to be generally decided in the bankruptcy court forum.<sup>140</sup>

(3) *Matters concerning the concentration of the firm's assets available for distribution and the fair and equitable treatment of creditors:* The US Bankruptcy Code contains multiple provisions: (i) to avoid past transfers so as to increase the common pool of assets, so as to assure that individual creditors cannot jump the

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<sup>136</sup> See § 157(b)(2)(A). Chapter 1, 11 U.S. Code. The debtor-in-possession option of the administration of the estate is the "trademark" of Chapter 11.

<sup>137</sup> See § 157(b)(2)(D). Chapter 1, 11 U.S. Code. The inflow of fresh capital is core. If the arbitration tribunal could restrict the debtor's right to acquire credit, the arbitration tribunal could, essentially, decide to cut off the capital inflow for the debtor, and in consequence, to factually, end the reorganisation process. Clearly, a collective ex post oriented regime in public ordering can, in this matter, only be subject to the judicial revision by the bankruptcy court and not by a court entitled by a contract.

<sup>138</sup> See § 157(b)(2)(G) Chapter 1, 11 U.S. Code. The US policy decision to protect the debtor's estate, to build a strong and defensive fence, and to increase the assets available for the collective procedure is supported by § 362 and core for the effective management of the estate by a debtor-in-possession or trustee. Only as long as the debtor is properly fenced against disruptive individual action, Chapter 11 remains the superior option for the debtor if compared with risky outside manoverous.

<sup>139</sup> The § 157(b)(2)(P) Chapter 1, 11 U.S. Code.

<sup>140</sup> See § 157(b)(2)(I) Chapter 1, 11 U.S. Code. "determinations as to the dischargeability of particular debts" and § 157(b)(2)(J) "objections to discharges". See therefore: *Matter of National Gypsum Co*, 118 F.3d 1056 (1997). as decided by the Fifth Circuit Court of Appeal.

queue and avoid the collective debt collection, and, crucially from an ex ante perspective, so as to disincentivize a run on the assets; (ii) provisions to regulate what belongs to the property of the debtor's estate and what has to remain in the debtor's property, i.e., what is available for the collective debt distribution; and, (iii) provisions to regulate the inter-creditor relations regarding the schedule and ranking of claims.

While the arbitral tribunal may decide matters which could arise out of insolvency, but which happen to fall into the time when the debtor is insolvent, the arbitral tribunal's power to decide matters which would question bankruptcy rights essential for the realisation of the policy goals of the US insolvency approach is naturally excluded. § 157(b)(2) names core proceedings of the forenamed types (i), (ii), and (iii). As such, provision of type (i) contain a special bankruptcy privilege which is not related to the question of the contract subject to arbitration but to special circumstances of preferential treatment or even a fraud which disadvantages other creditors.<sup>141</sup> Such core matters, regularly, have to be decided in the bankruptcy forum.<sup>142</sup> Provisions of type (ii) are concerned with the question as to whether an asset should be available for distribution to all creditors. If arbitral tribunals could pick away assets from the debtor's property by creating such an award, this would be an extraordinary privilege, which would, if the asset were of substantial value, make the collective procedure redundant.<sup>143</sup> Provisions of type (iii) regulate the inter-creditor conflict which only arises in the case of scarcity of resources, i.e., in case of the original common pool conflict of

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<sup>141</sup> See § 157(b)(2)(F) Chapter 1, 11 U.S. Code. "proceedings to determine, avoid, or recover preferences" and § 157(b)(2)(H) Chapter 1, 11 U.S. Code. "proceedings to determine, avoid, or recover fraudulent conveyances". A recently decided case by District Court for the Southern District of Texas illustrates that the court has to distinguish carefully as to whether a right in dispute is one which arises because of an insolvency right to avoid fraudulent transfers such as § 548, Chapter 5, 11 U.S. Code or if a fraud claim brought forward by the debtor could not similarly arise based on contract and statutory fraud and tort claims. Additionally, the court will have to examine as to whether an order would, in fact, undermine the purpose of the Bankruptcy Act (as discussed in this section for type (3)(i) proceedings) before it decides to grant or to dismiss a motion to compel with arbitration. In the present case, the court allowed the dispute to be decided in arbitration and disagreed with the debtor who had tried to shift the process to the insolvency forum. See therefore: *Elite Precision Fabrications Inc. v Gen. Dynamics Land SYS, Inc.* Case No. H-14-2086 (2015).

<sup>142</sup> See *In re Ghandy* 299 F.3d 489 (2002) and *In re Bethlehem Steel Corporation*, Case Nos. 01-15288 through 01-15302, 01-15308 through 01-15315 (Bankr. S.D.N.Y. July 15, 2008).

<sup>143</sup> See § 157(b)(2)(E) Chapter 1, 11 U.S. Code. "orders to turn over property of the estate" and therefore § 157(b)(2)(N) (N) orders approving the sale of property other than property resulting from claims brought by the estate against persons who have not filed claims against the estate".

insolvency (see section II. 3.).<sup>144</sup>

To sum up, in insolvency a stark concentration takes place, and this for the purpose of realising the policy goals of insolvency. Arbitration, in contrast, is a decentralized private ordering procedure which is based purely on contractual legitimation. The conflict between an individual (inter partes) and a collective proceeding is obvious. In the US, this conflict is resolved as follows: Since the US ratified the New York Convention and since the US courts followed the lead of *Scherk*, the general understanding has been that courts should support and not hinder arbitration. This does, however, not mean that the parties to a contract can extend the decision-power of the arbitration tribunal to matters which essentially concern third-parties and which would question the law-maker's command, expressed in statutes, in this case the Bankruptcy Code, to which all parties (with or without an arbitration agreement) have to subject their contractual rights. The conflict will be decided in two steps: (i) Is the matter of dispute a core proceeding of insolvency? If so, (ii) Would it undermine the law-makers command as expressed in the design of the Bankruptcy Code if this matter were decided by an arbitration court? Both questions relate to (i) the special rights created by the Bankruptcy Code and (ii) the law-makers policy decisions as expressed in the law. The courts have taken a quite liberal approach, when answering, especially, the second question in context of the facts of the individual case. In order to contribute to the clarification of the conflict question raised, three categories were identified and discussed with reference to the law-makers policy goals as expressed in the Bankruptcy Code and relevant case law:

*(1) Matters concerning the collective decision-making process.*

*(2) Matters concerning the going-concern of the debtor.*

*(3) Matters concerning the concentration of the firm's assets available for distribution and the fair and equitable treatment of creditors. The last category being concerned with (i) special bankruptcy privileges which are not related to*

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<sup>144</sup> See § 157(b)(2)(K) Chapter 1, 11 U.S. Code. "determinations of the validity, extent, or priority of liens" and § 157(b)(2)(M) Chapter 1, 11 U.S. Code. "orders approving the use or lease of property, including the use of cash collateral" and 157(b)(2)(O) Chapter 1, 11 U.S. Code. "other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity security holder relationship, except personal injury tort or wrongful death claims". Also § 157(b)(2)(B) Chapter 1, 11 U.S. Code as for the "allowance or disallowance of claims against the estate or exemptions from property of the estate, and estimation of claims or interests" fits well into this category and, in so far, overlaps with the classification in (1) *Matters concerning the collective voting process of the creditors (restructuring)*. See also § 157(b)(2)(C) Chapter 1, 11 U.S. Code. "counterclaims by the estate against persons filing claims against the estate".

*the question of the contract subject to arbitration but with special circumstances of preferential treatment or fraud; being concerned with (ii) the question as to whether an asset should be available for the distribution to all creditors; and being concerned with (iii) matters regulating the inter-creditor conflict.*

If a matter of dispute falls within one of these categories, the bankruptcy court will determine, considering the special circumstances of the case, as to whether the dispute question has to be decided by the bankruptcy court so as to give effect to the law-maker's command, as for the policy goals underlying the US approach to resolve debt crisis in the public ordering forum. Note in this context, that it is well possible that a case falls within two or more of the forenamed categories at the same time. For instance, if a matter of dispute if decided by an arbitration court would threaten to tear the debtors assets apart to essentially a piece-meal liquidation, this would, potentially, not only affect the 'going-concern of the debtor' (2) but also the 'concentration of assets' and 'fair and equitable treatment' (3)(ii)(iii) purposes of the Bankruptcy Code.<sup>145</sup>

If, however, a matter of dispute did not fall within the respective categories and could well arise out of insolvency, courts did not hesitate to allow arbitration.<sup>146</sup> Even if a proceeding was a core proceeding, courts have, in the second step, decided that this matter of dispute could be decided by arbitration because it was not necessary to rule on this issue in the bankruptcy forum in order to give effect to policy goals of insolvency, as, for instance, in *In re Farmland Industries* and *In re Mirant Corporation*.<sup>147</sup> Courts are willing to support the

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<sup>145</sup> See for instance: *Re Thorpe Insulation* decided by the Ninth Circuit Court of Appeal (No. 10-55744) (2012). In a more recent case concerning the proof of a claim in a Chapter 13 case, the court held that it was within its and not within the arbitration court's authority to decide a matter of proof which did affect the debtor substantially in its effort to reorganise. The court, however, held in the same case that a claim for damages as a counterclaim by the debtor could be dealt with by the arbitration court. See therefore the Fourth Circuit Court of Appeal's decision in *Moses v Cashcall*, No. 14-1195 (2015).

<sup>146</sup> See therefore: *In re Orion Picture Corporation* 4 F.3d 1095 (1993) and *In re Cooker Restaurant Corporation* 292 B.R. 308 (2003). In *re Orion Picture Corporation*, the defendant Showtime submitted that the bankruptcy court had wrongly decided to assume the dispute about the question as to whether Showtime was in breach of its contract with the insolvent party which Showtime had stopped to perform (post-petition) because the plaintiff Orion had, as Showtime argued, breached a "key-man" clause, which required the debtor to employ at least two out of four named managers in specified positions (pre-petition). The Second Circuit Court of Appeal agreed with the defendant and held that the matter of dispute may be decided by arbitration. In *re Cooker Restaurant Corporation*, the Southern District Court of Ohio allowed arbitration, reversing the bankruptcy court's decision, holding that the question as to whether a the insolvent party has not complied with the payment provisions of a settlement agreement before the debtor eventually became insolvent can be decided by way of arbitration.

<sup>147</sup> *In re Mirant Corporation* 316 B.R. 234 (2004). In this case, a Texas bankruptcy court allowed arbitration on the matter of dispute in a core proceeding concerning the "proof of a claim", i.e., sec 157(b)(2)(B). The court found, however, that a decision about the proof of the claim, as it was relatively small, would not impair the purpose of reorganisation.



dispute resolution in arbitration as long as the law-maker's command as expressed in the Bankruptcy Code's design is not counteracted by the private ordering agreement to arbitrate.

### **3. England**

#### **3.1 The Concept of Distressed Debt Management in England**

The UK restructuring and insolvency law model in its present form comes closest to the 'creditors' bargaining' ideal of an insolvency regime as it would be designed to preserve pre-insolvency entitlements and to uphold contractual agreements to the highest possible degree when transferred to a collective debt management regime.<sup>148</sup> A high degree of flexibility in private ordering allows for continuous adjustments of the distressed debt management solution to changing extra-legal circumstances.

In the UK, the typical provider of debt capital is a bank or, in case of large loans, a syndicate of banks. The relation between the bank and the debtor is built on a long-term lending relationship. The bank monitors the debtor's performance and acts quickly and professionally once the debtor approaches financial difficulties, with a specialised division in credit control and risk management. The bank loan covenants are tight so as to allow the bank to exert control and move the debtor into the direction in the bank creditor's interest. The loan is typically secured with a floating charge, giving the bank lender extra control powers. It can be expected that the bank will add value in promoting a diligent business strategy, in preventing unreasonable risky investments, and in contributing special expertise. The lazy or rough lender hypothesis that an over-secured bank lender would rush to enforcement does not hold; first, because of the chance for future business, and second, because of the reputation damage to the bank's lending business.<sup>149</sup> Finally, not only the lending relation between the debtor and its main creditors is based on long-term relations, but even more importantly between the bank creditors themselves. Opportunistic free rides in a single common pool problem will not emerge where the players are aware that they will have to work together in future syndicated

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<sup>148</sup> A modest re-distribution, arguably efficiency reasons, takes place in favour of employees according to sec 175, 386, Schedule 6, Category 4 and 5 Insolvency Act 1986. The 'Crown privilege' for taxes is, for good reasons, abolished since the reform of the Enterprise Act 2002 took effect.

<sup>149</sup> For the debtor-creditor relation in the UK see: Julian Franks and Oren Sussman, *Financial distress and bank restructuring of small to medium size UK companies* 9 Review of Finance 65 (2005).

loan contracts. Hence, the relation is either formalised by contract or enforced by a mutual understanding of repeated joint games, i.e., informal rules.<sup>150</sup>

The UK restructuring and insolvency law mirrors the assumptions of strong debtor-creditor and inter-creditor relations. The administrative receivership, which is about to run out, has for long been the instrument of debt management by bank lenders. The floating charge holder could appoint an administrative receiver upon the crystallization of the floating charge, whose main duty was not the management of the estate with the goal of value-maximisation but the satisfaction of the appointing charge holder's claim, i.e., a powerful enforcement agent.<sup>151</sup> With the insolvency law reform in the Enterprise Act 2002, the public ordering law-maker adopted a new course for the UK insolvency law, shifting from a rather contract-based, individualistic enforcement procedure to a collective procedure, which at least formally favours rescue over debt enforcement in liquidation. Administration is the main procedure by which means a struggled debtor shall be revived. As an external manager, the administrator runs the debtor's business and distributes the proceeds to the creditors under the protection of a stay against individual action.<sup>152</sup> A restructuring proposal by the administrator can be approved by a simple majority of creditors present and voting at a meeting or by proxy.<sup>153</sup> There does not exist a debtor-in-possession equivalent as a comprehensive and properly fenced procedure in public ordering in the UK.

There are, moreover, two capital restructuring options available for solvent and insolvent debtors which have each proven quite successful in the past—the company voluntary arrangement (CVA) and the scheme of arrangement (SoA).<sup>154</sup> The CVA allows for a binding majority decision on a restructuring plan by half in number and 75 per cent in value of creditors present and voting or voting by proxy.<sup>155</sup> A cram-down of secured creditors is not possible. In a SoA, a 75 per cent approval of creditors present or voting by proxy of a

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<sup>150</sup> For the inter-creditor relations in the UK and the so-called London Approach see: Armour and Deakin, supra-note 38.

<sup>151</sup> On administrative receivership, its benefits and flaws see: John Armour and Sandra Frisby, *Rethinking Receivership* 21 (1) Oxford Journal of Legal Studies 73 (2001).

<sup>152</sup> Section 8, SCHEDULE B1, para 59–62, 65 UK Insolvency Act 1986 on the general administrators' role and Section 8, SCHEDULE B1, para 43 UK Insolvency Act 1986 on the stay on individual legal actions.

<sup>153</sup> Section 8, SCHEDULE B1, para 53, UK Insolvency Act 1986 and, rules 2.42 and 2.43 of the UK Insolvency Rules 1986.

<sup>154</sup> On schemes of arrangement see: Louise Gullifer and Jennifer Payne, *Corporate Finance Law*, 729–763 (Hart Publishing, 2<sup>nd</sup> edn, 2015).

<sup>155</sup> Rules 1.19(1) and 1.20(1) UK Insolvency Rules 1986.

qualified class binds the respective class of creditors. There is no cram-down of an entire class and each class shall assemble creditors of similar rights.<sup>156</sup>

If a going-concern sale, reorganisation, and/or restructuring fails, the last option will be a liquidation of the debtor's assets and winding-up of the company. In this process, the directors might be held liable for their misbehaviour. Importantly, they might become liable under the wrongful trading provision for any loss occurred because their actions destroyed value for creditors in the vicinity of insolvency.<sup>157</sup> This 'stick' shall encourage sufficiently early filings for insolvency.

A shift in the traditional lending structure in the UK is taking place. Still, the majority of outstanding debt investments is held by banks. The share of public bond financing is, however, constantly increasing with debt acquisition on the capital markets even outpacing bank loans in value for certain quarters in recent years. If the trend continues, this will call into question the current design of an insolvency law which is designed for especially long-term concentrated lending relations. Fortunately, the UK bond market has traditionally shown the flexibility in contract design to cope with the challenges of a dispersed body of unrelated bondholders via collective action clauses as a private ordering debt restructuring regime.<sup>158</sup> The London-style bonds have, prominently, been an example of such prudent design in the discussion about sovereign bond debt restructuring.<sup>159</sup>

In summary, distressed debt in the UK is rather dealt with in the private than in the public ordering procedure with the public ordering procedure setting the bargaining points for private ordering negotiations. The concentration effect is, if seen from a comparative perspective, rather weak. Private autonomy is upheld to a quite high degree and transformed into a last resort insolvency procedure. Certainty prevails and the debt management by creditors begins ex ante and continues throughout the process of ex post debt crisis resolution.

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<sup>156</sup> Section 899 (1) UK Companies Act 2006. On the discussion what constitutes a class see: *Re Hawk Insurance Company Ltd* [2001] EWCA Civ 241.

<sup>157</sup> Section 214 UK Insolvency Act 1986.

<sup>158</sup> David Ehmke, *Publicly Offered Debt in the Shadow of Insolvency* 16 (1) European Business Organization Law Review 63 (2015).

<sup>159</sup> Christian Kirchner and David Ehmke, *Private Ordering in Sovereign Debt Restructuring: Reforming the London Club* 3 Oxford University Comparative Law Forum (2012).

### 3.2 The Arbitraribility of Dispute Matters in Insolvency in England

The question how the contracting parties' agreement to delegate the resolution of disputes to an arbitral tribunal is affected by insolvency, first, depends on the form of insolvency procedure and the party initiating or desiring to defend the case in arbitration: Where the debtor goes into voluntary liquidation on its owner's initiative, the liquidator can "bring or defend any action" in an arbitral procedure for the debtor on his own violation.<sup>160</sup> The liquidator, however, needs the court's permission for doing so in case of a compulsory winding up.<sup>161</sup> In administration, the arbitration agreement will be enforceable if the trustee adopts the contract<sup>162</sup> while the trustee will need the creditor's committee's consent and the court's approval to proceed in an arbitral dispute resolution if he rejects the contract.<sup>163</sup> If, however, the other party to the arbitration agreement wants to initiate or commence a procedure against the debtor in a voluntary winding up, the party may do so. There is no automatic stay in voluntary liquidation. Nonetheless, the court may, on application of the liquidator, a contributory, or a creditor of the company, stay any proceeding, and as the High Court clarified in *Philpott v Lycee Francais Charles de Gaulle School*<sup>164</sup>, in reference to *Frankice (Golders Green) Ltd v The Gambling Commission*,<sup>165</sup> any arbitral proceeding.<sup>166</sup> An initiation or commencement of an arbitration procedure against the debtor in a compulsory winding up procedure requires a leave from the court.<sup>167</sup> In administration, the other party to the arbitration agreement will be able to proceed against the debtor if the trustee adopts the contract so that the debtor will be bound to the arbitration agreement.<sup>168</sup> The law in this regard has been held to be the same in both situations where a foreign party has been declared insolvent, and where the insolvent party is domestic.<sup>169</sup> In situations where the contract has

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<sup>160</sup> Sec. 165 (3), Sch. 4 para 4 Insolvency Act 1986.

<sup>161</sup> Sec. 167 (1)(a), Sch. 4 para 4 Insolvency Act 1986.

<sup>162</sup> Sec. 349A (2) Insolvency Act 1986.

<sup>163</sup> Sec. 349A (3)(a) Insolvency Act 1986. See also: Sch. 1 para 6 Insolvency Act 1986.

<sup>164</sup> *Philpott v Lycee Francais Charles de Gaulle School* [2015] EWHC 1065 (Ch) at paragraph 5.

<sup>165</sup> *Frankice (Golders Green) Ltd v The Gambling Commission* [2010] EWHC 1229 (Ch) at paragraph 38.

<sup>166</sup> Sec. 112(1) Insolvency Act 1986.

<sup>167</sup> Sec. 130(2) Insolvency Act 1986.

<sup>168</sup> Sec. 349A (2) Insolvency Act 1986.

<sup>169</sup> See *Bannai v Erez* [2013] EWHC 3689 (Comm), where Burton J refused the appeal against an anti-suit injunction against a trustee-in-insolvency from bringing proceedings in an Israeli court. This was in spite of the fact that the respondent did not intend to initiate arbitration proceedings, but merely to prevent proceedings in the Israeli courts.

not been adopted, the court, on the application of an interested party, has discretion whether to enforce the arbitration agreement.<sup>170</sup>

Secondly, the question has to be answered under which conditions the court may stay an arbitral proceeding in voluntary winding up, under which conditions the court may sanction the liquidator's or administrator's request to pursue an arbitration procedure, or under which conditions the court may give the other party of the contract a leave to proceed against the debtor. The question as to whether the court will stay arbitration, or grant a permission/leave to initiate or continue arbitration, respectively, depends on the arbitrability of the matter in dispute. In the previously referred to, quite recent High Court decision in *Philpott v Lycee Francais Charles de Gaulle School*, Judge Purle underlines the pro-arbitration policy in English law and the limits of arbitration by citing *Fulham Football Club (1987) Limited v (1) Sir Richards & Ors*.<sup>171</sup> Even though *Fulham Football Club* is a company law case,<sup>172</sup> Lord Justice Patten pointed out some important principle for the arbitrability of dispute matters; also in relation to insolvency: "It is necessary to consider in relation to the matters in dispute in each case whether they engage third party rights or represent an attempt to delegate to the arbitrators what is a matter of public interest which cannot be determined within the limitations of a private contractual process."<sup>173</sup> As such, a matter of dispute may not be arbitrable if it involves (i) 'third party rights' and (ii) a 'matter of public interest'. That is logically consequent. Arbitration is designed as an inter partes dispute resolution forum. If another party, and this concerns point (i) and (ii), could be made subject to the inter-party arbitral tribunal without prior consent, this would not reinforce the principles of contractual freedom and party autonomy, but it would erode the contractual freedom and autonomy of the party which would be forced into a contractual dispute resolution scheme without consent.

Insolvency is such a delicate area of law where the arbitration concept of inter-partes dispute resolution clashes with the insolvency concept of a collective procedure. The court in *Fulham*

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<sup>170</sup> Sec. 349A (3)(b) Insolvency Act 1986.

<sup>171</sup> *Philpott v Lycee Francais Charles de Gaulle School* [2015] EWHC 1065 (Ch) at paragraph 21 and 22.

<sup>172</sup> In *Fulham Football Club (1987) Limited v (1) Sir Richards & Ors* [2011] EWCA Civ 855, the appellant Fulham contested a s.9 AA order staying the appellant's petition under s.994(a) Company Act 2006, i.e., a unfair prejudice claim, against Sir Richards, whom Fulham accused of having disadvantaged Fulham in a transfer of Peter Crouch from Portsmouth to Tottenham. Sir Richards would have acted as unauthorised agent in this transfer. Disputes arising in context of the contractual relation in the Football Association Premier League of which the parties were members and Sir Richard was chairman, should be dealt with in arbitration. The Court of Appeal disagreed with Fulham that this matter had to be decided in the forum of the public court instead of the arbitral tribunal, emphasising the priority of the inter partes arbitration agreement.

<sup>173</sup> *Fulham Football Club (1987) Limited v (1) Sir Richards & Ors* [2011] EWCA Civ 855 at paragraph 40.

*Football Club* cites the Singapore Court of Appeal on the question of arbitrability in insolvency in *Larsen Oil and Gas Pte Ltd v Petroprod Ltd*. According to the Singapore Court of Appeal's ruling, matters of dispute concerning rights and obligations created by the insolvency regime itself are generally non-arbitrable<sup>174</sup> while matters of dispute concerning pre-insolvency rights and obligations may be assumed by the court in the insolvency forum if a dispute resolution in arbitration would affect 'substantive rights' of other creditors in the collective procedure of insolvency.<sup>175</sup> In reference, especially to the first matter of (potential) non-arbitrability, Lord Justice Patten holds, exemplary, that the parties to a contract cannot regulate matters of dispute which are inherently created by and connected with the insolvency procedure itself, such as how the property of the estate in liquidation may be used, or how the liquidator may exercise its avoidance powers.<sup>176</sup>

So far, the English approach concerning the initiation of arbitral proceedings in insolvency for the part of objective arbitrability resembles the discussion of arbitrability in insolvency in the US. In the US and in England, the law-makers have each articulated a pro-arbitration policy choice with the enactment of a quite liberal Federal Arbitration Act and Arbitration Act, respectively. The discussion about a distinction between inter partes matters of dispute and matters of disputes affecting third party rights and public interests, as vested in and expressed by the Insolvency Act 1986 has much in common with the discussion about 'core' and 'non-core' proceedings, of which 'core-proceedings' arise as original insolvency rights, which will be non-arbitrable if arbitration jeopardises the policy underlying the Bankruptcy Code.<sup>177</sup> Unfortunately, there does not exist a list as in § 157(b)(2) US Bankruptcy Code, nor is the case law on the arbitrability of specific insolvency proceedings in England in particular rich. Since, however, the English courts have coined differently what is in essence the question of 'core' and 'non-core' proceedings in the US, and since the policy underlying the Insolvency Act and the Bankruptcy Act, respectively, is the benchmark in both jurisdiction to tilt the balance between arbitration and insolvency, a recourse to the principles developed for the US seems to be fruitful; the particularities of English insolvency law shall be pointed out.

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<sup>174</sup> *Larsen Oil and Gas Pte Ltd v Petroprod Ltd (in official liquidation in the Cayman Islands and in compulsory liquidation in Singapore)* [2011] SGCA 21 at paragraphs 45–46.

<sup>175</sup> *Larsen Oil and Gas Pte Ltd v Petroprod Ltd (in official liquidation in the Cayman Islands and in compulsory liquidation in Singapore)* [2011] SGCA 21 at paragraph 47–50.

<sup>176</sup> *Fulham Football Club (1987) Limited v (1) Sir Richards & Ors* [2011] EWCA Civ 855 at paragraph 74.

<sup>177</sup> For a discussion of the US position see VI. 2.2.1 and VI. 2.2.2.

*(1) Matters concerning the collective decision-making process (restructuring):*  
The collective decision-making process is a matter of the very nature of insolvency in many regulatory regimes. While the English insolvency regime, as discussed in section VI. 3.1 stands in the tradition of contract-controlled debt collection in the form of the administrative receivership, the law-makers has made clear with the reform of the insolvency law in the Enterprise Act 2002 that the individually controlled debt collection has to make way for a procedure conducted for the benefit of all creditors. As such, a dispute matter which would if decided by an arbitral tribunal undermine the concept of collective decision-making by the body of creditors in form of a vote or by the liquidator / administrator as an agent of the body of creditors should be considered non-arbitrable.

*(2) Matters concerning the going-concern of the debtor (reorganisation):*  
Different from the administrative receiver who was first and foremost responsible to the appointing floating charge holder, the administrator is the agent of ‘the company’s creditors as a whole’ having regard to the seniority in the inter-creditor relation.<sup>178</sup> The administrator may manage the estate in the interest of reorganisation but with a focus on value-maximisation for the common pool of creditors.<sup>179</sup> Certainly, the arbitral tribunal cannot take-over the administration procedure and give directions in questions of the administration of the estate by the trustee, as this would erode the public interest in the rescue of the company and the third party interests of other creditors. If, however, the decision about a pre-insolvency right or obligation in arbitration affected the administration of the estate factually, the court will have to make a balancing decision taking into account the inter-partes interest in the arbitral dispute resolution on the one hand and the interest of creditors as a whole, with special consideration of the interests of propriety holders.<sup>180</sup>

*(3) Matters concerning the concentration of the firm’s assets available for distribution and the fair and equitable treatment of creditors. The last category being concerned with (i) special insolvency privileges which are not related to the*

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<sup>178</sup> Sch B1 para 3 (2) subject to (4) Insolvency Act 1986

<sup>179</sup> Sch B1 para 1 (a) in light of Sch B1 para 3(b) referring to 1(b) Insolvency Act 1986.

<sup>180</sup> James Hargrove and Vanessa Liborio, *Arbitration and Insolvency: English and Swiss Perspective* (2009) 75 *Arbitration* 47, at 50 in reference to *Re Atlantic Computer Systems plc* (no 1) [1990] EWCA Civ 20.

*question of the contract subject to arbitration but with special circumstances of preferential treatment or fraud; being concerned with (ii) the question as to whether an asset should be available for the distribution to all creditors; and being concerned with (iii) matters regulating the inter-creditor conflict:* Similar to US law, the English insolvency law embodies several provision for (i) the reversal of pre-insolvency transactions in disfavour of the common pool such as transactions at an undervalue (s 238 IA), preferences (s 239 IA), and fraudulent transfers (s 423 IA),<sup>181</sup> or common law principles for (ii) the maximisation of the pool of assets by rendering void contracts contradicting this purpose (anti-deprivation principle), or (iii) for the equal treatment of creditors (pari passu principle).<sup>182</sup>

The same as for the US, it applies to English law that the conflict between arbitration and insolvency concerning the arbitrability of dispute matters in insolvency has to be answered by reference to the questions, first, as to whether a right arises from the Insolvency Act itself, or as to whether the exercise of a pre-insolvency right jeopardises the insolvency policy after the creditors' rights have been transferred to a collective procedure. The court will consider the interest of the party applying for a stay on arbitration, or to grant a permission/leave to initiate or continue arbitration, respectively, and balance it with the rights of third parties arising in the collective procedure of insolvency. And if the purpose of English insolvency, which is especially the satisfaction of creditors' claims in a collective procedure (see V. 3., a prevailing preference over the rescue of the debtor), is not undermined, the courts will be cautious to reject the demand of arbitral dispute resolution. In two recent decisions, the courts have decided in favour of arbitration where no third party rights in insolvency were jeopardised: *Philpott v Lycee Francais Charles de Gaulle School*, decided by the High Court in 2015, concerned a set-off as the taking of an account according to Rule 4.90 of the Insolvency Rules 1986, i.e., a "proof of claims" issue. In *Salford Estates (No. 2) v Altomart Ltd*, the Court of

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<sup>181</sup> See § 157(b)(2)(F) Chapter 1, 11 U.S. Code. US Bankruptcy Code "proceedings to determine, avoid, or recover preferences" and § 157(b)(2)(G) „proceedings to determine, avoid, or recover fraudulent conveyances“ and compare to Lord Justice Pattern in *Fulham Football Club (1987) Limited v (1) Sir Richards & Ors* [2011] EWCA Civ 855 at paragraph 74: "They cannot override the provisions of the IA 1986 [...] The same must go for the exercise of the liquidator's powers under ss.238-9 IA 1986. They involve an exercise of a statutory power to intervene in and set aside transactions with third parties in the context of the insolvency regime."

<sup>182</sup> See § 157 (b)(2) (B), (K), (M), and (O) Chapter 1, 11 U.S. Code and compare with Lord Justice Pattern in *Fulham Football Club (1987) Limited v (1) Sir Richards & Ors* [2011] EWCA Civ 855 at paragraph 74: "They cannot override the provisions of the IA 1986 which apply on liquidation by agreeing between themselves or with a particular creditor that property which belongs to the company in liquidation should be dealt with other than in accordance with the Act: see *British Eagle International Air Lines Limited v. Compagnie Nationale Air France* [1975] 1 WLR 758."



Appeal held in 2014 that the lower court, although it was not bound by s.9(1) Arbitration Act to stay a petition for winding-up, could within its discretionary power of sec. 120 (1) (f) Insolvency Act 1986 consider the arbitration clause to which the petitioner had agreed ex ante and stay the petition for winding up.<sup>183</sup> In this case, the debtor was solvent and the petition was based on the fact that the debtor had not paid the (disputed) debt owed to the single petitioner. It was, therefore, not obvious that third party rights or public interests would be harmed if the case was stayed in favour of arbitration. The courts will have to strike the balance in the individual case in reference to the here discussed principles.

#### **4. Russia**

##### **4.1 The Concept of Distressed Debt Management in Russia**

The economist János Kornai described the operating code for corporations in socialism as “soft budget constraints”.<sup>184</sup> In socialism, corporations are owned by the state, and debt is, similarly, owed to other state corporations. If a firm cannot repay its debt, the firm will be bailed-out. As such, there is no insolvency procedure and a re-distribution from profitable corporations to financially and/or economically distressed corporations takes place. The downsides of this approach are severe: From an ex post perspective, economically distressed corporations keep on burning resources which could be deployed more efficiently elsewhere. From an ex ante perspective, the lack of a disciplinary force of insolvency means the concomitant absence of an incentive for prudent risk-taking, diligent budget planning, and for investments into innovation and effort ex ante.

After the downfall of the Soviet Union, Russia transformed from a planned economy towards the model of a market economy. As it is true for most transformation economies within the borders of the former Soviet Union, Russia borrowed legal transplants from developed market economies for the reform of its corporate and insolvency law.<sup>185</sup> The history of try and err in reform is quite telling for the dynamics of transition. While the formal law can be easily changed, informal rules of old power remain and inhibit the smooth transformation of the law in the books into reality. This is in particular the case where those occupying the switching point positions pursue their own agenda. In contrast, a developed capitalist economy is

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<sup>183</sup> *Salford Estates (No. 2) v Altomart Ltd*, [2014] EWCA Civ 1575.

<sup>184</sup> János Kornai, ‘The soft budget constraint’ 39 *Kyklos* 3 (1986).

<sup>185</sup> For an analysis of transition economies and the effect on lending see: Reiner Haselmann, Katharina Pistor, and Vikrant Vig, *How Law Affects Lending* 23 (2) *The Review of Financial Studies* 549 (2010).

characterised by the rule of the ‘formal’ law. After the first law of 1992 was barely ever used, being criticised as impractical and technically insufficient, a new law was enacted in 1998. The new law was designed to protect creditor rights. It was, however, used as a tool for hostile takeovers at a cheap price, regularly with the support of a bribed judge and a puppet administrator.<sup>186</sup> If not for hostile takeovers, the law was used as a debt collection device by the tax authorities which were responsible for the majority of petitions. The law was soon reformed and replaced by the currently valid version of 2002.

The 2002 insolvency law is structured as follows: On an application of the debtor, its creditors, or a specially entitled body such as the tax authority, the debtor (soon to be) “incapable to pay its debt” enters the procedure. The creditors have to present an enforceable judgement or arbitration award, a requirement which has contributed to the sharp decrease in applications for insolvency by creditors.<sup>187</sup> With the commencement of the procedure, the judge appoints an administrator. During the time of the 1998 law, this was the Trojan horse for the acquirer to gain control over the target. In order to avoid such misuse, the new law asks the judge to request a list of three administrators to be prepared by a self-regulating organisation. The debtor and in case of a creditor petition the applying creditor can delete each one candidate from the list. Certain minimum qualification standards for administrators are set.<sup>188</sup> The administrator will first act as a provisional administrator on the observation/supervision stage, during which claims are registered, the debtor’s financial situation is assessed, and a creditor’s meeting is summoned. Individual procedures are stayed and debt collection becomes a collective procedure. The debtor maintains possession but is subject to supervision in important questions. From this stage on, an amicable agreement may be concluded, or the debtor may enter a procedure of financial restoration, of external administration, or liquidation. The creditor meeting may make a decision about the entry into the respective procedure.

The parties can enter into an amicable agreement and settle the debt dispute in a restructuring plan. Alternatively, under the financial restoration procedure, a debt repayment plan is exercised. A third party may guarantee the debt or repay (part of) the debt on the debtor’s

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<sup>186</sup> Hiroshi Oda, *Russian Commercial Law* 206–208 (Brill Academic Pub, 3<sup>rd</sup> edn, 2012).

<sup>187</sup> Article 39(2) Federal Law on Insolvency 2002.

<sup>188</sup> On standards, rights, and duties of administrators and self-regulating organisation see: Articles 20, 21, 22, 23, 25, 26 Federal Law on Insolvency 2002. On the selection of the administrator see: Article 45 Federal Law on Insolvency 2002.

behalf. If, instead, the debtor enters external administration, the management will be replaced and the administrator will conduct the debtor's business affairs. A stay on individual action and debt repayment shields the troubled business from cash outflow. Within one month, the administrator prepares a plan which has to be sanctioned by the creditors to become effective for execution. The administrator may not execute certain actions of particular importance such as the sale of the business without the creditor's qualified approval. This way, a misuse of power by the administrator shall be prevented. If the debtor's business is seen to be not worth to be reorganised, the debtor's assets will be liquidated, the firm will be dissolved, and the firm's assets will be sold, typically auctioned.<sup>189</sup> The proceeds of the estate shall be distributed according to the order set out in Art. 134 Federal Law on Insolvency 2002. After the procedural costs and the costs for the administration of the estate during insolvency are paid, most importantly, claims for pensions and remuneration by employees rank before the claims of other creditors; even before secured claims if the security was created after the employees' claims emerged (Art. 138 I, II Federal Law on Insolvency 2002). The position of tax claims is discussed controversially, since the Federal Law on Insolvency 2002 describes a different order in ranking than the Civil Code 1996 in Art. 64. According to Article 3 para 2 of the Civil Code 1996, all laws shall conform with the Civil Code. The Supreme Commercial Court has decided that the distribution order of the Civil Code applies to liquidation (bankruptcy) while it shall not apply to distributions in other insolvency schemes.<sup>190</sup>

The Russian law to deal with financial distress suffers from a typical transition economy defect. While the law itself could operate to resolve financial distress, it is rarely used effectively. Exploitation and corruption pervert the purpose of the law. Informal rules factually suspend the insolvency law in its intended design to incentive value-maximising actions, to increase the availability of debt capital, and to cut out economically distressed firms from the market. A major player in the application of the law, and a problem in its effective exercise is the state itself. First, the federal or regional governments as well as state-controlled/owned banks regularly hold significant debt positions and not seldom also significant equity positions in Russian corporations. Depending on their commitment, they are

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<sup>189</sup> On the stay on individual action and the initiation of a collective procedure instead see Articles 63 and 95 Federal Law on Insolvency 2002. On the observation/supervision stage see Chapter IV (Articles 62–75) Federal Law on Insolvency 2002 and Oda, *supra*-note 187, 214–216. On the financial rehabilitation stage see Chapter V (Articles 76–92) Federal Law on Insolvency 2002 and Oda, *supra*-note 187, 216–218. On the external administration stage see Chapter VI (Articles 93–123) Federal Law on Insolvency 2002 and Oda, *supra*-note 187, 218–223. On the liquidation stage see Chapter VII (Articles 124–149) and Oda, *supra*-note 187, 223–227. On the amicable agreement stage see Chapter VIII (Articles 150–167) and Oda, *supra*-note 187, 227–228.

<sup>190</sup> See Oda, *supra*-note 187, 225–227 on the ranking of claims.

themselves biased in selecting corporations for insolvency petition or shielding corporations from other creditors' demands. If a company is economically distressed but politically important for a region, i.e., if many jobs and local businesses depend on this company, the regional government will have an incentive to avoid liquidation for reasons of public choice. Empirical evidence suggests that the court system is often insufficient in so far as judges are unlikely to apply the law impartial and objective. While bribery in hostile take-over cases was in particular a problem during the time of the 1998 insolvency law, political influence on court decisions remains a dangerous obstacle for an unbiased and predictable application of the law. Judges are practically dependent on the regional executive authorities' support, which makes them vulnerable to political influence. If a debtor, for instance, is politically important for a regional government, the regional court will be under pressure to shield the debtor against collection attempts and to support a rescue strategy for an economically distressed debtor on the cost of its creditors.<sup>191</sup>

The Russian approach in distressed debt management is a mess. Informal rules contradict formal legal rules, which makes insolvency highly unpredictable. Ex ante debt management is hardly possible when creditors cannot expect that their contractual rights are cost-effectively enforceable, but when they have to fear that the insolvency law is misused to re-distribute wealth, e.g., to the acquirer or to the politically important debtor. Not the Russian insolvency law itself but the access to its objective and reliable application is a major issue.

#### **4.2 The Arbitraribility of Dispute Matters in Insolvency in Russia**

The arbitraribility of dispute matters in insolvency in the US and England was a core issue of investigation for the project undertaken and discussed in sections VI. 2.2 (US) and VI. 3.2 (England). A thorough analysis of the insolvency law, especially with a focus on the underlying policy considerations with a road-test in case law research was conducted with the goal to answer the question how the courts will balance arbitration and insolvency once a conflict arises. For Russia, the story in this context is rather short: dispute matters which concern the insolvency procedure are not subject to an enforceable dispute resolution in an

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<sup>191</sup> For a real life account of insolvency in Russia see: Katsumi Fujiwara, *The Development and Performance of the Bankruptcy System in Contemporary Russia* 1 *The Journal of Comparative Economic Studies* 59 (2005); Ariane Lambert-Mogiliansky, Konstantin Sonin, and Ekaterina Zhuravskaya, *Are Russian Commercial Courts Biased? Evidence from a Bankruptcy Law Transplant* 35 (2) *Journal of Comparative Economics* 254; Dannis Lai Hang Hu, *The state and the development of corporate insolvency law in China and Russia: A comparative perspective* 2 (3) *Asian Education and Development Studies* 212, especially 216–217, 219–221 (2012).

arbitration procedure. As such, rights which emerge from the insolvency procedure itself cannot be a matter of dispute to be resolved with binding effect in the forum of an arbitral tribunal. Different from the US and England, where the insolvency courts decide on a case-by-case basis as to whether a matter of dispute about rights which arise from the Bankruptcy Code or the Insolvency Act, respectively, may be submitted to an arbitral tribunal,—conditional upon that the underlying policy goals, third party rights, or public interest are not jeopardised—the Russian public court does not have to reach a balancing decision in this context. In consequence, rights which are created by the Federal Law on Insolvency 2002 such as the procedure for the appointment of the (provisional) administrator, the management of the estate, the entry into the insolvency procedure, or matters of creditors' collective choice are under the exclusive jurisdiction of the Russian public courts.<sup>192</sup> The strong concentration of dispute resolution in favour of a collective procedure in contrast to a procedure vulnerable to be controlled by individual creditors for reasons of wealth transfer (in hostile takeovers) becomes even more obvious after the Russian law-maker has made a U-turn in the reform of the insolvency law to the currently valid 2002 version.

Materially, the only matters available to dispute resolution in the forum of the arbitral tribunal are, consequently, pre-insolvency entitlements, i.e., the existence and scope of the contractual claim as it is not effected by one party's insolvency. If the arbitral court confirms the existence and defines the scope of a claim, it may grant an arbitral award which can be submitted as a proof of claim for the initiation of insolvency procedures or to the registration of claims for the final distribution scheme in insolvency. However, even for matters which arise in context of the pre-insolvency contractual relation, there is practically a time limit for the commencement of arbitration procedures. And even where an arbitral procedure was concluded in time, the court may—for public policy considerations—declare an award to be unenforceable. While public policy is a rarely applied defense in the US and in England, it is commonly used in Russia.<sup>193</sup> The legal uncertainty connected with the current court reform and the uncertainty resulting from the impact of informal rules contradicting formal law quite generally worsen the prospect for arbitration in insolvency even more. Eventually, the insolvency of one party to an arbitration agreement leads to major hurdles for an effective procedure of dispute resolution alternative to the public ordering forum.

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<sup>192</sup> See the discussion of arbitrability in section V. 3.4.

<sup>193</sup> See the discussion of public policy in VI. 3.4.

## **VII. A Comparative Review of Three Distinct Models of Conflict in Insolvency and International Arbitration: US, England, and Russia**

### **1. Three Different Stories of Distress: US, England, and Russia**

There are three distinct stories to be told about the management of distressed debt in the US, England, and Russia, and the way each story is written depends (i) on the law in the books and (ii) on the law in reality. The analyses in sections VI. 2.2, VI. 3.2, (and VI. 4.2), which will be concluded in a comparative analysis in section VII. 2., relate directly to the policy considerations of the insolvency law in the books. When courts have to balance the interests of an efficient dispute resolution scheme in arbitration with the policy goals underlying the insolvency law, third party rights affected in insolvency, or public interests, it is paramount to characterise the operating code for the respective insolvency regime, as this was done per country in sections VI. 2.1, VI. 3.1, and VI. 4.1. Since, however, a positivist legal analysis does only promise to tell half of the story, an adjustment to extra-legal circumstances and informal rules was conducted so as to enrich the per country analyses in sections VI. 2.1, VI. 3.1, and VI. 4.1. Such a real-life check can enhance the analysis not only for an impact analysis of the insolvency law but also as a groundwork for a cartography of the actual limits of arbitration in conflict with insolvency.

Following the concept of clarification by comparison, the three jurisdictions of US, England, and Russia will be compared in a ‘law in the books’ and ‘law in reality’ check according to five points of conflict identified and discussed in section IV. 3.

*Private v Public Ordering:* A clear public ordering agenda is set by the law-maker in the US. The US Bankruptcy Code is designed to give the captain an incentive to enter the public ordering procedure early. The options for collective debt management in context of a dispersed lending structure are significantly curtailed. The English law-maker, in contrast, has designed an insolvency law which gives room for pre-insolvency negotiations. In a concentrated lending structure, ex ante and ex post debt management takes place cooperatively and in the shadow of the public ordering law. Contracts are enforced and pre-insolvency entitlements are respected to an as high as reasonable possible degree. In Russia, the classification between public and private ordering changes once the law undergoes a reality check. While the insolvency law, especially after its reform to the 2002 version, tends to establish an institutional preference for public ordering in the books, and to cut off pre-

insolvency contractual arrangements, as demonstrated for arbitration in sections V. 3.4 and VI. 4.2, the reality often looks differently. The entry barriers for creditor petitions and the institutional inefficiencies discussed in VI. 4.1, create a probably unintended but factual preference for private ordering dispute resolution out of formal insolvency.

*Ex Ante v Ex Post Orientation:* The US provides the school book example of an ex post oriented insolvency regime. Ex ante debt management by creditors remains an exception; debtors are offered a second chance to turn around the business under the protective and supportive regime of the Bankruptcy Code. In England, to mark the difference, the creditors invest into monitoring and control. The insolvency law is the extension of the contractual control mechanism transferred to a collective procedure. Creditors, especially secured creditors, maintain control. The debtor's position is comparatively weak. The English insolvency law, thus, qualifies as the supreme example of an ex ante oriented regime. With Russia, again, the case becomes complicated. With the reform of the insolvency law, the collective position for creditors was strengthened in relation to the previous act which allowed for strong control exercised by individual creditors; a position which was, however, easily captured by creditors with ulterior interests. Because high entry barriers for creditors to file a petition and because the dominance of informal rules such as political influence lead to significant uncertainty in advance planning, the Russian model can be most accurately described as an insufficiently developed ex post oriented regime.

*Substantive Re-distributive Policies v Party Autonomy:* In England, the hypothetical consent found in the creditors' bargaining theory model is law. There is no substantive redistributive element in the law. In the US, re-distribution in divergence from the pre-insolvency entitlements, takes place (i) for efficiency reasons so as to incentive the debtor, and (ii) for a social agenda, e.g., in the 'second chance'-model, but more so in the preferential treatment of certain tax claims. Russia, eventually, marks an extreme in the case of substantive re-distribution (in formal and informal rules). Employees' claims and tax claims rank before secured and unsecured claims in bankruptcy; employees' claims in every distribution scheme under the Federal Law of Insolvency 2002.<sup>194</sup> The influence of the state on the actual conduct of the insolvency procedure, i.e., the (mis-)use of the insolvency law as either a tax collection tool or as a shield for life-extending measures for an economically distressed debtor show the

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<sup>194</sup> In England and the US, employees' claims rank have preferential status only as far as they arose within a limited time before insolvency.

re-distributive element of the Russian law in reality. At least for the re-distributive elements embodied in the formal law, the law-maker's policy goals have an impact on the limits of arbitration in insolvency.

*Concentration v Decentralization:* England provides the least centralized insolvency regime. Decentralized negotiations regularly take place in the shadow of the law. Restructuring procedures without a necessarily comprehensive scope (SoA and CVA) are at hand. Pre-insolvency entitlements are preserved to the highest possible degree. In the US, a strong concentration sets in with the commencement of the insolvency procedure. Debtor and creditors form a community of fate bound together in the attempt to rescue the business. In Russia, again, the law in the books does not really mirror the law in reality. While the design of the insolvency regime rather resembles an ex post oriented and centralized approach, the law in reality can look quite different: Because of the inefficiencies of the collective debt management tool in public ordering, especially creditors are often tempted to find solutions outside of formal insolvency.

*Certainty v Equity:* The English model most precisely reflects the creditors' pre-insolvency position in insolvency. The US model allows for certain deviations which, however, are already priced into the creditor's ex ante calculation, mostly for the incentive mechanism in the shared interest of debtor and creditors. The interest of equity is achieved by safeguards for equal treatments in the England and in the US. The Russian insolvency law, in contrast, entails some deviations from the pre-insolvency distribution order in the interest of a social agenda and on the cost of certainty. The strongest effect on certainty and equity, nonetheless, has the predominant role of informal rules, which potentially lead to wealth transfers capable to endanger both certainty and equity.

## **2. Three Concepts of Conflict: Insolvency and Arbitration**

The law-makers in the US, in England, and in Russia have each developed—in written laws and court decisions—concepts for the case that national insolvency and international arbitration clash. In sections V. 2.2, V. 3.2, VI. 2.2 (for the US), V. 2.3, V. 3.3, VI. 3.2 (for England), and in sections V. 2.4, V. 3.4, VI. 4.2 (for Russia), it was analysed how this conflict is decided in the respective jurisdictions; under which conditions in favour of the decentralized procedure of dispute resolution in arbitration and under which conditions in



favour of the centralized collective procedure of insolvency. Without that details shall be repeated at this stage, the comparative analysis relates to section IV.

First, the question of the variable surplus of arbitration arises. The surplus of international arbitration if compared to the national judicial infrastructure depends largely on the neutrality, competence, speed, and cost of the national courts. While the analysis did not reveal major differences in the effective dispute resolution in the US and in England for the neutral, competent, speedy, and cost-effective application of the law, the analysis of dispute resolution in insolvency in Russia brought to light that courts struggle with the problems of corruption and political influence, especially at a lower level. Not only are the courts but often are also the administrators less experienced in the exercise of legal and business judgement than this would be the case in US and England. The uncertainty which comes with the recent court reform is furthermore troubling. An arbitral tribunal with judges experienced in deciding business disputes could add substantial value in such a situation. The potential surplus of arbitration is, consequently, the largest in Russia.

Second, the limitations on arbitration in insolvency shall be comparatively summarized: To begin with the most restrictive approach when it comes to the clash of international arbitration and national insolvency, it is an unfortunate, but not even surprising, fact that the potential surplus of arbitral dispute resolution in Russia lies idle if one party to the arbitration agreement is insolvent. The time window for the initiation of arbitration in insolvency is relatively small and limited to the supervision stage; and also for the supervision stage there are practical reasons to refer the case to the public ordering court. While arbitration is still a possibility, the type of dispute matters in insolvency which may be decided by an arbitration court are strictly limited to non-insolvency disputes, i.e., disputes which arise from pre-insolvency contractual rights. Insolvency matters are not arbitrable. Eventually, an arbitral award is at risk to be held unenforceable where the court accepts the public policy defense; which is not unlikely in Russia.

In stark contrast to Russia, the law-makers in the US and in England, in the shoes of the legislator and the courts, are quite open towards arbitral dispute resolution in insolvency, with some particularities in each jurisdiction nonetheless. While the public policy defense is a last resort argument and rather unlikely to apply in England, the US courts may prove to be more willing to apply the public policy defense against the enforcement of arbitral awards. This

tendency relates well to the role of insolvency in England, where contractual relations are transferred with at less as possible frictions, and the US, where the centralized procedure is an expression of an ex post oriented public ordering scheme. The stepped system of subjective arbitraribily depending on the procedure in England is another difference in this context.

The major point of discussion and at the same time a similarity in principle and a difference in detail is, however, the objective arbitraribily of dispute matters in insolvency in the US and in England. In both the US and England, insolvency matters are not per se excluded from arbitral dispute resolution (as opposed to Russia). It is instead for the court to make a balancing decision between Scylla and Charybdis so as to find the safe passage in between both extremes. In England the courts will ask as to whether a delegation of a dispute matter would jeopardise third party rights and public interests, which is rather to be the case if rights created by the Insolvency Act itself are in dispute. In the US, the court will ask as to whether a dispute matter concerns a core proceeding, i.e., a right created by the Bankruptcy Code, and as to whether a delegation of dispute resolution to an arbitral tribunal would jeopardise the goals underlying the Bankruptcy Code. The principle is relatively similar: The court has to balance the individual interests as expressed in the inter partes arbitration agreement ex ante with the collective interests as they are embodied in the Insolvency Act or Bankruptcy Code, respectively. The court will do so in a case-by-case analysis, taking into account the special circumstances—an ex post pragmatic approach. However, the discussion of objective arbitraribily in VI. 2.2 and VI. 3.2 resulted in the identification of three categories recurring in the US and England, which can enlighten the discussion of objective arbitraribily, namely:

*(1) Matters concerning the collective decision-making process.*

*(2) Matters concerning the going-concern of the debtor.*

*(3) Matters concerning the concentration of the firm's assets available for distribution and the fair and equitable treatment of creditors. The last category being concerned with (i) special insolvency privileges which are not related to the question of the contract subject to arbitration but with special circumstances of preferential treatment or fraud; being concerned with (ii) the question as to whether an asset should be available for the distribution to all creditors; and being concerned with (iii) matters regulating the inter-creditor conflict.*

If a matter of dispute can be subsumed under one of these categories, there will be a conflict of arbitration and insolvency, i.e., the dispute matters concerns a right which is originally created by the Bankruptcy Code or Insolvency Act, respectively. The court will have to balance the benefits and costs which the parties may experience if the case is decided in favour of dispute resolution in the forum of either the arbitral tribunal or the public ordering insolvency court. Importantly, however, the US and the English courts will relate to different policy considerations when they try to tilt the optimal balance. The US courts will put a great weight not only on the highest possible satisfaction and equal treatment of creditors but also on the policy goal as expressed in the institutional design of the Bankruptcy Code to provide for a protective and supportive rescue regime. The second chance for the debtor in the *ex ante* and *ex post* interest of debtors and creditors may not be eliminated by an individual dispute resolution scheme. In England, the rescue of the firm is clearly subordinated to the interest of creditors in receiving an as high as possible satisfaction quota. Third party interests of other creditors are therefore the prime weights to be placed on the insolvency side of the balance. Hereby, especially the position of secured creditors has to be accounted for according to the policy underlying the Insolvency Act. While the concept of conflict in the US and England is similar in principle, differences are to be found in the details.

### **3. Review and Outlook**

The conflict between international arbitration and national insolvency is resolved at the national level. While one might desire to find a transnational approach, the limits to this pursuit are to be found in the differences of national insolvency laws. Even where the law-maker has made a pro-arbitration choice, international arbitration can—logically—not operate without limits. If, crucially, all dispute matters in insolvency were arbitrable, this would erode the collective character of insolvency entirely by way of an inter-partes agreement: a concept which is likely to be misused for private wealth transfers on the cost of efficiency and a fair, equal, and predictable treatment of creditors. The conflict question of international arbitration and insolvency, thus, has always to relate the respective concept of national insolvency.

In the study here conducted, the English approach of distressed debt management was identified to be *ex ante* oriented, to favour private ordering, decentralisation and certainty, and to strongly re-enforce private autonomy. The US approach of distressed debt management,

then, was identified to be ex post oriented, to favour public ordering, centralisation, and certainty, with a modest redistribution scheme on the cost of private autonomy. In both England and the US, the court will decide the conflict question by balancing the benefits and costs of a decision in favour of either dispute resolution in arbitration or insolvency, relating to the policy underlying the respective insolvency scheme. While this is the legal position, this finding needs a reality adjustment. The US approach is built on the assumption that the debtor will enter the procedure early and that the distressed debt problems are resolved in public ordering. The English approach instead grounds on the assumption that problems of distressed debt can often be resolved out of and in the shadow of insolvency. In consequence, conflicts arising when formal insolvency and international arbitration clash are more likely in the US than in England.

For Russia, a similar consideration applies. Insolvency is often the last resort, which most creditors try to avoid. However, this calculation has its flaws. Certain creditors have initiated insolvency early for ulterior reasons. The tax authorities still use the insolvency scheme as an easy debt collection tool. The court's response is often unpredictable. An unbiased application of the law is not guaranteed. A reality adjustment or mitigation of the finding that insolvency shuts the door for arbitration effectively is, thus, marred with the deficit of uncertainty—concerning the application of the law in the books. The situation in Russia calls for reform.

The goal of this voyage of exploration in the area where two opposing concepts of law meet, one based on the concept of tailor-made contractual agreements for dispute resolution inter partes, the other based on the concept of a collective dispute resolution scheme by coercion in distress, was to comparatively explore how each of them connects to the other one and how the seemingly stark contrast can be resolved in a balancing decision. The US and England provide each the example of a workable solution which relates to the particularities of the respective institutional design of the insolvency law. Russia reveals problems of a transition economy which may be overcome by legal reform; not only of the insolvency law and the rules relating to the limitation of arbitration, but also of the court system for the application of the written law. The comparative approach of analysing the approach to distressed debt management in the law and in reality as a benchmark for the analysis of the concrete conflict question for the limitations on international arbitration in insolvency may be seen as a transferable model which can be applied to the analysis of this research question in different jurisdictions.