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A BETTER ARGUMENT FOR UNIVERSALISM IN TRANSNATIONAL BANKRUPTCIES

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ABSTRACT

This paper presents an argument for the adoption of universalist policies toward transnational bankruptcies that is stronger than those that currently exist in the literature. Because international creditors can be assumed to adjust their contracts to the laws in place, attempts to protect local creditors cannot succeed. There is, therefore, no cost imposed on local creditors by the adoption of universalism. Furthermore, it is shown that territorialism imposes costs on transnational transactions that would not be present under universalism. These include the costs of uncertainty, information gathering, adjudication, "racing" to the courthouse and the distortion of capital flows and the distortion of investment decisions. This paper demonstrates that universalism is not only optimal in terms of global welfare, it is also optimal for any given country, subject only to a reciprocity requirement.

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I. Introduction

It has become cliché in the literature on transnational bankruptcies to observe that the "world is an increasingly smaller place" and that the world's economy is becoming increasingly integrated.[1] As evidence of this fact, commentators offer several spectacular international insolvencies which have occurred in the first half of this decade.[2] Such insolvencies present jurisdictional and choice of law problems which have been recognized for over 150 years.[3] It is generally agreed that some form of international cooperation is necessary to deal with these increasingly common events.[4] There are two polar alternatives available to deal with transnational bankruptcies -- a universal approach and a territorial approach. Under territoriality, each jurisdiction asserts control over the

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[1]Anthony M. Sabino & Nancy E. Susca, *The Role of Local Law in Determining the Property Rights of Foreign Debtors in Multinational Bankruptcies: Lex Fori Versus Comity*, 16 HAMLINE L. REV. 389, 389 (1993); *See* Todd Kraft & Allison Aranson, *Transnational Bankruptcies: Section 304 and Beyond*, 1993 COLUM. BUS. L. REV. 329, 331 - 32; Mike Sigal, Karen E. Wagner, John A. Barrett, Evan D. Flaschen, E. Bruce Leonard & Henry L. Goodman, *The Law and Practice of International Insolvencies, Including a Draft Cross-Border Insolvency Concordat*, 1994 - 95 ANN. SURV. BANKR. L. 1, 6.

[2]The triumvirate typically mentioned are Maxwell Communications, Bank of Credit & Commerce International (BCCI), and Olympia and York. *See* Evan D. Flaschen & Ronald J. Silverman, *Maxwell Communication Corporation plc: The Importance of Comity and Co-operation in Resolving International Insolvencies, in* CURRENT ISSUES IN CROSS-BORDER INSOLVENCY AND REORGANISATIONS 41, 41 - 47 (E. Bruce Leonard & Christopher W. Besant eds., 1994); Kurt H. Nadelman, "Rehabilitation in Int'l Bankruptcy Law: Lessons taught by Herstatt" 52 N.Y.U. L. REV. 1 (1977).

[3]*See* Joseph Story, COMMENTARIES ON THE CONFLICT OF LAWS §§ 405 - 06 (1834) (calling for an international bankruptcy system). *See also* Nadelmann, *supra*, note 2 (discussing the famous *Herstatt Bank* case in which the transnational bankruptcy system failed).

[4]For excellent presentations, *see* Jay L. Westbrook, *Choice of Avoidance Law in Global Insolvencies*, 17 BROOK. J. INT'L. L. 499 (1991) [hereinafter Westbrook, *Choice of Law*]; Jay L. Westbrook, *Theory and Pragmatism in Global Insolvencies*, 65 AM. BANKR. L.J. 457 (1990) [hereinafter Westbrook, *Theory and Pragmatism*]; Kraft & Aranson, *supra* note 1, at 329.

assets located within its territory and distributes them according to its domestic rules. Most observers, however, favor a universal approach in which all global assets are placed under the authority of a single jurisdiction (the "home country") which distributes the assets according to its local rules.[5] Despite this general consensus, prevalent among both academics and practitioners, the major industrialized countries have not made significant strides toward a universal transnational insolvency law.[6]

Commentators generally accept that adoption of universalist reforms is only possible if these reforms "yield[] economic benefits sufficiently great to command acceptance of universalism despite prejudice to local interests in particular cases."[7] In other words, it is felt that while universalism will yield certain efficiency benefits, abandonment of territoriality will also impose costs in certain cases. Many believe that in the race for post-bankruptcy assets, local creditors will, in at least some cases, lose the advantage over foreign creditors that is provided by territoriality. Legislators and judges

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[5]The definition of the "home country" is discussed in Part VII.

[6]*See infra* Part III.

[7]Westbrook, *Theory and Pragmatism*, *supra* note 4, at 458; *see* Donald Trautman, *Foreign Creditors in American Bankruptcy Proceedings*, 29 HARV. INT'L L.J. 49, 52 (1988) (stating that the factors used by American law in assessing a request for the turnover of assets are "all aspects of balancing an interest in international cooperation with the interests of local creditors); Westbrook, *Choice of Law*, *supra* note 4, at 514 ("the primary effect of the Grab Rule is to protect the primacy of local procedures and local law, with local creditors and sophisticated multinationals", "one could argue that [territoriality] . . . protects creditors used to relying on local law and procedures"); Kraft & Allison, *supra* note 1, at 337 ("the creditor is not the only one that suffers from the territoriality doctrine"); Timothy E. Powers & Rona R. Mears, *Protecting a U.S. Debtor's Assets in International Bankruptcy*, *in* 1 INTERNATIONAL LOAN WORKOUTS AND BANKRUPTCIES 27, 32 (Richard A. Gitlin & Rona R. Mears, eds., 1989) ("[territoriality] is defended on the basis of . . . protection of local creditors").

also fear this outcome, and as a result, are hesitant to adopt more universalist policies.[8]

This paper will demonstrate that attempts to protect local creditors by providing them with the security and comfort of domestic laws, preferential access to assets, and the convenience of local adjudication cannot succeed. What is given to local creditors by the legislature and the courts will be taken away by the credit market, leaving creditors no better off. This is so because modern credit markets are competitive -- and in a competitive market goods and services are sold at prices equal to their marginal costs. This implies that creditors will demand a return equal to their own cost of capital, the world rate of interest. For any given set of legal rules, the market will adjust such that all creditors receive this return in expectation. A rule that discriminates in favor of local creditors (e.g.: territoriality) will not yield benefits to them ex ante; rather it will cause local creditors to demand fewer (and foreign creditors to demand more) concessions in other areas. In practice, this may mean that foreign creditors will more frequently demand a security interest, impose more stringent contractual conditions, or simply demand a higher interest rate. For simplicity one can imagine these restrictions taking the form of variations in the contractual interest rate. In the case of a firm with multiple creditors spread among many countries, "local" creditors operating under a

[8]The very language of the U.S. Bankruptcy Code suggests that the protection of local creditors from inconvenience, prejudice or foreign laws is possible. *See* 11 U.S.C. 304(c)(2)-(4) (stating that courts should consider "(2) protection of claim holders in the United States against prejudice and inconvenience in the processing of claims in such foreign proceedings; (3) prevention of preferential or fraudulent disposition of property of such estate; (4) distribution of proceeds of such estate substantially in accordance with the order prescribed by this title"). The court in *In re Papeleras Reunidas, S.A.*, 92 B.R. 584 (Bkrtcy. E.D.N.Y. 1988) echoed this view, *id.* at 594 - 95 ("if this court should defer to the Spanish proceeding, Adams will be prejudiced by the omissions of Spanish law"); as did the court in *In re Toga*, 28 B.R. 165, 169 (Bkrtcy. 1983) ("This Court must protect United States citizens' claims against foreign judgments inconsistent with this country's well-defined and accepted policies.").

territorialist regime will accept a lower interest rate than they would demand under a universalist regime. These creditors recognize that in the event of bankruptcy the territorial laws of the jurisdiction will ensure that they receive more than a pro rata share of the assets.[9] Similarly, foreign creditors will demand a higher rate of interest because, in the event of bankruptcy, they will receive fewer assets than they would under universalism. Because creditors take account of the laws in effect when they make their loans, laws which distinguish between local and foreign creditors will not lead to systematically better outcomes for creditors.

Having established the case against the benefits of territoriality, the paper will demonstrate that the costs of territoriality are substantial, and higher than previously believed. Territorialism, as practiced in most countries, generates considerable uncertainty with respect to the ultimate choice of law. Creditors that are risk averse will demand a higher return in exchange for accepting that risk. Other costs are generated by the fact that territorialism imposes greater information gathering costs on creditors, requires the duplication of legal costs in different countries and forces an international race to the courthouses of the countries involved.

Finally, territorialism causes a distortion of investment decisions. Under a territorialist regime, a debtor with existing debt will face different interest rates from creditors in different countries. Rates will vary according to the access to assets that creditors will have in the event of bankruptcy. The firm, of course, is interested in its rate of return after interest payments. It will first be shown that the firm will borrow from the same country in which it invests. This implies that the

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[9]We assume that there are sufficient assets within the jurisdiction to provide creditors with more than a pro rata share of the assets that are available for distribution. If not, the choice between territoriality and universality is irrelevant to the recovery the local creditors receive.

investment location decision will be affected by the available interest rate in each country -- the firm will invest in the country where the difference between the return to its investment and its interest rate is the greatest. This will, in certain cases, be sub-optimal -- societally we prefer that the investment decision be based entirely on the total return to investment, ignoring the location of existing assets and creditors. In other words, the investment decision is distorted by territorial rules. Under universalism, the link between the country of investment and the country of the creditor is severed because all creditors receive equal treatment in bankruptcy. The distortion, therefore, disappears.

This interest rate differential between local and foreign creditors leads to different lending and investment patterns than would exist under universalism. It will be demonstrated that this result is especially true when only one country has territorial legislation while others have more universalist regimes. In such a situation, a country may benefit from territorial laws at the expense of other countries.[10] In a world in which all countries have universalist legislation some countries would face an incentive to "defect" and adopt territorial legislation. Multilateral universalism would not be sustainable. Reciprocity offers a solution to this problem.[11] By adopting universalism only when there exists reciprocity, the "prisoner's dilemma" mentioned above can be avoided.

[10]Note that in the case of unilateral territoriality, creditors will benefit because there will be greater demand for their capital and not because they receive better treatment in bankruptcy. Receiving preferential treatment in bankruptcy will merely allow local firms to offer lower interest rates than foreign firms and therefore attract more borrowers. See Part V for a discussion of this point.

[11]The preferred form of reciprocity will be discussed in Part VII. The paper envisages what Professor Westbrook refers to as "negative reciprocity." Westbrook, *Choice of Law, supra* note 4, at 468.

The paper is organized as follows. In the next two sections, I will provide an overview of the literature dealing with transnational bankruptcies, followed by a short summary of the law in the United States. In Part IV, I will discuss the state of modern capital markets, especially international capital markets, and the implication of market efficiency on lending decisions.[12] In Parts V and VI, I will discuss the implication of efficient capital markets and territoriality on lending and lending patterns, and present a new and stronger argument against territoriality and in favor of universality. In Part VII I will discuss some related issues and I will conclude with Part VIII.

II. The Prevailing View of Legislators and Commentators

Transnational bankruptcies are not new to either the business world or academia. Nor has there been a great shift in the perspective of legal academics over the years. In an article published in the Harvard Law Review in 1888, John Lowell wrote, "[i]t is obvious that . . . it would be better in nine cases out of ten that all settlements of insolvent debtors with their creditors should be made in a single proceeding, and generally in a single place. . . . If there is inconvenience in proving debts in a foreign country, ancillary administration might be granted here . . . ."[13] One hundred years later, the call for universalism continues: "all questions of importance to the distribution of the debtor's assets should be governed by the law of the debtor's principal place of business . . . . [T]here can be

[12]Market efficiency is actually a stronger condition than is needed here. The analysis merely requires that the market be able to price risk in some form (including, but not limited to, the availability of insurance).

[13]John Lowell, *Conflict of Laws as Applied to Assignments of Creditors*, 1 HARV. L. REV. 259, 264 (1888).

local ancillary proceedings."[14]

Despite the broad consensus among commentators, there has been virtually no movement toward universality on the part of western governments. Those changes that have occurred have been modest.[15] Legislators, judges, and commentators are all hesitant to adopt a universalist regime out of concern for the welfare of domestic creditors.[16]

The attitude of the American Congress can be ascertained by examining the text and

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[14]Trautman, *supra* note 7, at 58. Similar statements can be found in almost any article on the subject. *See e.g.*, Kraft & Aranson, *supra* note 4, at 364 ("A system that brings together all the creditors, and all the debtors' property, for a single distribution is the most efficient and equitable system possible."); Westbrook, *Choice of Law*, *supra* note 4, at 515 ("Universality . . . has long been accepted as the proper goal of international bankruptcy law by leading writers"); Jay L. Westbrook & Donald T. Trautman, *Conflict of Laws Issues in International Insolvencies*, *in* CURRENT DEVELOPMENTS IN INTERNATIONAL AND COMPARATIVE CORPORATE INSOLVENCY LAW 655, 667 (Jacob S. Ziegel, ed., 1994) ("In general, the goal in developing choice of law rules should be to apply the home-country law as pervasively as possible"). But see Stacey A. Morales & Barbara A. Deutcsh, *Bankruptcy Code Section 304 and U.S. Recognition of Foreign Bankruptcies: The Tyranny of Comity*, 39 BUS. LAW. 1573, 1595 - 96 (1984) (arguing for retention of U.S. jurisdiction over a foreign debtor's U.S. assets "unless the standards of section 304 clearly mandate that such control be relinquished through the mechanism of turnover.").

[15]For a discussion of the laws of various countries, *see* INTERNATIONAL LOAN WORKOUTS AND BANKRUPTCIES (Richard A Gitlin & Rona R. Mears, eds., 1989). For a discussion of attempts at multilateral solutions, *see* Donald T. Trautman, Jay L. Westbrook & Emmanuel Gaillard, *Four Models for International Bankruptcy*, 41 AM. J. COMP. L. 573 (1993); Kraft & Aranson, *supra*, note 1, at 351 - 61; Michael Bogdan, *The Nordic Bankruptcy Convention, in* CURRENT DEVELOPMENTS IN INTERNATIONAL AND COMPARATIVE CORPORATE INSOLVENCY LAW (Jacob S. Ziegel, ed., 1994).

[16]This characterization is accurate beyond the United States, but this paper will focus on the United States both because it is the jurisdiction with which I am familiar and because "American statutory law goes further than the law of any other industrialized nation in authorizing cooperation with foreign insolvency regimes." Douglass G. Boshkoff, *Some Gloomy Thought Concerning Cross-Border Insolvencies*, 72 Wash. U. L.Q. 931, 932. By examining the American situation, we learn a great deal about why there is not a greater global push for universality.

legislative history of § 304 of the Bankruptcy Code.[17] Under § 304, an ancillary case to foreign proceedings can be commenced by the filing of a petition by a foreign representative.[18] This filing, however, does not create an "estate" for the purposes of American bankruptcy law, as estates may only be created under §§ 301 - 03.[19] Despite this, reference is made in § 304 to both "property of the estate" and "the estate."[20] This suggests that the Bankruptcy Code considers the property located in the United States to be property of a foreign estate. Where full bankruptcy proceedings taking place within the United States, §541(a) provides that when a case is begun under §§301 - 303, an estate is created that includes "all of the . . . property, wherever located and by whomever held."[21] The reach of this statute has long been understood to include assets abroad, bringing those assets, in the eyes of American law, within the jurisdiction of American courts.[22] The fact that the United States claims universal jurisdiction when the main bankruptcy proceedings are taking place in the

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[17] REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 137, 93rd Cong., 1st Sess. 71 (1973) [hereinafter COMMISSION REPORT].

[18] 11 U.S.C. 304(a). A "foreign representative" is defined as a "duly selected trustee, administrator, or other representative of an estate in a foreign proceeding." 11 U.S.C. 101(24).

[19] 11 U.S.C. §541(a).

[20] 11 U.S.C. 304(b)(1)(B), (b)(2), (c).

[21] 11 U.S.C. 541(a).

[22] *See* In re Universal Money Order Co., 470 F.Supp. 869, 882 (S.D.N.Y. 1977); 1 DALHUISEN ON INTERNATIONAL INSOLVENCY AND BANKRUPTCY §2.02(1) - (2) at 3-157, 58 (1984); John D. Honsberger, *Conflict of Laws and the Bankruptcy Reform Act of 1978*, 30 CASE W. RES. L. REV. 631, 636 (1980); Stephen B. James, *International Bankruptcy: Limited Recognition in the New U.S. Bankruptcy Code*, 3 HOUS. J. INT'L L. 241, 269 -71 (1981); Kurt H. Nadelmann, *The National Bankruptcy Act and the Conflict of Laws*, 59 HARV. L. REV. 1025, 1029 (1946); Powers & Mears, *supra* note 7, at 31. Of course, the collection of foreign assets by the trustee is only possible with the cooperation foreign authorities who are often unwilling to allow such an assertion of jurisdiction.

United States and defines the estate in foreign bankruptcies to include U.S.-based assets demonstrates a preference for a single estate consisting of all assets.[23]

In passing §304, Congress sought to further the universality doctrine, as evidence by the legislative history: "the foreign representative may file a petition under this section . . . in order to administer assets located in this country, to prevent dismemberment by local creditors of assets located here, or for other appropriate relief."[24] Through §304(c), however, U.S. law significantly reduces the likelihood that assets located in the United States will be turned over to a foreign proceeding, as discussed in Part III below. Specifically, the statute instructs courts to consider "protection of claim holders in the United States against prejudice and inconvenience . . . prevention of preferential or fraudulent dispositions of property . . . [and] distribution of proceeds of such estate substantially in accordance with [the Bankruptcy Code]."[25] The common feature of each of these conditions is that it serves to protect the interests of local creditors after the foreign debtor has filed for bankruptcy. This policy, which can be described as universality subject to broad exceptions for assets that are part of a foreign estate but located in the United States, is consistent with an attempt

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[23]*See* Ulrich Huber, *Creditor Equality in Transnational Bankruptcies: The United States Position*, 19 VAND. J. TRANSNAT'L L. 741, 746 (1986) (stating that the language used in the Code "may be considered an implicit recognition by the Code of the concept of unity of the estate.")

[24]H.R. REP. NO. 595, 95th Cong., 1st Sess. at 324 - 25 (1977); S. REP. NO. 989, 95th Cong., 2d Sess. 35 (1978). This intent was also evident from the earlier legislative history: "to protect the estate against dismemberment by local actions in this country without the necessity of commencing a bankruptcy of rehabilitation case under this Act." REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 137, 93rd Cong., 1st Sess. 71 (1973).

[25]11 U.S.C. §304(c)(2)-(4).

to protect local creditors from the perceived risks of universality, while still attempting to produce the greatest efficiency gain by adopting universality where it is not believed to harm local creditors.[26]

Like the statute and its legislative history, commentators have adopted a universalist tone with respect to transnational bankruptcies.[27] What remains to explain is the failure of §304 to establish a legal regime that truly respects notions of universality. The usual answer provided by commentators, and, I believe, the correct one, is that policy makers and judges are concerned about the welfare of local creditors. Writing in 1944, Professor Nadelmann stated that "in most of the countries delivery of local assets . . . is refused at least if opposed by local creditors."[28] Those writing on the subject today take largely the same view, stating that the gains from universality are not valued highly enough to defeat the perceived interests of local creditors.[29] Thus, reluctance to adopt universalist policies is premised on a broad consensus among commentators that there is a loss

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[26]The United States is by no means unique in its effort to apply its bankruptcy laws extraterritorially while not allowing others to do so. Similar provisions are found in the laws of many countries. *See* Powers & Mears, *supra* note 7, at 31 n.6 (citing DALHUISEN, *supra* note 22, at 3-158)

[27]The case law, which tends to speak in universal tones even when denying relief, will be discussed in Part III.

[28]Kurt H. Nadelmann, *International Bankruptcy Law: Its Present Status*, 5 U. TORONTO L.J. 324, 339 (1944).

[29]*See* Douglass G. Boshkoff, *Some Gloomy Thoughts Concerning Cross-Border Insolvencies*, 72 WASH. U. L.Q. 931, 938 (1994) ("Cooperation is not valued as highly as the protection of American creditors"); Daniel L. Glosband & Christopher T. Katucki, *Claims and priorities in Ancillary Proceedings Under Section 304*, 17 BROOK. J. INT'L. L. 477, 477 ("[C]ourt and commentators have struggled with the tension between protecting local claims in local bankruptcy proceedings and the application of unfamiliar foreign insolvency laws."); Westbrook, *Choice of Law*, *supra* note 4, at 518 ("International cooperation will be achieved despite local prejudice only if policy makers are convinced . . . that over a run of cases local prejudice in some cases will be balanced by local gains in others.").

for local creditors when a country abandons territoriality. For example, Professor Westbrook states:

> The central argument for the Rough Wash is that a universalist rule will roughly even out benefits and loses for local creditors, who will gain enough from foreign deference to the local forum in one case to balance any loss from local deference to the forum in another. . . .[30]

And in an accompanying footnote:

> The bulk of countries most likely to join in transnational cooperation are those that believe that they are deficit countries at least as often as they are surplus countries. Countries that think they will routinely be in surplus will not be very eager to join an international scheme; the benefits to be realized by everyone from greater realization on assets are probably too imprecise to persuade them that greater asset prices will outbalance loss of a consistent surplus position.[31]

Note that under this analysis universalism becomes extremely difficult to accomplish. Professor Westbrook points out that absent benefits due to a reduction in transaction costs,

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[30]Westbrook, *Theory and Pragmatism*, *supra* note 4, at 465.

[31]*Id.* at 465 n.26. *See also* Honsberger, *supra* note 22, at 671-73 (stating that some may view a universal rule in the United States as a "giveaway" if American debtors do not receive similar treatment abroad); Gary Perlman, *The Turnover of Assets Under Section 304 of the Bankruptcy Code*, 12 FORDHAM INT'L L.J. 521, 531 (1989) (stating that courts which "emphasize the interests of U.S. creditors" are more likely to refuse turnover); Jay L. Westbrook & Donald T. Trautman, *Conflict of Law Issues in International Insolvencies, in* CURRENT DEVELOPMENTS IN INTERNATIONAL AND COMPARATIVE CORPORATE INSOLVENCY LAW 655, 657 (Jacob S. Ziegel ed., 1994) ("The losses [a universalist country's] creditors suffer in some cases would be balanced by gain in others. . . . It might [require reciprocity out of] fear[] that otherwise it would suffer greatly in a world of nations committed to the idea of territoriality"). *But see*, Kraft & Aranson, *supra* note 1, at 350 ("[C]reditors presumably know of the potential for bankruptcy and its attendant complications when they decide to do business with foreign companies.").

("transactional gain") only "deficit" countries will accept a universalist rule, but the problem is actually far worse.[32] Only deficit countries *with respect to the other universalist countries* would accept a universalist rule. It is, of course, impossible for all the universalist countries simultaneously to be deficit countries with respect to one another. Under this analysis there can be no stable coalition of universalist countries because those with a surplus vis a vis the others in the group will always defect, creating new surplus states (with respect to the remaining universalist states) who will in turn leave the coalition. There is no equilibrium in which a group of states can adopt and maintain universalist policies because there will always be some states that would be better off defecting.[33]

This examination, and the discussion of the case law in Part III, reveals that while all relevant groups -- legislators, judges, and commentators -- seem to favor universality in principle, each group has concerns about the practical effect on local creditors. There is recognition that universality yields significant efficiency gains and would be the best solution from a global perspective, but there is a perception that a form of prisoner's dilemma exists in which each country's dominant strategy is to adopt territorialist laws despite the global advantages of universalism. In other words, there appears to be a perception that the cooperative solution to the problem of transnational bankruptcies may differ from the non-cooperative solution. If we accept that universalism imposes costs on creditors in "surplus" countries, we must concede that achieving universalism is very unlikely,

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[32]A deficit country is one that is a net recipient of credit.

[33]This is an example of the "lemon's problem" first introduced by Akerlof. *See* George Akerlof, *The Market for Lemons: Qualitative Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970).

because there will always be some countries that would be better off abandoning universality.[34] This paper, however, challenges the notion that surplus countries must bear a cost in adopting universality. It argues that such costs are illusory and should not prevent the adoption of a universalist regime.

III. American Law

In this section I set out the current law of the United States. Discussion of the law of other countries can be found elsewhere and will not be presented here.[35]

Section 304 of the bankruptcy Code of the United States[36] was adopted as part of the

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[34]Universality would still, in principle, be attainable if the global efficiency gains -- sometimes called "transactional gain," Westbrook, *Theory and Pragmatism*, *supra* note 4, at 464 - 66 -- outweigh the net loss to creditors in surplus countries. The argument in favor of the efficiency gains, however, is precisely the argument that to date has failed to convince legislators to adopt universalist legislation.

[35]*See e.g.,* CROSS-BORDER INSOLVENCY: COMPARATIVE DIMENSIONS (Ian F. Fletcher ed., 1989) (discussing England, Canada, Australia, Germany, Sweden, and Argentina); CROSS-BORDER INSOLVENCY: NATIONAL AND COMPARATIVE STUDIES (Ian F. Fletcher ed., 1992); CURRENT DEVELOPMENTS IN INTERNATIONAL AND COMPARATIVE INSOLVENCY LAW (Jacob S. Ziegel ed., 1994);CURRENT ISSUES IN CROSS-BORDER INSOLVENCY AND REORGANISATIONS (E. Bruce Leonard & Christopher W. Besant eds., 1994); INTERNATIONAL LOAN WORKOUTS AND BANKRUPTCIES (Richard A Gitlin & Rona R. Mears, eds., 1989) (presenting a survey of many countries); Honsberger, *supra* note 22, at 661 - 663 (discussing Britain, Canada, France and Germany); Chin Kim & Jimmy C. Smith, *International Insolvencies: An English-American Comparison with an Analysis of Proposed Solutions*, 26 GEO. WASH. J. INT'L. L. & ECON. 1, 5 - 13 (1992) (providing a detailed discussion of English law);Koji Takeuchi, *Cross-Border Bankruptcy: Japanese Report*, INTERNATIONAL SYMPOSIUM ON CIVIL JUSTICE N THE ERA OF GLOBALIZATION, 81 - 89 (1992).

[36]11 U.S.C. 304.

Bankruptcy Reform Act of 1978.[37] The stated purpose of the legislation was "to administer assets located in this country, [and] to prevent dismemberment by local creditors of assets located here . . . ."[38] It is widely accepted by commentators that the statute reflected a desire on the part of American legislators to further the cause of international cooperation with respect to transnational insolvencies and that it continues to represent the furthest movement towards universality among the major industrialized countries.[39] The text of Section 304 is as follows:

> (a) A case ancillary to a foreign proceeding is commenced by the filing with the bankruptcy court of a petition under this section by a foreign representative.
> (b) Subject to the provision of subsection (c) of this section, if a party in interest does not timely controvert the petition, or after trial, the court may --
> (1) enjoin the commencement or continuation of
> (A) any action against
> (i) a debtor with respect to property involved in such foreign proceeding;
> (ii) such property; or
> (B) the enforcement of any judgment against the debtor with respect to such property....
> (2) order turnover of the property of such estate, or the proceeds of such property to such foreign representative; or
> (3) order other appropriate relief.
> (c) In determining whether to grant relief under subsection (b) of this section, the court shall be guided by what will best assure an economical and expeditious administration of such estate, consistent with --
> (1) just treatment of all holders of claims against or interests in such estate;
> (2) protection of claim holders in the United States against prejudice

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[37]Bankruptcy Reform Act of 1978, PUB L. NO. 95-598, 92 Stat. 2549 (1978).

[38]H.R. REP. NO. 595, 95th Cong., 1st Sess. 324 (1977), S. REP. NO. 989, 95th Cong., 2d Sess. (1978) 35.

[39]*See e.g.*, Douglass G. Boshkoff, *Some Gloomy Thoughts Concerning Cross-Border Insolvencies*, 72 WASH. U. L.Q. 931, 932 (1994) ("American statutory law goes further than the law of any other industrialized nation in authorizing cooperation with foreign insolvency regimes.").

> and inconvenience in the processing of claims in such foreign proceeding;
> (3) prevention of preferential or fraudulent dispositions of property of such estate;
> (4) distribution of proceeds of such estate substantially in accordance with the order prescribed by this title;
> (5) comity . . . .

For our purposes, §304(c) is the most important section -- it lays out the criteria to be used by the court in determining whether or not to grant requests for the turnover of assets or other relief. The tension between the desire to encourage international cooperation and the perceived need to protect domestic creditors is very clear in §304(c). Parts (2)-(4) attempt to minimize the burden on American creditors, while part (5) offers the courts a powerful tool for granting §304 petitions.

The tension in the statute is reflected in a body of case law that has failed to establish a coherent test by which to assess §304 petitions. The leading case in favor of a broad allowance of §304 petitions in *In re Culmer.*[40] In that case, the liquidators for BAOL, a Bahamian corporation, filed a §304 petition, seeking to enjoin attaching creditors from initiating or furthering proceedings against the company, to enjoin the creation or enforcement of any liens against property of the company in the United States, and to have the assets turned over to the Bahamas for distribution in the liquidation proceedings.[41] BAOL had over a hundred creditors, including several owed large sums of money.[42] Those opposed to the petition argued that the Bahamas could not ensure just

[40]25 B.R. 621 (Bankr. S.D.N.Y. 1982).

[41]*Id.* at 623.

[42]*Id.* at 624 - 25. Among the creditors were Arabank (owed $2.2 million); Bankers Trust (owed $1.6 million); Slavenburg Bank (owed $2.2 million); and Chase Manhattan Bank (owed over $350, 000).

treatment for all creditors. The U.S. Bankruptcy Court, placing the burden on those opposing the petition, was not convinced, stating that "no concrete facts were ever elicited tending to impugn the impartiality of the liquidators or the regularity with which the Bahamian liquidation is proceeding."[43] The court concluded that Bahamian law was consistent with the principle of equality of distribution and that "the Bahamas Supreme Court [] can 'best assure an economical and expeditious administration of [the BAOL] estate.'"[44]

The strong universalist language used by the court in *Culmer* is important in understanding the inconsistent Bankruptcy Court judgments. In addressing the claims of creditors holding preferences to which they would not be entitled in a Bahamian proceeding, the court stated that "[t]his Court is thus not obligated to protect the positions of fast-moving Americans and foreign attachment creditors over the policy favoring uniform administration in a foreign court."[45] Addressing the similarity between Bahamian and American law, the court enunciated the following standard: "[w]hether or not Bahamian law is identical in application to American law, there is nothing inherently vicious, wicked, immoral or shocking to the prevailing American moral sense . . . ."[46] Nor was the court moved by pleas that American creditors would be severely inconvenienced if the petition were approved. Quoting from *Canada Southern Railway v. Gebhard*[47] the court stated:

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[43]*Id.* at 628.

[44]*Id.* (quoting 11 U.S.C. 304(c)).

[45]*Id.* at 629.

[46]*Id.* at 631.

[47]109 U.S. 527, 537 - 38 (1883).

> [E]very person who deals with a foreign corporation impliedly subjects himself to such laws of the foreign government . . . . He is conclusively presumed to have contracted with a view to such laws . . . . It follows, therefore, that anything done at the legal home of the corporation, under the authority of such laws, which discharges it from liability there, discharges it everywhere.[48]

Of the factors listed in §304(c) of the Bankruptcy Code, the court in *Culmer* found comity to be the most important, pointing out that all the other factors listed in §304(c) have traditionally been included in deciding comity cases. The view led to the holding in *Culmer that* favors the granting §304 petitions, with only a narrow public policy exception.

In the cases that have granted turnover requests the emphasis has continued to be on comity, relying on the standard enunciated in *Culmer* -- turnover can be granted as long as foreign proceedings are inherently fair and are not "repugnant" to American ideas of justice. The attitude of this line of cases in best expressed in *In re Gee*[49] where the court says:

> Although comity is only one of six factors to be considered in determining whether to grant relief, it often will be the most significant . . . . Particularly where the foreign proceeding is in a sister common law jurisdiction with procedures akin to our own, exceptions to the doctrine of comity are narrowly construed. . . . For comity to be extended, it is necessary only that the foreign court abide by fundamental

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[48]*Id.* at 632.

[49]53 B.R. 891 (Bankr. S.D.N.Y. 1985).

standards of procedural fairness."[50]

Standing in stark contrast to the cases discussed above is a set of cases that have denied turnover requests. The most important of these is *In re Toga Mfg.*[51] In *Toga*, a Canadian company, engaged in bankruptcy proceedings in Canada, filed a §304 petition seeking an injunction against creditor action and turnover of U.S.-based assets. The court denied the petition on the grounds that a creditor (Hesse) "is recognized as holding a secured claim [under U.S. law] . . . . Under Canadian law, on the other hand, Hesse would most likely be considered an 'ordinary creditor.'"[52] Based on this fact, the court concluded that distribution of the proceeds would not be "substantially in accordance with the order prescribed by the U.S. Bankruptcy Code"[53] as required by §304. In dicta, the court defended its ruling, stating that the "Court must protect United States citizens' claims against foreign judgments inconsistent with this country's well-defined and accepted policies."[54]

The dramatically different approaches taken by the *Culmer* line of cases as compared to the *Toga* line stem from the inconsistent application of two matters of interpretation. The first is the emphasis to be placed on comity. Courts granting §304 petitions have typically considered comity to be the most important factor, while courts denying petitions argue that "it is best to equally consider all of the variables of §304 in determining the appropriate relief in an ancillary

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[50] *Id.* at 901 - 02.

[51] 28 B.R. 165 (Bankr. E.D. Mich. 1983).

[52] *Id.* at 168.

[53] 11 U.S.C. 304(c)(4).

[54] *Toga*, 28 B.R. at 170.

proceeding."[55] The second point of disagreement among courts is the degree to which the foreign law must resemble American law. In *Culmer* and *Gee* the court merely required that the foreign proceedings be fundamentally fair. Courts denying relief have usually taken a much narrower view of the law at issue. Rather than looking at the overall procedures in place in the foreign jurisdiction, these courts have looked more specifically at the specific questions of law that affect the American creditor before the court and asked if *that* creditor would do as well under the foreign proceeding. This view is evident in *Interpool Ltd. v. Certain Freights of M/V Venture Star*[56] in which the court asked if "United States creditors will be similarly protected in both jurisdictions"[57] and later in the opinion, "this Court does not intend to stand idly by while United States citizens and creditors are harmed."[58]

As the above noted cases demonstrate, there is great inconsistency in the application of the law on transnational bankruptcies in the United States, and attempts to reconcile the cases have not proved satisfactory.[59] In the words of one article on the subject, "the United States' treatment of

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[55]In re Papeleras Reunidas, 92 B.R. 584 (Bankr. E.D.N.Y. 1988) (denying a §304 petition where Spain was the foreign forum).

[56]102 B.R. 373 (D.N.J. 1988).

[57]*Id.* at 377.

[58]*Id.* at 380. This paper argues, of course, that such ex post assessments of the welfare of local creditors do not lead to an overall increase in the well being of those creditors. *See* Part IV.

[59]I will permit myself one more example -- the court in *Culmer* states in dicta that Canadian liquidation procedures -- which is exactly what is at issue in *Toga* -- meet the standard used by the *Culmer* court. "It is well-settled that the liquidation laws of Canada . . . are to be given effect under principles of comity." In re Culmer, 25 B.R. 621, 631 (Bankr. S.D.N.Y. 1982). In *Toga*, the court denied a §304 petition for turnover to Canadian courts, concluding that "comity requires that Hesse's claim remain in Michigan and United States courts, there to be fully litigated." In re Toga, 28 B.R.165, 170 (Bankr. E.D. Mich. 1983).

international bankruptcies is hopelessly unpredictable and at times provincial."[60] Transnational credit arrangements must account for this uncertainty both by attempting to minimize the exposure of creditors to loss in the event of a territorial ruling by the court and, if creditors are risk averse, by accounting for the risk generated by the legal uncertainty.

IV. The Efficiency of Capital Markets

In talking about the regulation of multinational activity, it is important to adopt a realistic view of the environment in which multinational firms operate. The first thing to note is that multinational firms and international creditors are typically sophisticated players in a sophisticated market. We should not fear that these creditors will fail to protect their interests. Any doubts about the capacity of international creditors to protect their interests, can be assuaged by looking at recent bankruptcies and observing the speed with which creditors attached their debtors foreign assets.[61] "In the modern world, sophisticated multinational creditors are increasingly able to claim in local

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[60]Kraft & Aranson, *supra* note 1, at 330. *See also* Kim & Smith, *supra* note 33, at 20 ("When a bankruptcy court is confronted with a section 304 proceeding, it can and will mold the statute to suit its own preferences and, quite possibly, its own views of justice with relation to the case at bar.").

[61]*See* Joseph D. Becker, *International Insolvency: The Case of Herstatt*, 62 A.B.A.J. 1290 (1976); Stefan A. Riesenfeld, *The Status of Foreign Administrators of Insolvent Estates: A Comparative View*, 24 AM. J. COMP. L. 288, 288-90 (1976). The speed with which large creditors can attach local assets also raises fairness issues as smaller creditors which are not fortunate to be in a jurisdiction in which assets exceed debts are the most likely to lose out in the international assets grab that follows an initial filing in one country. By centralizing the bankruptcy, universalism avoids this scramble for assets, thereby giving smaller creditors a greater opportunity to participate in the distribution.

proceedings all over the world."[62]

Because international creditors are sophisticated, repeat players, they can be expected to adjust their loan contracts to accurately reflect the risk to which they are exposing themselves. Put simply, their expectations about their legal rights and their actions based on those expectations will be formed by the law in place. We need not worry about the "likelihood of defeat or diminution of the settled expectations of creditors whose dealings with the debtor were based upon assumptions that the laws that would regulate their relationship were those of the local system."[63] Under a universalist (or any other) regime, creditors' expectations will accurately reflect their legal rights.

Nor is the ability to understand the legal background of a transaction limited to large banks. Even small creditors have reason to be familiar with the laws governing their loans. When there is a non-trivial chance of bankruptcy, counsel for the creditor can be expected to consider the effect bankruptcy would have on the debt, including the risk of having to pursue one's claim in a distant jurisdiction. Knowing that they face a risk of bankruptcy, creditors will lend with this risk in mind. Furthermore, even the smallest of consensual creditors can, if they feel unable to accurately assess the legal climate, assign the risk to an entity that is better able to estimate it.[64] The first way to do so is to simply refuse to extend credit. Payment on delivery or payment in advance would, from the point of view of the creditor, eliminate the risk of bankruptcy. This would force the multinational

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[62]Westbrook, *Choice of Law*, *supra* note 4, at 514.

[63]Ian F. Fletcher, *International Insolvency: A Case for Study and Treatment*, 27 INT'L LAW. 429, 430 (1993).

[64]The analysis of this paper does not apply to the important case of non-consensual creditors such as tort creditors and (perhaps) employees. Ancillary proceedings may offer a way of dealing with such creditors. *See infra* Part VII(c).

debtor to borrow funds from another source -- most likely a bank which would be able to properly account for the risk of bankruptcy. Refusing to extend credit may, of course, not be a practical option for a creditor that risks losing business if it does not extend credit. An alternative solution in such a case would be to arrange a letter of credit. Under a letter of credit arrangement, the supplier contracts with the buyer for delivery of the goods, but contracts with the bank for payment. The bank in turn contracts with the buyer for reimbursement. Because each of the contracts is independent, the supplier does not face the risk of bankruptcy. Instead, this risk is transferred to the bank in exchange for a fee. In this manner, even a small, unsophisticated creditor can avoid unnecessary loses due to the legal climate in which it operates.[65]

Those who remain concerned about the "defeat of creditors settled expectations" must explain not only how those expectations are formed if it is not by the laws in place, they must also explain why those expectations would conform more closely to the current legal regime than to an alternative regime. If expectations are not formed by the existing legal background, it is plausible to assume that those expectations will be defeated under the current territorial regime as much as they would be defeated under universalism. In discussing transnational bankruptcies we must keep in mind that when debts are greater than assets, some creditors will not be paid.[66] It is odd to simply

[65]Under a letter of credit, the fee charged by the bank will, of course, reflect the cost of bearing the risk of bankruptcy. The creditor is, therefore, informed of the cost of the risk which can then be passed on to the debtor in the same way as would be done by a large creditor.

[66]Territorialism does not, of course, change this fact. In every case in which a local creditor in country A is able to recover because there are assets within the jurisdiction, there is also a creditor in country B that is denied recovery altogether because the assets in A are seized by local creditors in A and fast moving multinational creditors. The question for those criticizing universality on the basis of defeated expectations must explain why the expectations of the creditor in B are not frustrated while the expectations of a creditor in A would be frustrated under

assume that under one regime the creditors who receive less than full payment have taken into account the risk they faced while under a different regime the same creditors were somehow unable to account for this risk.[67]

The market on which borrowing is done is the international credit market.[68] Discussions of the size and efficiency of world capital markets is beyond the scope of this paper and can be found elsewhere. For our purposes, it is enough to note that there is wide consensus that the market for capital is truly global.[69] Therefore, the market is most properly modeled as a competitive one.

As in any competitive market, sellers (i.e. lenders) will sell at a price equal to marginal cost.

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a universalist regime in which there was a single distribution. This question is especially troubling when one accounts for the fact that assets (especially financial assets) are mobile and easily moved from one jurisdiction to another prior to bankruptcy.

[67]Those who doubt the ability of creditors to know the laws in place must also explain the existence of a vast legal framework to regulate lending and other commercial transactions. It is generally expected that agents know the laws and how those laws affect them. There is no clear reason why that presumption should be reversed in this instance. For example, violation of the automatic stay under the U.S. Bankruptcy Code is subject to sanction and ignorance of the stay is not a defense (though ignorance of the bankruptcy is). *See* 11 U.S.C. 362(a), (h). If creditors are unaware of the laws in place, the entire regulatory structure of commercial dealings is called into question.

[68]Of course, some borrowing is done in what might be considered more local markets, for example, extension of credit by suppliers. Because transnational firms have access to international credit, however, they will only seek credit from "local" credit markets if it is cheaper there than it is elsewhere -- implying competition with international credit. Therefore, when we speak of transnational firms, we are necessarily speaking about an international credit market.

[69]*See e.g.*, HAL H. SCOTT & PHILIP WELLONS, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY AND REGULATION, 1 - 32 (1995). Total international borrowing from banks and bond markets was $492 billion in 1992 and had reached a peak of $977 billion in 1990. *Id.* at 10 -11. "[T]he international system has become a multinational system, a global system where capital flows directly and in growing quantities from one economy to another." *Id.* at 22. *See also* BRUNO SOLNIK, INTERNATIONAL INVESTMENTS, 154 - 61 (1991) (discussing the size and sophistication of the international bond market).

In the case of credit markets this means that creditors will lend at an interest rate equal to their own cost of capital, the world interest rate. The interest rate will be adjusted to account for the risk that the creditor faces. For our purposes the relevant risk is the risk of bankruptcy. Should the debtor enter into bankruptcy proceedings, the creditor may well get less than full repayment, and the creditor will demand a higher interest rate to account for this risk. A risk neutral creditor will demand an interest rate sufficiently high that it will receive the world interest rate *in expectation.*[70] If the legal regime reduces a creditor's ability to collect in bankruptcy, the creditor will demand a higher interest rate to account for the increased risk.

Laws that establish preferential treatment for local creditors merely change the amount each creditor will receive in the event of bankruptcy. Since creditors will still seek to receive the world interest rate in expectation, and since expectations are forward looking, both local and foreign creditors will offer interest rates that reflect their legal rights. It will still be the case that in individual bankruptcy proceedings local creditors will get more in bankruptcy than their foreign counterparts. But this windfall in bankruptcy will be made up for by a lower interest rate charged in the event that there is no bankruptcy. Because only one contingency can be regulated (i.e. the bankruptcy state), the other contingency (i.e. non-bankruptcy) will adjust to ensure that local creditors will not receive more in expectation under a territorial regime than they would under a universalist regime. Similarly, foreign creditors will charge a higher interest rate outside of bankruptcy to account for the small recovery they can expect in bankruptcy. If there exists

[70]For example, if the world interest rate is 10%, there is a 25% chance of bankruptcy and if the creditor expects to receive no payment in the event of bankruptcy, the creditor will demand and interest rate of "r" such that: (.25)(0) + (.75)(r) = .10. In other words, the creditor will demand an interest rate of 13.3%.

uncertainty regarding the choice of law in the event of bankruptcy (as there is under current U.S. law) the above expectations analysis will still apply. Risk neutral creditors will simply lend based on a weighted average of the possible legal outcomes.[71]

V. Territorialism and the Costs of Borrowing

(a) Costs of Uncertainty

Under the current system of rules -- which is neither strictly territorial nor strictly universal -- there is substantial uncertainty with respect to the eventual choice of law.[72] This implies uncertainty with respect to a given creditor's priority status. For example, an American creditor lending to a German firm operating in the United States will not be certain if it can rely on American bankruptcy law and American courts or if it will have to deal with German law. The same uncertainty will plague a German creditor lending to the same U.S.-based branch.

Of course, if we imagine firms to be risk neutral this form of uncertainty is not important because creditors will demand an interest rate based on a weighted average of the possible outcomes. A creditor will still demand, and will receive, the world rate in expectation -- where the expectation is taken at the time the loan is made. If, in the event of bankruptcy, there is a 50% chance that the creditor will have to litigate in country A and a 50% chance that it will have to litigate in B, and if

[71]*See infra* Part V, for a discussion of the additional costs of uncertainty if firms are risk averse.

[72]*See supra*, Part III; Kraft & Aranson, *supra* note 1, at 336 (" No creditor knows when dealing with an international company, which country's laws would apply if the company becomes insolvent.").

the creditor would demand interest rate of 8% if it knew it would have to litigate in A but a rate of 6% if it knew litigation would be in B, then the creditor would demand a rate of 7%, leaving it as well off in expectation as it would be in a world of certainty.

If firms are risk neutral, therefore, even a partial move towards universality should generate efficiency gains as will be discussed in Part VI. On the other hand, if firms are risk averse, as suggested by the corporate finance literature,[73] the partial universality that exists in many countries today may not lead to any gain in efficiency. The uncertainty with respect to the choice of law decision will induce risk averse creditors to demand a higher expected return to capital in exchange for accepting a greater variance in the distribution of returns, thereby increasing the rate of interest required for investment and undermining the efficiency gains of universalism. This increase in the interest rate will raise the threshold return required in order to induce investment, implying that the total amount of investment will be reduced.

A regime of strict territoriality is very predictable and will, therefore, not generate the same level of uncertainty. There will remain, however, some uncertainty that would not exist under universalism. Consider, for example, the basic facts of *In re Axona Int'l Credit & Commerce, Ltd.*[74] When Chemical bank learned that Axona International had collapsed, the bank attempted to attach Axona's bank accounts in the United States. Under territorial rules, those assets would have been distributed under American law. Even under such a territorial regime, however, at the time

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[73]*See, e.g.*, Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, J. FIN. ECON., Oct. 1976; Eugene Fama & Michael Jensen, *Agency Problems and Residual Claims*, J.L. & ECON., JULY, 1983.

[74]924 F.24 31 (2nd Cir. 1991).

Chemical bank entered into an agreement with Axona, Chemical could not be sure that American law would apply in the event of bankruptcy. It would be a simple matter for Axona, prior to filing for bankruptcy, to transfer its accounts to a bank in another jurisdiction, ensuring that the case would be judged under the laws of that jurisdiction. Where the assets in question are highly mobile, territoriality leads to only limited certainty with respect to the rules that apply in bankruptcy. Whether motivated by business reasons or a desire to favor some creditors over others, a debtor can easily transfer assets out of one jurisdiction and into another.[75]

(b) Direct Costs of Bankruptcy

The second type of cost imposed by territorialism is more direct and arises out of the bankruptcy itself, rather than out of the uncertainty involved. It includes the additional costs of information gathering, adjudication, and an international race to the courthouse.

Consider first the costs imposed on the creditor (and passed on to the debtor) at the time of the initial transaction. Before lending, a prudent creditor will investigate the laws under which a bankruptcy will be adjudicated. In particular, a creditor is interested in knowing its level of seniority with respect to all other debt, and the value of the assets that will be available to satisfy that debt. Under a universalist regime, the creditor's informational needs are relatively modest. It is important to know the laws of the home state of the debtor in order to establish one's priority ranking, and it

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[75]Note that in the case of an attempt to favor one creditor over another, there may be a remedy if the actions of the creditor are judged to constitute a fraudulent conveyance or an avoidable preference, 11 U.S.C. 544, 547, 548. Pursuing such a claim, however, would not avoid the basic choice of law problems that the creditor faces -- once the assets are move to another jurisdiction, the laws of that jurisdiction (including choice of law) will apply.

is important to know the total value of the assets that will be left over should bankruptcy occur. With this information, the creditor will be able to assess the risk to which it is exposing itself and will be able to judge the wisdom of the loan in question.

Under a territorialist regime, however, the creditor needs to gather more information at greater cost. Because the applicable law is determined by the country in which the assets are located, the creditor must be familiar not only with the laws of every country in which there are assets, it must also concern itself with the possibility that assets will be moved to a different jurisdiction. In principle, the creditor could find itself pursuing assets in any jurisdiction in the world. Although in practice it will almost always be safe to assume that certain jurisdictions will not be relevant, it will rarely be the case that the creditor can safely assume that no other jurisdiction will become relevant in the future. Even if we restrict consideration to the major industrialized countries, the creditor would still face considerable cost in attempting to assess the risk to which it is exposed should the assets be moved to one of those countries. Furthermore, under territoriality, the creditor needs more information regarding the location of assets than it requires under universality. It is not enough for the creditor to merely know the total value of debts and assets, rather it must determine its priority and the value of the assets that will be available in each country in which there are (or in which there may be) assets. This means that the creditor must know both the identity and the location of all the other creditors and the location of all assets. Only with this information is it possible to assess the risk represented by the loan. The cost of gathering such information may be substantial, and is certainly greater than the cost of gathering information under universalism.[76]

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[76]Note that because this cost is born by every creditor, for every loan and is not limited to those that end in bankruptcy, the amounts at stake are very large.

If we imagine that there are N countries with assets and that there are M other creditors (and if we ignore the possibility that assets may be moved from one country to another), territoriality requires the creditor to acquire information on the value of assets in each country, the nationality of the other creditors, and his priority in each country. This is a total of 2N+M pieces of information. Under universalism, the creditor needs only 2 pieces of information -- the total value of assets and his priority under the laws of the home country.

Note also that each piece of information required under territoriality will be more difficult to collect. For example, the applicable laws in country A may depend on whether or not there has already been a bankruptcy filing in country B, and whether or not a distribution has taken place.[77] The extent to which turnover of assets is allowed may also depend on the country to which the assets would be delivered -- A may allow turnover to B, but not to C.[78] In this latter case, the creditor will require information about each country with respect to every other country, plus information on the nationality of other creditors and the value of assets in each country -- a total of $N^2 + M$ pieces of information.

Another cost imposed by territorial laws is the large increase in the cost of actually adjudicating the bankruptcy and distributing the assets. Consider first the position of the creditors.

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[77]For example, under the U.S. Bankruptcy Code, §508(a) specifies that payment in a foreign proceeding must be taken into account in an American distribution.

[78]For example, the United Kingdom provides for some flexibility on the part of courts when there are certain "established arrangements" in place between the U.K. and the foreign jurisdiction. No such arrangements exist with the U.S. *See* Ian F. Fletcher, *Commentary on Boshkoff, Some Gloomy Thoughts Concerning Cross-Border Insolvencies*, 72 WASH. U. L.Q. 943, 943 - 44 (1994).

They must file in multiple jurisdictions[79] and litigate and negotiate in all of these jurisdictions, often simultaneously. Furthermore, each jurisdiction must apply its own judicial apparatus to the case, leading to tremendous duplication of effort.[80] For example, it may be necessary to conduct discovery separately in each jurisdiction in order to accommodate different procedural rules -- even though the substance of the discovery may change very little. Under universalism, creditors can file in a single jurisdiction and a single jurisdiction's judicial machinery is called upon to administer the case.

Territoriality also encourages an international race to the courthouse. Once bankruptcy proceedings begin, or are imminent, creditors will scramble to attach assets in jurisdictions which have not yet begun bankruptcy proceedings. This practice is obviously not desirable as a policy matter, and indeed, "would not be tolerated in *any* country where a bankruptcy petition had been filed."[81] Such a race is wasteful both because parties spend resources in an effort to achieve a higher priority and because it may tie up assets needed for reorganization. The winners of such a race will normally be either fortuitously placed local creditors or large, sophisticated multinational creditors.[82]

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[79]With the possible exception of creditors operating in jurisdictions where the assets exceed the debt. In that case, the creditor may be able to get as much by filing locally as it would by filing in multiple jurisdictions.

[80]*See e.g.*, Daniel M. Glosband & Christopher T. Katucki, *Claims and Priorities in Ancillary Proceedings Under Section 304*, BROOK. J. INT'L L. 477, 481 (1991) ("Territoriality . . . necessitates the cost and inefficiency of a full bankruptcy proceeding in each country that houses assets.")

[81]*Id.* at 481; *see also* Honsberger, *supra* note 22, at 635 ("[D]omestic laws of all countries prohibit execution of a single creditor after an adjudication in bankruptcy.").

[82]*See* Honsberger, *supra* note 22, at 635 ("The recent collapse of several large financial institution holding assets in many countries has shown that the most knowledgeable creditors are very swift in attaching their debtors' foreign assets." *citing* Becker, *supra* note 63; Riesenfeld, *supra* note 63, at 288-90).

Under universality, there is only a single adjudication, so the automatic stay under U.S. law or similar provisions under foreign laws would make it impossible to attach assets once the proceedings are underway.

A final cost imposed by territorialism, and one of the most often cited by commentators, is a fairness cost.[83] The basic fairness argument is that a single proceeding ensures that all creditors receive a fair percentage of the assets. Favoritism for local creditors is reduced. While the fairness argument generally supports my view that a universal approach is desired, it must be noted that it is not persuasive. Two problems with the argument, pointed out by Professor Westbrook, are that "every country honors equality of distribution primarily in the breach. Every enactment is riddled with exceptions . . . . As a result, a universalist rule will only make unequal distribution somewhat less unequal . . . . The second weakness of the fairness argument is that in this wicked world it is unlikely to succeed if in conflict with perceptions of self-interest."[84] Furthermore, the fairness argument is largely undercut by the analysis in this paper. Because creditors are able to determine the laws before contracting, they will take such laws into account when establishing the terms of the contract. When the creditor is fully aware of the agreement, it is difficult to argue that it is unfair. The creditor will be compensated for accepting a contract under which it does poorly in bankruptcy in the form of a better outcome in the no-bankruptcy state of the world. This can only be considered "unfair" if one restricts oneself to an ex post assessment. Ex ante, each creditor contracts for the

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[83]*See* Kraft & Aranson, *supra* note 1, at 336; Westbrook, *Theory and Pragmatism*, *supra* note 4, at 466.

[84]Westbrook, *Theory and Pragmatism*, *supra* note 4, at 466.

world rate in expectation.[85]

This section has demonstrated that the territorial system which now operates yields less value for distribution than does universalism. It yields less value because creditors must spend more in pursuit of settlement when bankruptcy occurs, and it yields less because the investment itself will be discouraged by uncertainty and the cost of gathering information. There is no doubt that a universalist system would operate with fewer costs of the sort discussed above -- thereby creating a larger pie. As discussed in Part IV, it does not appear that territoriality distributes the pie in a manner that is systematically more favorable to certain countries, suggesting that universalism is a better policy choice.

VI. Distortions Created by Territoriality

The simplest analysis of creditor reaction to universalism is given in Part IV. Creditors will adjust their interest rates to reflect the risk of lending given the legal rules in place and will receive the same return in expectation under universalism as they would under territoriality. The debtor will always pay the same amount in interest regardless of the mix of local and foreign creditors.[86] If the

[85]In order to make a fairness argument, one must claim either that creditors are not capable of changing their behavior in response to the legal regime (a claim which would necessarily call into question the entire Bankruptcy Code and the UCC, both of which attempt to alter behavior through legal rules) or that credit markets are more accurately characterized as imperfectly competitive and that borrowers, not lenders, have market power. Neither claim is plausible.

[86]This is so because the interest rate premium demanded by foreigners (interest discount offered by local creditors) will depend on the amount of local borrowing (foreign borrowing). For example, if all borrowing is from a single foreign creditor, that creditor will not demand an interest rate premium since there are no local creditors. In other words, territorial legislation will not reduce his priority for payment. If half of the borrowing is from a local creditor, however, the foreign creditor will demand an interest rate premium and the local creditor will offer a

debtor begins with zero debt and zero assets, his behavior is unaffected by the territorial regime. In this case, therefore, the harm done by the territorial legislation is to increase the costs and affect the source of borrowing as discussed in Part V, without delivering any offsetting benefits, as discussed in Part IV. This is already a much more compelling argument for universality than the conventional argument which relies on the perceived local costs of universalism being outweighed by the global efficiency gains for every country.

A further deepening of the analysis reveals that territorial rules not only impose a cost in the form of uncertainty and unfairness, they also distort the allocation of capital. Under a territorialist regime, foreign investment will, under certain circumstances, be made sub-optimally, leading to a dead-weight loss that could be avoided under universalism.[87]

(a) Universalism

Imagine a multinational enterprise, with pre-existing debt, that is considering an investment abroad.[88] The optimal outcome for society would be for the firm to invest where the rate of return

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discount. These will exactly offset one another from the point of view of the debtor. More generally, the interest premium paid to foreign creditors will always be exactly offset by an interest rate discount given by local creditors. The debtor is, therefore, indifferent to the mix of creditors.

[87] A more technical presentation of much of the following analysis is made in Lucian Bebchuk & Andrew Guzmán, *An Economic Analysis of Transnational Bankruptcy*, (1995) (unpublished manuscript, on file with author).

[88] For simplicity, we will assume throughout that the firm is exactly solvent at the time of the new investment and that it borrows less than 100% of the funds necessary for the investment, getting the balance from its own assets. This implies that the asset to debt ratio will always be higher in the country in which investment takes place. It is the creditors from the country with the greatest asset to debt ratio that will offer the lowest interest rate. By making the above

to capital is greatest. That is, if the firm can earn a return of, say, 6% in Britain, but 8% in the United States, it should invest in the United States. This is the optimal or "first-best" outcome. Under a multilateral universalist regime, all creditors will, in the event of bankruptcy, receive a distribution that is determined under the laws of the debtor's home country. The location of the assets at the time of filing will not favor some creditors over others, so creditors will not be concerned with -- and the rate of interest available to the firm will not be affected by -- the location of the assets. The firm can, therefore, focus entirely on the return to investment, which will lead to investment in the country offering the highest return. In other words, universalism leads to the first-best investment decision.

(b) Bilateral Territorialism

Consider next the investment decision of the firm if all countries are territorialist. For simplicity, imagine that there are only two countries in which the firm can invest, called A ("America") and B (Britain). Assume that the firm has existing debt, held entirely by creditors in A. The firm must borrow from a creditor in either A or B and invest in one of the two countries. There are, therefore, four possible borrowing-investing combinations.[89] An initial result that can be demonstrated is that the firm will always borrow from a creditor in the country in which the firm

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assumption, this country will always be the host country. Without the assumption, the analysis would remain essentially unchanged, though it would be somewhat more complicated. If we make the alternative assumption that the home country of the firm has the greater asset to debt ratio, we will still get a distortion; this time favoring investment in the home country.

[89]One can imagine borrowing some from A and some from B, but it can be shown that this will never be the optimal strategy for the firm.

intends to invest.[90] If the firm chooses to invest in A, for example, creditors in A know that in the event of bankruptcy they will receive treatment equal to that received by the pre-existing creditors, and will offer an interest rate that accounts for this fact.[91] Creditors in B know that if the firm invests in A, the pre-existing creditors will receive preferential treatment in bankruptcy because they will be local creditors. The creditors in B will be at a disadvantage relative to those in A and the interest rate offered by potential creditors in B will reflect this added risk. In other words, if the firm intends to invest in A, potential creditors from A will offer a lower interest rate than those from B because the territorial laws will give the "local" creditors a greater return in the event of bankruptcy. The firm obviously wants to borrow at the lowest possible rate and will therefore borrow from a creditor in A.

Similarly, if the firm intends to invest in B, creditors from A know that in the event of bankruptcy they will be given the same standing as the existing creditors. Potential creditors from B, however, will be given preferential treatment over the existing creditors in A and will therefore be able to offer an interest rate discount and still receive the world rate of interest in expectation. In this case, the firm will obviously prefer to borrow from the creditor in B. What this analysis has shown, then is that the firm will always borrow from creditors in the country in which it intends to invest.[92]

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[90]Under the alternative assumption discussed in *supra* note 88, this result is reversed and the firm will always borrow from the home state.

[91]Throughout the paper it is assumed that at the time firm borrows funds it also commits to use those funds in a particular form of investment in a particular country.

[92]This result is consistent with the observed phenomenon that multinationals tend to finance foreign direct investment locally. *See* RICHARD E. CAVES, MULTINATIONAL ENTERPRISE AND

Under universalism, all creditors would offer the same interest rate because they would all be treated equally in the event of bankruptcy. The firm's investment decision would therefore be based entirely on the return to investment in the two countries. Under territoriality, however, this is not the case. If the firm decides to borrow and invest in A, potential creditors there realize that in the event of bankruptcy they will have to share the remaining assets with the old creditors. This is the same result as would exist under universalism, so creditors will demand the same interest rate as they do under universalism. If the firm chooses to borrow and invest in B, however, potential creditors there know that they will receive preferential treatment relative to the pre-existing creditors and will, therefore, be able to offer a lower interest rate than the creditors from A -- i.e.: an interest rate *discount*.

The firm seeks to maximize its profit and will therefore borrow and invest in the country in which it can achieve the greatest possible return *net of interest payments*. In other words, the firm will compare the return to investment in A minus the interest rate available in A to the return to investment in B minus the interest rate available in B. Letting i_A, i_B represent the interest rate offered by creditors from A and B respectively and letting R_A, R_B represent the return to investment in each country, the firm will invest in A if and only if $R_A - i_A \geq R_B - i_B$; otherwise the firm will invest in B. If the return to capital is greater in A than it is in B ($R_A \geq R_B$), but the return to the firm net of interest payments is greater in B ($R_A - i_A \leq R_B - i_B$), the firm will invest inefficiently. This result is driven by the gap between the interest rates charged by creditors which in turn is caused by the territorialist legal regime.

ECONOMIC ANALYSIS, 176 - 77 (1982).

Consider the following simple example. The firm's existing debt is located in America. The firm can invest in America where it is able to earn a return (before interest payments) of, say, 10%. Alternatively, the firm can invest in Britain and earn 9%. The first-best solution, of course, is to invest where the assets have greatest value -- America. A universalist regime would lead to this outcome because creditors' rights are not affected by the location of the assets. The creditors will therefore offer the same interest rate regardless of the location of the assets. Under territoriality, however, the interest rate available to the firm will depend on the location of the investment. If the firm intends to invest in America, the best it can do is to borrow from a creditor in America and pay the same interest rate as under universality, as discussed above. This will lead to an interest rate of, say, 8%. The firm could also choose to invest in Britain, where the creditors would offer an interest rate discount. They might offer an interest rate of, say, 6%.

Under these conditions, the firm will choose to invest in Britain where it can earn a return (Net of interest payments) of 3% (9% - 6%). If it invested in America it would only earn a return of 2% (10% - 8%). The territorialist regime has led the firm to invest inefficiently.

(c) Unilateral Territorialism

Consider now the situation if only one of the two countries is territorialist, while the other has a policy of universalism. Under such a scenario, the universalist policy does place the universalist country at a disadvantage, though not because of the effect on its creditors, as is often claimed, but rather because it will reduce the amount of investment flowing into the country. We will assume throughout that country B has a territorial regime in place while A is universalist. As demonstrated in the previous section, the firm will always borrow from the country in which it intends to invest.

Notice first that regardless of the location of the initial debt, if the firm seeks to borrow and invest in A, it will receive the same interest rate as it would under universalism. The creditors in A recognize that in bankruptcy they will not be favored over the old creditors. This will be true whether the old creditors are from A -- in which case it is merely a domestic bankruptcy -- or from B -- in which case there will be adjudication in the home state of the debtor (assumed to be B) and creditors from A will have the same standing there as they would under universalism.[93]

Suppose, instead, the borrowing and investment is to take place in B. Obviously, if the initial debt is held by creditors in B, the firm will face the interest rate that would be available under universalism. If the initial debt is in A, however, creditors in B will be prepared to offer an interest rate discount as they will gain preferential access to the assets in the event of bankruptcy.

This analysis implies that if the firm has existing debt in A and is deciding between a new investment in A and an investment in B, it will be offered a lower interest rate in B. This will create a distortion in favor of investment in B at the expense of investment in A. If, for example, the firm can earn 10% in A but 9% in B, and if the interest rates available in A and B are 8% and 6% respectively, the firm will choose to invest in B (for a net return after interest charges of 3%) rather than A (where it would get a net return after interest payments of only 2%). The first best solution

[93]Note that we assume that territoriality only affects ancillary proceedings, and does not affect the fairness of principal bankruptcy proceedings that take place within the territorial country. We do not rule out some degree of favoritism toward local creditors, but we assume that whatever favoritism exists is the same as under a universalist regime. This is realistic -- it is generally accepted that courts in the U.S., for example, give all creditors equal treatment in a general bankruptcy proceeding under American law; and it is also acknowledged that courts often favor local creditors when a §304 petition is at issue.

in this example is for investment to take place in A. We once again have a distortion of the investment decision.

Note that unlike under bilateral protectionism, the effect under unilateral protectionism is in only one direction. There is an incentive that favors investment in B rather than in A, but there are no circumstances in which investment in A is favored when it would be more efficient in B. This is noteworthy because it demonstrates the importance of reciprocity. Without reciprocity, a single country could deviate from a regime of universalism in order to encourage investment in that country. The country would then benefit from increased flows of investment at the cost of other countries.

The countries, therefore, face a form of prisoner's dilemma. It is clear that the best outcome is for all countries to cooperate in a universalist regime, whereby they can achieve the first-best outcome. Each country, however, faces a dominant strategy that dictates adopting a territorialist regime.

The solution is reciprocity. By conditioning universality on reciprocity, a country ensures that it is not in the position of country A in the above example. When the other country implicated in the bankruptcy is territorialist, we return to a territorial resolution. This will provide a strong incentive to maintain a universalist regime as the benefits of territoriality will disappear. There are various forms of reciprocity imaginable. This paper argues for "negative reciprocity," a term coined by Professor Westbrook.[94] "Negative reciprocity permits the jurisdiction to cooperate until there is

[94] *See* Westbrook, *Theory and Pragmatism*, *supra* note 4, at 468

clear evidence that the other jurisdiction will not."[95] It is a presumption in favor of universality that avoids the problem of every party waiting for some other party to be the first to implement universalist policies. Requiring reciprocity prevents a country from achieving the benefits of being a territorialist in a world of universalists.[96]

Reciprocity is not a required element under §304 of the Bankruptcy Code of the United States.[97] Nevertheless, some commentators have questioned "whether, because of section 305(c)(5) [comity], the granting of relief may be (or even must be) contingent on reciprocity."[98] The classic definition of comity is given in *Hilton v. Guyot*[99]:

> 'Comity,' in the legal sense, is neither a matter of absolute obligation, on the one hand, nor of mere courtesy on the other. But it is the recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens or of other persons who are under the protection of its law.[100]

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[95] *Id.*

[96] Reciprocity will only affect the behavior of those countries that have some outflow of investment. A country that is a frequent recipient of foreign direct investment but has low levels of outward foreign investment will face few costs if other countries become territorialist. In this case, some form of treaty of international agreement is necessary.

[97] 11 U.S.C. 304.

[98] Ulrich Huber, *Creditor Equality in Transnational Bankruptcies: The United States Position*, 19 VAND. J. TRANSNAT'L. L. 741, 759 (1986).

[99] 159 U.S. 113 (1895).

[100] *Id.* at 163 - 64.

In the original decisions on comity in the United States, including *Hilton v. Guyot*, reciprocity was considered to be a required element.[101] More recently, however, American courts have abandoned the reciprocity requirement in deciding comity cases,[102] although some commentators continue to call for such a requirement.[103] The issue was addressed but not resolved in *Cunard Steamship Co. v. Salen Reefer Services, AB*.[104] In that case, the court did not require reciprocity, but left open the possibility that reciprocity might be determinative in some cases, stating that "while reciprocity may be a factor to be considered, it is not required as a condition precedent to the granting of comity."[105] The decision in *Cunard* creates yet more uncertainty for the parties negotiating a transnational agreement, leaving no clear indication of whether or not comity implies that reciprocity will be

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[101] *See* Hilton v. Guyot, 159 U.S. at 227 - 28; Waxman v. Kealoha, 296 F. Supp. 1190, 1194 (D. Haw. 1969)

[102] *See e.g.*, Johnston v. Compagnie Générale Transatlantique, 242 N.Y. 381, 387 (1926) (stating that comity "rests, not on the basis of reciprocity, but rather upon the persuasiveness of the foreign judgment"); In re Colorado Corp., 531 F.2d 463, 469 (10th Cir. 1976); Somportex Ltd. v. Philadelphia Chewing Gum Corp., 453 F.2d 435, 440 n.8 (3d Cir, 1971); Direction der Disconto-Gesellscaft v. United States Steel Corp., 300 F. 741, 747 (S.D.N.Y. 1924), *aff'd*, 267 U.S. 22 (1925) (stating that the court in *Hilton v. Guyot* "certainly did not mean to hold that an American court was to recognize no obligations or duties arising elsewhere until it appeared that the sovereign of the locus reciprocally recognized similar obligations existing here").

[103] Powers & Mears, *supra* note 7, at 82 (stating that U.S. law should "insist on a showing that reciprocity is available to the U.S. Debtor with assets located in the foreign jurisdiction"); Westbrook, *Theory and Pragmatism*, *supra* note 4, at 467 - 68. *But see* Ulrich Huber, *Creditor Equality in Transnational Bankruptcies*, 19 VAND. J. TRANSNAT'L L. 741, 760 (1986) ("Conditioning relief on reciprocity diminishes the effectiveness [section 304] to a level of insignificance."); Stacey A. Morales & Barbara A. Deutcsh, *Bankruptcy Code Section 304 and U.S. recognition of Foreign Bankruptcies: The Tyranny of Comity*, 39 BUS. LAW. 1573, 1576 (1984) ("[comity] appears to be a dead letter under U.S. law").

[104] 773 F.2d 452 (2d Cir. 1985).

[105] *Id.* at 460.

considered if bankruptcy occurs. In order to meet the needs of certainty in the transnational commercial arena, and in order to encourage all countries to adopt and maintain universalist policies, reciprocity should be established as a requirement for application of universalist laws to a case.

(d) It is the Firm that bears the Costs of Territorialism

We have demonstrated above that territorialism leads to a variety of costs being imposed. It is important to understand that it is the firms that bears these costs. By assuming that credit markets are competitive, we have also assumed that creditors cannot bear these costs; they will continue to receive the world interest rate regardless of the regime in place. This includes what has until now been labeled the "initial" creditors. Creditors lending to a firm will always consider the risk that the firm may later invest abroad and put that creditor at a disadvantage in bankruptcy.

Initial creditors will therefore demand a higher rate of interest to account for the risk that the firm will invest abroad. When the firm does invest sub-optimally due to the distortions discussed in this paper, it is the firm that bears the cost. Under universality or territoriality the firm must pay its creditors the world rate in expectation. The firm can therefore be expected to get whatever surplus is earned beyond that interest rate. In other words, if the firm invests sub-optimally, earning 10% rather than 9%, it is the firm that suffers the 1% loss. The firm nevertheless chooses to invest sub-optimally because it faces a "time inconsistency" problem.[106] Initially, the firm would be better off to commit to a universalist regime, in which case the firm would not be induced to invest sub-optimally. Once the firm has borrowed funds, however, the analysis present in this Part applies and

[106]*See* OLIVIER J. BLANCHARD & STANLEY FISCHER, LECTURES ON MACROECONOMICS 70 - 72 (1989).

the firm will react to the incentives in place. Because the firm cannot commit to a universalist regime, creditors will anticipate the distortion and charge an interest rate that accounts for it. The firm will, ultimately, pay the cost of the distortion.

If we consider that at the time the firm borrows the initial debt it may not be known if it will invest abroad, we see that the firm may be able to spread the cost to other firms. Because the creditor does not know which firms will choose to go abroad in the future, it must charge a higher rate to all firms. In other words, all firms pay a higher interest rate and those that go abroad get a windfall by being able to capture a lower interest rate from foreign creditors who recognize that they will have an advantage in bankruptcy. This amounts to a subsidy in favor of multinational activity, paid for by those firms that do not invest abroad.[107]

VII. Discussion

Having outlined a new, stronger argument for universalism, it is appropriate to step back and consider some related issues. This section begins with a rules versus standards analysis of transnational bankruptcies, concluding that the current approach is more like a standard than the proposal suggested by this paper, and that a rule would be a more appropriate approach. The other subsections address certain questions and problems which arise in a discussion of a universalist rule. While the problems mentioned are not fully discussed in this paper, it should be clear that none of them pose insurmountable obstacles.

[107]Alternatively, creditors may demand clauses in the contract that forbid investment overseas, or require some minimum capitalization within the jurisdiction. These represent, of course, significant barriers to capital mobility and impose costs of their own.

(a) A Rules versus Standards Analysis

The relative merits of the current hybrid situation -- under which the final outcome is unclear ex ante, and the judge exercises a large amount of discretion -- and a more complete move toward universality can be analyzed in terms of the rules versus standards literature. Under the current regime, participants cannot be certain of their standing ex ante, because the statute does not define expressions such as "protection of claim holders in the United States against prejudice or inconvenience;"[108] "substantially in accordance with [the United States Bankruptcy Code]";[109] or the other conditions governing the decision of the court. Nor is the case law a source of comfort for agents planning a transaction; as discussed in Part III, court decisions are inconsistent and unpredictable. The existing law is, therefore, best described as a standard -- meaning that the content of the law is determined ex post.[110] The more fully universal system advocated in this paper would establish with clarity that the law to be applied will be the law of the home jurisdiction and is therefore best described as a rule.

An extremely useful discussion of the relative merits of rules and standards is provided by Professor Kaplow:

> If conduct will be frequent, the additional costs of designing rules -- which are borne once -- are likely to be exceeded by the savings realized each time the rule is applied. Thus, rules involve a wholesale approach to an information problem, that of

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[108]11 U.S.C. 304(c)(2).

[109]11 U.S.C. 304(c)(4).

[110]*See* H.L.A. HART, THE CONCEPT OF LAW, 126 - 31 (1961); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 621 (1992).

determining the law's appropriate content. Standards instead require adjudicators to undertake the effort, which may have to be done repeatedly . . . . And, regardless of whether adjudication will be frequent, many individuals contemplating behavior that may be subject to the law will find it more costly to comply with standards, because it generally is more difficult to predict the outcome of a future inquiry . . . than to examine the outcome of a past inquiry. They must either spend more to be guided properly or act without as much guidance as under rules. Thus, when behavior subject to the relevant law is frequent, standards tend to be more costly and result in behavior that conforms less well to underlying norms. . . .[111]

In other words, rules tend to be more costly to establish, but are less costly to apply -- both in the context of adjudication and in the context of providing legal advice. One must therefore weigh the extra costs of a rule against the savings in its application.

With respect to transnational bankruptcies, the two central issues under a rules versus standards analysis are, therefore, the frequency of bankruptcies and the frequency of transnational lending. These are empirical questions, but there can be little doubt that transnational bankruptcies do occur and that they are very costly. More importantly, we know that transnational lending is common and involves large sums of money.[112] By promulgating a clear rule, the costs imposed on international lending will be reduced for exactly the reasons discussed above. In contrast, leaving a standard in place imposes greater costs on lending, greater costs on the parties involved in a

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[111]*Id.* at 621 (footnotes omitted).

[112]*See infra*, note 68.

bankruptcy as they must go to court on the jurisdictional question as well as the merits, and greater costs on the judicial system which must "undertake the effort" of "determining the law's appropriate content" in each case.[113]

The gains from a rule must be compared to the costs of adopting the rule. In the case of transnational bankruptcies, the content of that rule is already established -- it should require that bankruptcies be adjudicated under the laws of principal place of business of the debtor.[114] For this reason, the cost of adopting a rule is low.

This casual analysis, therefore, suggests that a rule would be more suitable than the existing standard. More generally, it is precisely because the field of bankruptcy is well suited to rules that it is governed by a statute that typically addresses questions at a very high level of detail.

A clear rule would also make it easier for creditors -- especially small creditors -- to accurately assess their legal position.[115] If one is concerned that creditors will fail to adjust their interest rates (or other terms) to a universalist regime, one should be even more concerned about the current regime under which creditors *cannot* anticipate how the choice of law issue will be resolved. The ability of creditors to understand and adapt to the existing legal regime is, in fact, greater under a clear universalist rule than under a vague and inconsistent standard.

A possible objection to a rule-based approach is that rules are both over and under-inclusive.

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[113]Kaplow, *supra* note 109, at 621.

[114]Subject only to narrow exceptions for certain priority claimants and for fraudulent or discriminatory practices. The rule in *In re Culmer*, 25 B.R. 621 (Bankr. S.D.N.Y. 1982), for example, as discussed above, could be adopted at very low cost and would achieve the benefits of universality.

[115]*See* Kaplow, *supra* note 109, at 563.

The rule advocated by this paper would not be an exception to this general observation. Some creditors, either because they are non-consensual or because they simply fail to take account of the risk involved, will be forced to litigate abroad while others, having contracted for a higher interest rate because they expect the assets to be distributed by a foreign forum in the event of bankruptcy, will succeed in collecting assets in an ancillary petition. These effects can be minimized through the use of restricted ancillary proceedings,[116] but cannot be eliminated. There are, however, two reasons why this criticism is insufficient to overcome the other advantages of a rule. The first is that the current standard is equally over and under-inclusive. The case law discussed in Part III demonstrates that it is the court's interpretation of the factors of §304 that is determinative, rather than the facts of the case. The existing law does not separate cases based on their ability to pursue their claims abroad, and cannot identify the creditors that adjusted their rates to account for the risk of foreign adjudication in bankruptcy.

The second reason for adopting rules despite the over and under-inclusiveness issue is offered by existing commercial law. Even the most casual observer can recognize that with respect to commercial matters, the rules versus standards debate has been decided in favor of rules. Virtually every aspect of commercial dealings is governed by a detailed statute, the most important of which is the UCC. It would be curious indeed to decide that a vague standard is preferred on this one question of bankruptcy law, given that rules are preferred in almost all other commercial matters.

(b) Contracting Around the Law

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[116] *see* Part VII(c).

In a domestic law setting, inefficiencies of the sort discussed in this paper can often be resolved through contract. In many contractual settings, parties, by choosing a forum in the contract, can specify the forum in which they will litigate their differences and can thereby avoid any problems associated with forum shopping and choice of law. In both the international and bankruptcy contexts, however, this sort of private solution is not available. Put simply, "[p]arty autonomy is of little value . . . because the essence of avoidance law in every jurisdiction is vindication of the rights of strangers to the contract and the community's choice of distribution priorities. Obviously the parties cannot be left free to choose the law governing the rights of others or altering a mandatory scheme of distribution."[117] Private contractual solutions to the inefficiencies discussed in this paper are not readily available.

(c) Employees and Other Priority Creditors

A possible hurdle to the adoption of a universal regime might be a concern for the welfare of creditors that are not considered to be sophisticated or that are not operating in a competitive market. The most obvious example would be tort creditors, but the category could also include employees that are not highly organized, and the government (seeking tax claims). Two problems exist with respect to these creditors. The first is that their claims may be too small to justify litigating them in a distant forum and they will, therefore, receive nothing in bankruptcy. The second is a concern that they will be unable to assess the risks they face due to lack of information

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[117] *Westbrook, Choice of Law, supra* note 4, at 503 n.18. For American examples, *see In re Rubin* 160 B.R. 269, 277 (S.D.N.Y. 1993) ("bankruptcy proceedings often negate explicit contract provisions") and cases cited therein.

or coordination.[118]

The first problem could be dealt with through some local administrative proceeding. It is important, however, that this proceeding follow as closely as possible the priority scheme in the main jurisdiction. For this reason, the best option may be to establish truly ancillary local proceeding which apply *the law of the main jurisdiction.* In principal, this should leave the small creditors no better or worse off than they would be if they litigated in the home jurisdiction, except for saving them the costs of that litigation.

The second problem is more difficult. To protect these creditors in an international bankruptcy is, essentially, to alter the distribution priorities of the home country. For example, if country A is the home country but does not accord employees a high priority in the distribution scheme, country B may be unwilling to turn over the assets, reasoning that its employees will be left with no recovery. Unfortunately, the only way to deal with this problem is to satisfy certain creditors out of local assets before turning over the balance. Such an approach is a form of partial territoriality, and should be recognized as such. It could lead to the same problems associated with territoriality that are discussed in this paper. On the other hand, limited local distributions might overcome many of the objections to universalism. It is very important, however, that these local distributions be kept to a minimum in order to prevent the exception of local distribution from swallowing the rule of turnover. Perhaps only creditors who receive priority status in domestic

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[118]Tax claims face the additional problem that countries are reluctant to use their legal systems to facilitate the collection of revenue for another country. *See, e.g.,* Government of India v. Taylor, [1955] A.C. 491 (denying enforcement of an Indian tax claim in British courts); United States v. Harden, [1963] S.C.R. 366 (denying enforcement of an American tax claim in Canadian courts); British Columbia v. Gilbertson, 597 F.2d 1161 (9th Cir. 1979) (denying enforcement of a Canadian tax claim in the United States).

bankruptcy[119] should be paid locally. In this way, local distribution priorities will be accurately reflected in the turnover policy.

(d) The Definition of the Home Country

Finally, there may be some concern about the definition of the "home country." While it is true that this may be a problem in certain cases, those cases will be extremely rare. "Although circumstances will exist in which determination of the home country of a corporation will be difficult, it will usually be self-evident." The "principal place of business" test is generally accepted as the best way to identify the home jurisdiction. This provides a (usually) readily identifiable home country without creating the distortions in the legal regime of countries and in the behavior of firms that are associated with a test based on the location of incorporation.[120]

VIII. Conclusion

Legal commentators have been calling for a more universalist regime for many years. With the continuing increase in international business transactions, the need for a more cooperative transnational bankruptcy regime is not questioned. This paper has attempted to demonstrate that the perceived benefits of territoriality are largely illusory and that the costs of it are greater than

[119]Meaning that they receive a higher priority in bankruptcy than they would outside of bankruptcy. Under U.S. law, perhaps only "priority" claimants under §507 of the Bankruptcy Code could be paid locally.

[120]Donald T. Trautman, *Foreign Creditors in US Bankruptcy Proceedings*, 29 HARV. INT'L L.J. 49, 55 & n.31 ("It is almost universally agreed that jurisdiction for a business enterprise is its principal place of business.").

previously believed. It is important for legislators and judges to recognize that they cannot, by manipulation of the legal regime, capture rents for their own citizens that are greater than the returns offered by the market. It is important for legislators and judges to recognize that efforts to capture such rents will instead lead to an efficiency loss, some of which will be borne by their own firms. Finally, it is important for legislators and judges to recognize that the self-interest of a country is, in fact, consistent with the efficient global outcome. Universality with a reciprocity requirement will allow countries to enact a universalist international regime in which all countries have an incentive to comply with universalist norms and, thereby, to achieve the efficient outcome. A move toward greater cooperation in the area of bankruptcy would represent a significant step by the international community in its effort to keep pace with the globalization of business transactions. The sooner that step is taken, the sooner all countries will benefit from the efficiency gain that is available.