

## INTRODUCTION

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This Symposium is a tribute to the late Professor Barry L. Zaretsky (1950-1997). Barry was a member of the Brooklyn Law School faculty for nineteen years. He was a teacher and mentor to countless Brooklyn Law School students, as well as a distinguished bankruptcy and commercial law scholar. He was also a good friend to many of the authors who have contributed to this volume.

In 1996, Barry and Ian Fletcher, then of Queen Mary and Westfield College, University of London, organized the first symposium entitled *Bankruptcy in the Global Village*. Professor Fletcher describes the context of that symposium in his contribution to this volume. That conference occurred at a time when there was much lawmaking activity in the area of international insolvency. However, none of the ongoing projects had yet borne fruit. The American Law Institute's *NAFTA Insolvency Project* was in full swing, but was years away from producing the influential *Principles of Cooperation Among NAFTA Countries*. The European Union's *Insolvency Convention* had stalled, and was consigned to a limbo from which it emerged only in 2002. The United Nations Commission on International Trade Law (UNCITRAL) Model Law on Cross-Border Insolvencies was still over a year away from endorsement by the General Assembly.

Since 1996, much has changed. The initiatives of the first wave, in process in 1996, are now operational. The *NAFTA Principles* were published in 2003. The UNCITRAL Model Law has been adopted by nine countries, including—with the enactment of Chapter 15 in 2005—the United States. In 2000, the European Union promulgated a regulation based on the *Insolvency Convention* that went into force in 2002 and now governs insolvencies in EU member states. The first-wave initiatives had a common theme. Each of the various harmonization efforts was procedural in nature—designed to create rules and mechanisms that would allow courts to coordinate their efforts in cross-border insolvency cases. Substance, of course, was lurking just around the corner, and the second wave of international bankruptcy law reform efforts has focused in that direction. UNCITRAL has completed a Legislative Guide on insolvency law, and is preparing one on the law of secured credit, to name just two of the ongoing initiatives. UNIDROIT, the World Bank, and others have reform efforts underway in the areas of both bankruptcy and secured

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credit. Meanwhile, practice has continued to develop with cross-border cases becoming increasingly common.

The Articles in this volume are wide ranging, but we have organized them into four conceptual clusters. The first cluster consists of the Key-note by Professor Paulus, and Articles by Professors Fletcher, Pottow, and Janger. Professor Paulus explores and evaluates efforts by multilateral institutions to harmonize substantive bankruptcy law during the last decade. Fletcher, Pottow, and Janger also take stock of the developments of the last decade, and consider how best and how far to push multilateral harmonization efforts forward. The second set of papers focuses attention on the current efforts to harmonize substantive law. Professors Block-Lieb and Halliday explore the novel approach to harmonization used by UNCITRAL in the Legislative Guide on Insolvency. Professor Harris and Nick Segal each examine the interaction between bankruptcy law and the law of secured credit, with attention to the effect of substantive legal differences on bankruptcy cases. Finally, Professor Rasmussen suggests that market convergence may make legal harmonization unnecessary. The third cluster looks at the role of choice of law in cross-border cases. Gabriel Moss explores recent cases under the EU Insolvency Regulation that have struggled with the problem of defining a debtor's center of main interest, while Professor Westbrook explores both how the center of main interest should be determined and what questions should be determined by a debtor's forum choice. Finally, the last cluster of papers is in the nature of two epilogues: one focused on practice and the other on lawmaking. Professor Ziegel explores the evolution of Canada-U.S. cross-border cases under the NAFTA principles and the newly adopted Chapter 15, while Professor Halliday explores the determinants for a successful international insolvency lawmaking initiative and makes some predictions and suggestions for the various ongoing lawmaking efforts.

The Articles build on the work of the first symposium, and we hope that they are as helpful to the ongoing development of global bankruptcy law and practice. Those of us who participated in the symposium this past October were continually aware of Barry Zaretsky's absence, and of his presence. He would have enjoyed himself. We missed him, and we thank him for providing, yet again, an opportunity to explore a topic that he found (and made) interesting.

# GLOBAL INSOLVENCY LAW AND THE ROLE OF MULTINATIONAL INSTITUTIONS

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The topic of this symposium, *Bankruptcy in the Global Village: The Second Decade*, is grand and demanding. The concept of a “global village” implies something beyond the technicalities of particular national laws; instead, it conjures a view of bankruptcy that transcends national legal systems—bankruptcy at a meta-level. But this conference is not only geographically “meta.” It is also temporally “meta.” It seeks to transcend time as well as space. The reference to “the second decade” harks back to an earlier symposium at Brooklyn Law School organized by Professors Barry Zaretsky and Ian Fletcher that still forms an important cornerstone for many insolvency-related discussions.<sup>1</sup> The topic of this symposium thus includes past and present, national institutions and multinational lawmaking efforts. With these multiple dimensions in mind, I would like to trace a few themes as a prelude to the discussion of the next few days.

## I. THE FIRST DECADE

Choosing 1996 as a starting point does some injustice to the decades that came before. The introduction of Chapter 11 into the U.S. Bankruptcy Code in 1978 initiated a worldwide re-thinking of the options that bankruptcy law can offer.<sup>2</sup> Similarly, the invention of “protocols” by creative judges and practitioners created a powerful tool to overcome the stalemate situations that arise frequently in cross-border bankruptcies as a result of conflicts among national bankruptcy laws.<sup>3</sup> But choosing 1996

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1. Symposium, *Bankruptcy in the Global Village*, 23 BROOK. J. INT'L LAW 1 (1997).

2. Outside the United States, the stigmatizing effect of a bankruptcy proceeding has been—and in many regions of this world still has—a powerful blocking impact on the efficiency of a reorganization option. The idea of a fresh start to be offered to a debtor through the bankruptcy proceeding has been for quite a long time unique to the United States.

3. The beginning of this invention is marked by the *Maxwell* case. See Evan D. Flaschen & Ronald J. Silverman, *The Role of the Examiner as Facilitator and Harmonizer in the Maxwell Communication Corporation Insolvency*, in CURRENT DEVELOPMENTS IN INTERNATIONAL AND COMPARATIVE CORPORATE INSOLVENCY LAW 621 (Jacob S.

also recognizes that the mid-nineties saw bankruptcy law elevated to a central position in the globalizing world. The East Asia crisis brought the world perilously close to a global economic breakdown when Japan, Russia, and finally Brazil, one after the other, followed the so called Tiger States to the brink of economic collapse. This threat led the then-G7 States (now G8) to form a new multilateral institution, the Financial Stability Forum, to develop tools to prevent a similar crisis in the future.

The efforts made by this forum are reported on its Web site.<sup>4</sup> One of its most prominent products is the articulation of twelve legal attributes that are crucial for a country's financial stability, such as accounting and auditing standards, fiscal transparency, and banking and insurance supervision as well as insolvency and creditor rights. The inclusion of insolvency law on the list is a new development; insolvency law is newly seen and understood as a safeguard and anchor for the stability of a country's financial health.

The task of supervising and fostering legal developments in each one of the twelve areas is entrusted to various institutions such as the International Monetary Fund (IMF), the Organisation for Economic Cooperation and Development (OECD), or the World Bank. At the peak of the crisis in early 1998, the IMF was pushed to take care of this area and in 1999 it published its description of a fundamental pattern for orderly and effective insolvency procedures.<sup>5</sup> Thereafter, however, responsibility shifted to the World Bank, which developed a more detailed set of principles for insolvency law and creditors' rights. The ultimate result, the *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems*, was made public in 2001.<sup>6</sup>

The perception of insolvency law's global importance extended beyond the Bretton Woods institutions. Initiated by an Australian proposal, the United Nations—more precisely, the United Nations Commission on International Trade Law (UNCITRAL)—sought to draft yet another guidebook for insolvency legislation. UNCITRAL developed guidelines, which were published in 2004 and may now be the most voluminous

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Ziegel ed., 1994); Jay Lawrence Westbrook, *The Lessons of Maxwell Communication*, 64 *FORDHAM L. REV.* 2531 (1996).

4. See Financial Stability Forum, About the Compendium of Standards, [www.fsforum.org/compendium/about.html](http://www.fsforum.org/compendium/about.html) (last visited Apr. 1, 2007).

5. These procedures are published in a booklet available on the IMF's Web site. International Monetary Fund (IMF), *Orderly & Effective Insolvency Procedures* (1999), <http://www.imf.org/external/pubs/ft/orderly/index.htm>.

6. World Bank, *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems* (2001), available at <http://siteresources.worldbank.org/GILD/PrinciplesAndGuidelines/20162797/Principles%20and%20Guidelines%20for%20Effective%20Insolvency%20and%20Creditor%20Rights%20Systems.pdf>.

book ever written on global insolvency legislation.<sup>7</sup> The work of UNCITRAL and the World Bank were not identical, so the addressees—that is, the legislative decision makers—were initially somewhat troubled when they had to decide which of the guidelines to follow. However, in 2005, after having clarified the differences, the World Bank drafted a revised version of its Principles and blended them with UNCITRAL's Legislative Guide.<sup>8</sup> The consequence thereof is that the Financial Stability Forum has entrusted both multilateral institutions with shared<sup>9</sup> responsibility.

Why, after years and years of disinterest has insolvency law suddenly become the focus of not one, but three multilaterals? As noted above, the East Asian bubble made it clear that a crucial factor for investors interested in a particular jurisdiction is an insolvency law that is effective, and guarantees an orderly proceeding with a fair, transparent, and predictable treatment of the stakeholders. However, this insight is not new. The roots go back to the early sixteenth century in Antwerp, the then economic metropole of Europe, when foreign merchants demanded from the Town Fathers the enactment of a bankruptcy law for their protection.<sup>10</sup>

Here I can offer a few thoughts about the relevant factors. The answer itself seems, at first, irritatingly ephemeral. When one takes the psychological stance of a foreign investor, however, the lessons of Antwerp and Asia seem obvious: from that perspective it is perfectly understandable that equitable treatment of a debtor's creditors is preferable to a system

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7. United Nations Commission on International Trade Law (UNCITRAL), *Legislative Guide on Insolvency Law* (rev. 2005), available at [www.uncitral.org/pdf/english/texts/insolven/05-80722\\_Ebook.pdf](http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf). For a description of its legal parameters, see Susan Block-Lieb & Terence Halliday, *Incrementalisms in Global Lawmaking*, 32 BROOK. J. INT'L L. 851 (2007); for its contents, see Jacob Ziegel, *Canada-United States Cross-Border Insolvency Relations and the UNCITRAL Model Law*, 32 BROOK. J. INT'L L. 1041 (2007).

8. World Bank, *Principles for Effective Insolvency and Creditor Rights Systems* (rev. 2005), available at <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/LAWANDJUSTICE/GILD/0,,contentMDK:20774193~pagePK:64065425~piPK:162156~theSitePK:215006,00.html>.

9. "The World Bank is co-ordinating a broad-based effort to develop a set of principles and guidelines on insolvency regimes. The United Nations Commission on International Trade Law (UNCITRAL), which adopted the Model Law on Cross-Border Insolvency in 1997, will help facilitate implementation." Financial Stability Forum, 12 Key Standards for Sound Financial Systems, [http://www.fsforum.org/compendium/key\\_standards\\_for\\_sound\\_financial\\_system.html](http://www.fsforum.org/compendium/key_standards_for_sound_financial_system.html) (last visited Apr. 1, 2007).

10. For this example, see also Christoph G. Paulus, *A Short History of European Insolvency Law*, INSOL WORLD (SILVER JUBILEE ISSUE), 2007, at 14; Christoph G. Paulus, *Entwicklungslinien des Insolvenzrechts*, 61 KTS ZEITSCHRIFT FÜR INSOLVENZRECHT 239, 242 (2000) (F.R.G.).

in which the creditors are afraid that the debtor is playing a game—alone or in a collusive way with some of the other creditors—the outcome of which is not equal (or at least transparent and predictable). In the absence of transparency and equality of distribution, distribution of the remnants of a business may be only the prelude to another game, played without these foreign creditors (or most of them). A disturbingly clear example for such a strategy seems to be the present-day *Yukos* case in Russia.<sup>11</sup>

From a legal perspective, however, things are more complicated. First, it is axiomatic that insolvency law is a focus point for the commercial law of any jurisdiction. Just as a painter creates the impression of three-dimensions by reference to a focus point, numerous legal areas such as the law of secured transactions, corporate law, corporate governance, non-performing loans trading, out-of-court-settlements—to name but a few—become fully understandable only against the background of a nation's insolvency law.<sup>12</sup> Therefore, if insolvency law is a pillar of a jurisdiction's commercial law, the need is manifest to build it up in a particularly strong, efficient, and stable manner.

Second, and perhaps more importantly, insolvency law has the potential to influence not only an economy's micro-level, but also its macro-level. Insolvency law is now (and newly) politically salient. As such, it is burdened with political expectations or demands. As increasing numbers of enterprises break down, and huge companies like Enron, Parmalat, Asia Pulp & Paper, or Varig go bust, the efficiency of insolvency law is tested in a way that goes far beyond almost any other law. Public scrutiny as well as political guilt-shifting and grandstanding are then very likely on the agenda. Reform or introduction of a national insolvency law with the option of a reorganization proceeding is a convenient vehicle that allows the political class to comfortably reject any claims for a bailout of firms that are seen by the public as too big to fail. Responsibility for rescue is shifted to the administrator or the courts in charge.

And finally, in this context, an orderly and effective insolvency law exerts a disciplining function on all actors on the stage. It is the art of good insolvency legislation to strike a balance between disciplining the debtor<sup>13</sup> as well as the creditors. Experience teaches that this can be done

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11. See generally Joseph Tanega & Dmitry Gololobov, *Yukos Risk: The Double Edge Sword, A Case Note on International Bankruptcy Litigation and the Transnational Limits of Corporate Governance*, 3 N.Y.U. J. L. & BUS. (forthcoming 2007).

12. Elsewhere, I have tried to elaborate this idea in more detail. See Christoph G. Paulus, *Verbindungslinien des Modernen Insolvenzrechts*, 49 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT 2189 (2000) (F.R.G.).

13. In times of systemic economic difficulties, legislators might wish to alter their insolvency laws to an overly protective system for the debtors. If they do so, they are well

in various ways: there is no self-evident primacy of a creditor-driven system over a court-driven system,<sup>14</sup> as there is no clear evidence that a harsh system is better or worse than a lenient one. What is necessary and decisive is the credible threat for the debtor not to escape into an insolvency proceeding for his own benefit and for the creditors not to push their common debtor into such proceedings for their benefit. No one should stand to gain something in an insolvency proceeding that could not be gained outside of it.

All of these preceding considerations point towards insolvency law's overarching importance and offer a justification for the multilaterals' efforts in this field. However, irritating counterexamples exist that undermine the validity of these very considerations. The most important of these examples is the present-day Chinese economy. While China's new insolvency law came into force on July 1, 2007,<sup>15</sup> it has a multi-year period of enormous economic growth behind it without precedent in economic history—and without an effective insolvency law! Be this as it may, history is full of countless examples of the driving force of mere perception without any proven factual justification.

Now that there are three guidelines out in the world—the smallest and earliest from the IMF; the medium sized, second, from the World Bank; and the most voluminous and, for now, the last word, from UNCITRAL—there is a momentum that can be observed in insolvency law's world which points towards a certain substantive global convergence. This convergence may occur through the force of the IMF's and the World Bank's conditionality or the respective anticipated obedience, or it may occur through a national political leadership's wish to connect its country with the modern stream of essential legislation, or it might occur simply through the persuasive power and quality of these guidebooks. Regardless of the reason, there is a broad movement all over the

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advised to re-change it after the end of such crisis. The Statute of Colombia from 1996 is a striking example for this attitude and the disadvantages of “sticking to it until now.” See generally Adolfo Rouillon, World Bank, *Colombia: Derechos de Crédito y Procesos Concursales* (May 2006). Note, however, that Colombia is about to change its law (from mid-2007 on) to make it a bit more balanced.

14. An example is comparison between the two neighboring countries of France and Germany: the former has quite a court-driven system, whereas the latter is prominently creditor-driven. For the latter approach, see Manfred Balz, *Market Conformity of Insolvency Proceedings: Policy Issues of the German Insolvency Law*, 23 BROOK. J. INT'L L. 167 (1997).

15. For descriptions of the new law, see Bruno Arboit & Darren FitzGerald, *A Great Leap Forward—China's New Enterprise Bankruptcy Law*, INSOL WORLD, Fourth Quarter 2006, at 36; Mike Falke, *China's New Law on Enterprise Bankruptcy*, 16 INT'L INSOLVENCY REV. 63 (2007).

world to comply with these standards.<sup>16</sup> Even though the expert might recognize considerable differences in each volume, they have much in common. In particular, they all introduce a rescue proceeding which was—due to the worldwide predominant perception of a bankruptcy stigma on a bankrupt debtor—unthinkable in many jurisdictions only a decade ago. Nowadays, it is hard to find any insolvency law without this option.<sup>17</sup>

However, one must take care not to be overoptimistic. The convergence described, more often than not, refers to the law on the books rather than the law in action. Many countries have adopted quite modern insolvency legislation that appears on paper as successful approximations of the propositions in the guidebooks.<sup>18</sup> But, upon closer inspection, it becomes apparent that the law in action bears little resemblance to the written law. For various reasons—ranging from opposition to intrusion by the imposing multilateral institution and its dominant shareholder(s) to sheer opportunism—institutions within jurisdictions defy this convergent pull and simply ignore their codified law.

This must be taken very seriously, not least because this attitude coincides—accidentally or not—with a general problem of anti-globalization: the national actors might have the impression that they are forced to accept an imposed law that is designed to bring them in line with a certain capitalistic idea of bankruptcy law.<sup>19</sup> Any answer to such an allegation

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16. Elsewhere, I have described this development in somewhat more detail. See Christoph G. Paulus, *Rechtsvergleichung im Nationalen und Internationalen Insolvenzrecht: Eine Erfolgsgeschichte*, in EINHEIT UND VIELFALT DES RECHTS: FESTSCHRIFT FÜR REINHOLD GEIMER ZUM 65. GEBURTSTAG 795 (Rolf A. Schütze ed., 2002) (F.R.G.).

17. For an insightful report about the factual problems of implementing the respective rules in the Asia Pacific region, see Nick Hood, INSOL Europe, *Management Change—The Last Restructuring Taboo*, in INTERNATIONAL CASELAW-ALERT No. 11, IV/2006, at 4, (Aug. 27, 2006), available at <http://www.eir-database.com/download/caselaw/7/International-Caselaw---Alert-No-11-IV-2006-August-27,-2006.pdf>.

18. Professor Halliday describes this divergence in his contribution to this symposium as “implementation gap.” Terence Halliday, *Legitimacy, Technology, and Leverage: The Building Blocks of Insolvency Architecture in the Decade Past and the Decade Ahead*, 32 BROOK. J. INT'L L. 1081, 1098-99 (2007).

19. See the particularly telling story told by Boris Kozolchyk, *Secured Lending and Its Poverty Reduction Effect*, 42 TEXAS INT'L L. J. (forthcoming 2007) (manuscript at 12), available at <http://www.law.arizona.edu/faculty/FacultyPubs/Documents/Kozolchyk/ALS06-33.pdf>. A Mexican NAFTA negotiator asked him:

why it was that Mexico's law of secured transactions had to resemble that of the United States and Canada, my reply was that the proper question was not what law Mexico had to emulate but whether Mexico did in fact desire secured lending. If it did, its law had to be based on principles that reflected those prac-

by advocates of convergence must be based on a thorough analysis; an analysis that identifies deeper necessities such as the general need for economic development and/or empowerment of the poor<sup>20</sup> or the like. If this is not done or—even worse—not possible, then the multilaterals would be well advised to refrain from further promotion of their guide-books.<sup>21</sup> Indeed, as a question mark, caution flag, or—depending on one’s own perspective—exclamation mark, to the best of my knowledge there has been little interest in how Arabic and the majority of African<sup>22</sup> countries deal with the break-down of their economic enterprises.<sup>23</sup> And, almost never—irrespective of the *ceteris paribus* impressive internationality of the respective drafting groups—are there any Arabic or African representatives participating.

## II. TRANSITION FROM THE FIRST TO THE SECOND DECADE

These remarks bring us to the threshold of the second decade. The pull towards convergence of the world’s insolvency laws will predictably increase, as the multilaterals appear to have developed an “appetite” for more. UNCITRAL is a striking example with its recently acclaimed search for further fields of engagement in the insolvency area. Now the work will go further into details; be it the treatment of groups in insolvency, court-to-court communication,<sup>24</sup> arbitration in insolvency law, or something else. While more or less hailed and welcomed by the experts,

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tices tried and tested in active financial marketplaces and thus capable of universal usage.

*Id.*

20. The fact that the enactment of a bankruptcy law has the potential to lead to an empowerment of the poor can be demonstrated in the context of the introduction of an insolvency law for states. See Christoph G. Paulus, *A Statutory Proceeding for Restructuring Debts of Sovereign States*, 49 RECHT DER INTERNATIONALEN WIRTSCHAFT 401, 402–05 (2003) [hereinafter Paulus, *Statutory Proceeding*].

21. For this, see also Halliday, *supra* note 18, at 1082–90.

22. An exception might be bigger states such as South Africa or regional attempts such as the Organisation pour l’Harmonisation du Droit des Affaires en Afrique (OHADA).

23. To be sure, most of these countries do have insolvency laws (many of them following quite closely the French model). However, what is questioned here is the law in action.

24. For this see, for instance, Jay Westbrook, *The Duty to Seek Cooperation in Multi-national Insolvency Cases*, in THE CHALLENGES OF INSOLVENCY LAW REFORM IN THE 21ST CENTURY 361 (Henry Peter, Nicolas Jeandin & Jason J. Kilborn eds., 2006); Christoph Paulus, World Bank, *Judicial Cooperation in Cross-Border Insolvencies: An Outline of Some Relevant Issues and Literature* (2006), [http://siteresources.worldbank.org/GILD/Resources/GJF2006JudicialCooperationinInsolvency\\_PaulusEN.pdf](http://siteresources.worldbank.org/GILD/Resources/GJF2006JudicialCooperationinInsolvency_PaulusEN.pdf).

it should not be forgotten that further convergence requires development of a common and basic understanding of the reason and need for this expansion, and the rationale must reach beyond the mere benefit of multinational companies.

It seems to me that much is to be done in this respect; this has to be stressed particularly in light of the recommendations of one of the members of the World Bank Group. Every year, the International Finance Corporation (IFC) publishes its *Doing Business* report, in which they measure the world's economy using a purely creditor-oriented approach. In 2006, with respect to necessary insolvency reforms, they recommended that the best solution is to give the creditors as much say in the proceeding as possible<sup>25</sup>—a remarkably simplistic statement which, of course, is heavily influenced by its own interest and the almost complete exclusion of any lawyer in the drafting process. One wonders how countries that traditionally have a strong emphasis on court-driven proceedings and which are doing fine economically will react—the present China or India are ideal examples.

The problem with the above-mentioned task of developing a sound and broad based justification for harmonization or convergence is that the need is arising at a time when the pace of change is increasing as well.<sup>26</sup> One indicator is that the worldwide expanding trade in non-performing loans has already led, in numerous cases, to a changed pattern of creditor behavior. The traditional model of bankruptcy law is based on the assumption of a debtor bound together with all his creditors on the other side by bipolar face-to-face relationships<sup>27</sup>—a paradigm which implies a general mutual knowledge of debtor and creditor. It has now become the increasingly predominant economic reality that the debtor does not know who his creditors are; irritatingly enough, nor do the creditors know who their debtor is. The trading of claims on what is commonly called the “secondary market” continues even after an insolvency proceeding has commenced. As a German banker once told me: banks are trading with everything that has not climbed the tree by “three.”

It might thus happen that an administrator has engaged in negotiations with creditors about a particular solution of the case—maybe even in

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25. See World Bank, *Doing Business 2007—How to reform*, at 55 (2006).

26. See Simon Davis, *Greater Use Should Be Made of Derivatives in Restructuring Transactions*, in GLOBAL INSOLVENCY & RESTRUCTURING YEARBOOK 2006/07 21 (4th ed.); Sijmen de Ranitz, *Foreward: Global Trends in the Field of Restructuring and Insolvency*, in GLOBAL INSOLVENCY & RESTRUCTURING YEARBOOK 2006/07 1 (4th ed.); See also INSOL INT'L, CREDIT DERIVATIVES IN RESTRUCTURINGS: A GUIDEBOOK (2006).

27. Note that the English word “obligation” stems from the Latin word “obligare,” which means primarily “to bind together.”

advance of opening the proceeding—and is thereafter confronted with a different set of creditors when the case is filed or once time has come to vote on the plan. To be sure, such a scenario need not automatically be unfavorable for the insolvency proceeding as such. There is, for instance, the possibility that an envisaged reorganization attempt will be enhanced by the introduction of new creditors. Assume that they have bought the respective claims from the original creditors for thirty cents on the dollar; this price makes it an economically sound judgment to accept a dividend of fifty cents in a case where the original creditors possibly would, after waiting out the case, have wanted more.<sup>28</sup> On the other hand, there is an equally large chance that these new creditors may be willing to settle for a quick sale of the debtor's business or assets, without any longer term strategy on the administrator's or debtor's side.

As a rule of thumb, the anonymity which is the inevitable companion of this modern development in credit markets bears the threat of inhumanity. This interrelation is evidenced by long-lasting historical experience. Therefore, the new pattern of stakeholders might undermine a legislature's consideration of social policy; for example, French insolvency law with its strong emphasis on the protection of workers may find this policy swept away by the short-term interests of debt traders. In any case, work-outs are likely to become more complicated as there are more diverse interests involved. Cautious lenders are already beginning to exert some control over the possibility of restructurings by inserting "unanimous decisions clauses" into their loan agreements. Such clauses have achieved some prominence in the context of sovereign debt restructuring attempts.<sup>29</sup>

A further consequence of converging insolvency procedures is that by enhancing the power of the court at the debtor's center of main interest, forum shopping is likely to become even more prominent than it already is today.<sup>30</sup> The European Insolvency Regulation presents the paradox clearly. Designed with the intent to prevent forum shopping by bringing the disparate insolvency legislations of the various member states closer together, this very regulation seems to have provoked forum shopping,

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28. Example taken from Steven T. Kargman, *Addressing Financial Distress in the Emerging Markets: An Overview of Key Concepts in Corporate and Sovereign Debt Restructurings*, 31 *CURSO DE DERECHO INTERNACIONAL* (Organización de los Estados Americanos, Comité Jurídico Interamericano) 453 (2004).

29. See Paulus, *Statutory Proceeding*, *supra* note 20, at 401.

30. For this observation, see John A. E. Pottow, *The Myth (and Realities) of Forum Shopping in Transnational Insolvency*, 32 *BROOK. J. INT'L L.* 785 (2007); Robert K. Rasmussen, *Where are all the Transnational Bankruptcies? The Puzzling Case for Universalism*, 32 *BROOK. J. INT'L L.* 983 (2007).

and considerable litigation over forum choice! The obvious lesson to be learned therefrom is that partial harmonization, engagement and familiarity may foster a search for potential advantages.<sup>31</sup> This is not here the place to evaluate forum shopping as a general phenomenon and to discuss its pros and cons. All that is to be derived from this development is that insolvency practitioners must adjust to the new pattern and its demands. They are increasingly confronted with situations in which they must evaluate conduct on the basis of foreign (or even multiple foreign) law(s). This hints at the thorny and inevitable question of whether or not a certain act or transaction done in one jurisdiction might trigger the avoidance laws of another? Needless to say that these new demands require highly qualified professionals.

Finally—still speaking from brink of the second decade—the increased complexity of insolvency law and its strong emphasis on the reorganization option gives reason to a new positioning of insolvency law in general. To varying degrees, in many jurisdictions, insolvency law was seen as a somewhat isolated field with few direct connections to other areas of law.<sup>32</sup> It followed its own set of rules, conditioned by the particular circumstances of the debtor's insolvency. This remains unchanged, of course. What is likely to change, however, is the increasing awareness of an insolvency law's function as part of a broader context.

This context is best described (even in German) by “turnaround law.” Its unifying property is that it deals with those economic assets (including workers, goods, services, and any other economically useful and valuable good) which, for whatsoever reason, are no longer (or, maybe even not at all) used in the most efficient manner and which shall be repositioned there. Seen from this perspective, insolvency law forms part of a large spectrum of seemingly disparate areas of law, such as corporate governance, the specific creditor protection rules within corporation law, distressed debt trading, out-of-court settlement law, and many others. Insolvency law is, thus, no longer isolated but just a link—a very important one, of course—in a longer chain of other laws. The consequence of this insight is that harmonization of insolvency law may not be

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31. The statutory cornerstone for this search is—at least presently—the interpretation of the term “center of main interests”; for this, see Gabriel Moss, *Group Insolvency—Choice of Forum and Law: The European Experience Under the Influence of English Pragmatism*, 32 BROOK. J. INT'L L. 1005 (2007); Jay Lawrence Westbrook, *Locating the Eye of the Financial Storm*, 32 BROOK. J. INT'L L. 1019 (2007).

32. To be sure, this observation relates to this law's perception and does, therefore, not contradict with what has been stated above about the objective influence of insolvency law on other fields of law.

enough. It will be necessary to integrate and adapt of insolvency law to this new legal surrounding.<sup>33</sup> This is the task of the second decade.

### III. THE SECOND DECADE

Having described the developments of the last decade, a few words about the likely further development of insolvency law are in order, as well as a warning about certain dangers which call for close monitoring by the experts.

As indicated, the next years will likely be dominated by the effort to integrate the new insolvency environment into a coherent whole. This task will require hard work, beginning with the academics and then the practitioners and the multilateral institutions. In a world which is evermore interdependent, and which is equipped with limited resources, the need will increase to move these resources to their best possible (or highest-valued) use as smoothly and promptly as possible.

The true difficulty with fulfilling this task will be, however, that it has to be done on a multi-dimensional cultural level. A “one-size-fits-all” approach is bound to fail. Not only do different jurisdictions have different priorities, they may have entirely different understandings as to the goals of a proceeding—be it protection of the enterprise, protection of workers, or maximizing value for creditors. Notwithstanding the naïve solution proposed by the IFC in its *Doing Business* report, present political realities will not permit a pure creditor-driven proceeding to be presented as the best possible (and certainly not a consensus) solution.<sup>34</sup>

A further prediction must be mentioned, if only as an aside: as the world shrinks toward a global village, the question of how to deal with overindebted states—and thus their insolvencies—must move to the top of the agenda. To the extent that this picture of the world as a village becomes reality, there is no way not to deal with the economic disparities among nations. Like in any small village, the pressure on the rich to do something about the poverty of the neighbors will grow. It is my strong conviction that the right solution will not be found in the refinement of Collective Action Clauses but in the further development of what the IMF called a Sovereign Dispute Resolution Mechanism (SDRM).<sup>35</sup> Therefore, insolvency law will have to play its role in this context.

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33. For example, as a consequence of the automatic stay reorganization within an insolvency proceeding, which might contradict the rules of the unfair competition law.

34. See Ian Fletcher, *Maintaining the Momentum: The Continuing Quest for Global-Standards and Principles to Govern Cross-Border Insolvency*, 32 *BROOK. J. INT'L L.* 767, 776-84 (2007).

35. See Paulus, *Statutory Proceeding*, *supra* note 20, at 401-02.

Another likely development in the second decade that calls for alertness, particularly of the experts, and maybe even particularly of the academic experts, is greed. To the degree that economic globalization transcends the borders of national legislatures, the greed of the "big players" in this game will likely seek to use harmonization efforts to shift aside local obstacles. Powerful entities seek, with greater or lesser success, exemptions from the applicability of certain local legal rules (tax law, labor law, environmental law, etc.). As lawmaking proceeds at the global level, such efforts may achieve even better results because of the scarcity of respective rules there, and the possibility of "one stop shopping."

A regional example is the decision of the Australian legislator in the late nineties to make netting-agreements insolvency-proof in their insolvency law in order to make the country more attractive for economic investment.<sup>36</sup> An even more striking example is the Cape Town protocol as drafted by UNIDROIT:<sup>37</sup> it provides for a worldwide applicable super-priority for certain collateral in all insolvency laws on the globe. Even though so far restricted to only a few goods, a tendency behind any such attempt is recognizable; global rules shall be set in force which overthrow the application of local laws for the benefit of global players with effective lobbyists (to be sure, not only in the realm of insolvency law<sup>38</sup>). The primary addressees of these attempts are, of course, the multilateral institutions such as UNIDROIT or IFC. Needless to say, the success of these attempts will undermine the fundamentals of insolvency law, and in particular any broad-based economic justification for harmonization.

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36. See Peter Costello, MP, Treasurer of the Commonwealth of Australia, Second Reading Speech on the Australian Prudential Regulation Authority Bill, 1998, available at [http://fsi.treasury.gov.au/content/downloads/PublicInfo/Speeches/FSI\\_SecondReadingSpeeches.rtf](http://fsi.treasury.gov.au/content/downloads/PublicInfo/Speeches/FSI_SecondReadingSpeeches.rtf).

37. Convention on International Interests in Mobile Equipment, Nov. 16, 2001, S. Treaty Doc. No. 108-10, available at <http://www.unidroit.org/english/conventions/mobile-equipment/main.htm>. Steven Harris mentions, in his contribution to this volume, UNIDROIT's drafting of a further Protocol. Steven L. Harris, *Choosing the Law Governing Security Interests in International Bankruptcies*, 32 BROOK. J. INT'L L. 905, 913 n.31 (2007).

38. Another example would be article 54 of the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID) which provides for an enforcement title that has to be recognized by all states. For this, see Giuliana Canè, *Enforcement of ICSID Awards: Revolutionary or Ineffective?*, 15 AM. REV. INT'L ARB. 439 (2006); for a general description of the procedure, see Giorgio Sacerdoti, *Investment Arbitration Under ICSID and UNCITRAL Rules: Prerequisites, Applicable Law, Review of Awards*, 19 ICSID REV. 1 (2004).

# MAINTAINING THE MOMENTUM: THE CONTINUING QUEST FOR GLOBAL STANDARDS AND PRINCIPLES TO GOVERN CROSS-BORDER INSOLVENCY

*Ian F. Fletcher\**

## FOREWORD—IN MEMORIAM

A little more than ten years ago, on September 19, 1996, to be exact, the author of this Article was privileged to take part in a truly exceptional and ground-breaking symposium conceived and arranged by the friend and colleague whose loss we continue to mourn, and to whose memory we dedicate these present proceedings. The symposium of September 1996 was a co-sponsored venture by Brooklyn Law School together with the Centre for Commercial Law Studies based in Queen Mary & Westfield College, University of London.<sup>1</sup> It followed the precedent of other joint symposia mounted by these two institutions around that time, of presenting the same conference program at consecutive meetings in New York and London, thereby widening the live impact of the proceedings and enabling the high-caliber array of speakers to interact with audiences on two continents. As the Director of the Centre for Commercial Law Studies during that period, the author attended several of the symposia in an *ex-officio* capacity, but when the theme of “Bankruptcy in the Global Village” was first mooted, it was inevitable that my involvement in the proceedings would be more than merely symbolic. Nevertheless, it is appropriate to acknowledge that the original concept for the 1996 symposium came from Professor Barry Zaretsky, and that it was he and his colleagues who worked tirelessly to ensure that the inaugural session held in Brooklyn was an unqualified success, characterized by a sense of infectious energy and enthusiasm that emanated from Barry himself. The professional dedication which Barry brought to the organization of the working sessions of the symposium was matched by a warm and generous spirit of hospitality which he and his wife, Joan, extended to those of us who were visiting from “out of town.” As one reflects on the unaffected conviviality of those times spent together a decade ago, and is then mindful of all that has happened in the intervening years, in New York and beyond, it seems imperative that we reaffirm

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1. The College within the University of London formerly known as Queen Mary and Westfield College has subsequently adopted the name “Queen Mary, University of London.” Queen Mary, University of London, Web site, <http://www.qmul.ac.uk> (last visited May 20, 2007).

our commitment to the pursuit of the high scholarly purposes, and to the spirit of international collegiality, which were among the many cherished qualities which will be forever associated with the name of Barry Zaretsky.

## I. INTRODUCTION: THEN AND NOW

### A. *Work in Progress, 1996*

Surveying the landscape of international insolvency—or bankruptcy—law as it was constituted in 1996 from the vantage point of the closing months of 2006, one is struck by the speed and extent of the changes which have taken place in the intervening years. Perusal of the collected papers from the first Global Village Symposium as published in the *Brooklyn Journal of International Law*<sup>2</sup> provides a snapshot of the state of evolution of a number of major projects at that point in time. The American Law Institute's (ALI) *NAFTA Insolvency Project*, for which Professor Jay L. Westbrook was the U.S. Reporter, was actively engaged in the task of seeking common ground and shared principles among the laws of the three NAFTA countries with regard to the conduct of cross-border bankruptcies.<sup>3</sup> By the fall of 1996, draft statements of the laws of all three jurisdictions had already been prepared,<sup>4</sup> creating a necessary platform for the completion of the project. However, the exacting process of discovering and formulating the agreed-upon principles still lay in the future, and was only concluded in May 2000.<sup>5</sup>

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2. Symposium, *Bankruptcy in the Global Village*, 23 BROOK. J. INT'L L. 1 (1997).

3. Jay Lawrence Westbrook & Jacob S. Ziegel, *The American Law Institute NAFTA Insolvency Project*, 23 BROOK. J. INT'L L. 7 (1997).

4. AM. LAW INST., TRANSNATIONAL INSOLVENCY PROJECT: INTERNATIONAL STATEMENT OF UNITED STATES BANKRUPTCY LAW (Discussion Draft 1996); AM. LAW INST., TRANSNATIONAL INSOLVENCY PROJECT: INTERNATIONAL STATEMENT OF CANADIAN BANKRUPTCY LAW (Council Draft No. 1, 1996); AM. LAW INST., TRANSNATIONAL INSOLVENCY PROJECT: INTERNATIONAL STATEMENT OF MEXICAN BANKRUPTCY LAW (Preliminary Draft No. 1, 1996).

5. Final Drafts of the four volumes comprising the product of the American Law Institute (ALI) Transnational Insolvency Project were approved by the council and members of the ALI at the organization's annual meeting in May 2000. All four volumes were subsequently published in 2003 by Juris Publishing, Inc. The first three volumes contain national reports of the relevant laws of the three NAFTA countries—Canada, Mexico, and the United States—while the fourth volume, entitled *Principles of Cooperation Among the NAFTA Countries*, carries the statements of principles and recommendations. AM. LAW INST.: TRANSNATIONAL INSOLVENCY: COOPERATION AMONG THE NAFTA COUNTRIES: INTERNATIONAL STATEMENT OF CANADIAN BANKRUPTCY LAW (Juris Publishing 2003); AM. LAW INST.: TRANSNATIONAL INSOLVENCY: COOPERATION AMONG THE NAFTA COUNTRIES: INTERNATIONAL STATEMENT OF MEXICAN BANKRUPTCY LAW (Juris

Meanwhile, the long-running saga of the European Union Insolvency Convention had, earlier in the year 1996, suffered the latest of a series of miscarriages of fortune which had consigned the text to an uncertain state of limbo. Although the concluded text of the convention had been signed by fourteen of the fifteen states which then comprised the membership of the European Union, the failure of the United Kingdom to append its signature by May 23, 1996<sup>6</sup> (the last day of the six-month "window" during which the convention was open for signature), caused the entire convention to lapse.<sup>7</sup> Although it was technically possible for the project to be resurrected at some future time by unanimous agreement of the entire E.U. membership of fifteen, it was questionable whether the political conditions for such a maneuver would be achievable in the immediate aftermath of the acrimonious events of May 1996. At the Brooklyn Symposium in September of that same year, the author ventured the opinion that the convention might possibly be revived and concluded at some time during 1997, although the process of ratification might occupy several more years before the convention could enter into force.<sup>8</sup> That opinion was mistaken on a number of counts, although the final outcome can be regarded as having produced a more effective instrument of legal integration than had been in prospect while the project was cast in the form of an international convention.

It was not until 1999 that the requisite circumstances, and the shared political will, were forthcoming to permit the revival of the insolvency project.<sup>9</sup> On the other hand, the inspired decision to recycle the substantive text of the lapsed convention in the form of a regulation of the Council of the European Community totally transformed the legal potency of the measure and the immediacy of its entry into force.<sup>10</sup> The

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Publishing 2003); AM. LAW INST.: TRANSNATIONAL INSOLVENCY: COOPERATION AMONG THE NAFTA COUNTRIES: INTERNATIONAL STATEMENT OF UNITED STATES BANKRUPTCY LAW (Juris Publishing 2003); AM. LAW INST.: TRANSNATIONAL INSOLVENCY: COOPERATION AMONG THE NAFTA COUNTRIES: PRINCIPLES OF COOPERATION AMONG THE NAFTA COUNTRIES (2003) [hereinafter AM. LAW INST., PRINCIPLES].

6. European Union, Convention on Insolvency Proceedings, *done* Nov. 23, 1995, 35 I.L.M. 1223, 1223.

7. *Id.* art. 49.

8. Ian F. Fletcher, *The European Union Convention on Insolvency Proceedings: An Overview and Comment, with U.S. Interest in Mind*, 23 BROOK. J. INT'L L. 25, at 27, 33.

9. Initiative of Germany and Finland on Adoption of a Council Regulation on Insolvency Proceedings, submitted May 26, 1999, 1999 O.J. (C 221) 8 (EC).

10. The measure acquired the force of law, with supremacy over any conflicting provisions of domestic law, on May 31, 2002 throughout all the E.U. Member States with the exception of Denmark. Council Regulation 1346/2000, 2000 O.J. (L 160) 1 (EC). Denmark, a signatory to the Insolvency Convention which lapsed in 1996, secured a spe-

accession of ten further states to membership of the European Union between 1996 and 2004<sup>11</sup> has resulted in a total of twenty-four European States being currently subject to the Regulation on Insolvency Proceedings (EC Regulation). This figure was increased still further with the accession of two more states as E.U. Members in January 2007.<sup>12</sup>

Although not in a sufficiently advanced state to be examined in detail during the course of the 1996 Symposium, another significant project in progress at that time was the cycle of twice-yearly meetings of an expert working group convened by the United Nations Commission on International Trade Law (UNCITRAL), aimed at producing model legislative provisions on cross-border insolvency which could be enacted by states as part of their domestic laws.<sup>13</sup> The concept of the Model Law on Cross-Border Insolvency, as it ultimately came to be known, was a pragmatic response to a growing realization that the rate of progress towards the development of multilateral conventions to provide for the orderly conduct of international insolvencies was impossibly slow and faltering and would be incapable of delivering workable results for global application within any foreseeable time frame. An alternative strategy was therefore adopted with a view to establishing a framework of standardized legislative provisions which, if incorporated in parallel fashion into the domestic laws of a number of commercially significant states, could ensure the

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cial exemption under the terms of the Maastricht and Amsterdam Treaties, of 1992 and 1997 respectively, which amended and consolidated the primary treaties on which the European Community and the European Union are based. Protocol on the Position of Denmark arts. 1, 2, 1997 O.J. (C 340) 1, 101; Treaty of Amsterdam Amending the Treaty on European Union, Oct. 2, 1997, 1997 O.J. (C 340) 1 [hereinafter Amsterdam Treaty]; Treaty on European Union, Feb. 7, 1992, 1992 O.J. (C 191) 1 [hereinafter Maastricht Treaty]. Under this so-called "permanent opt-out," Denmark is excluded from the effects of legislation enacted under Articles 61(c) and 67(1) of the Treaty Establishing the European Community. See Treaty Establishing the European Community arts. 61(c), 67(1), Mar. 25, 1957, 298 U.N.T.S. 3, consolidated version at 2002 O.J. (C 325) 33. The EC Regulation on Insolvency Proceedings was adopted under the terms of the two articles in question. The non-participation of Denmark is confirmed by Recital 33 to the Regulation. Council Regulation 1346/2000, para. 33, 2000 O.J. (L 160) 1, 4.

11. European Union, Treaty and Act of Accession (Athens Treaty), Sept. 23, 2003, 2003 O.J. (L 236).

12. Final approval for the accession of Romania and Bulgaria to the status of full membership of the European Union with effect from January 1, 2007, was announced in a press release by the European Commission on September 26, 2006. Press Release, European Comm'n, Commission Confirms Bulgaria's and Romania's EU Accession on 1 January 2007, Completed by a Rigorous Package of Accompanying Measures (Sept. 26, 2006).

13. See U.N. Comm'n on Int'l Trade Law [UNCITRAL], 26<sup>th</sup> Session, July 5–23, 1993, *Report of the United Nations Commission on International Trade Law on the Work of its 26th Session*, paras. 302–06, U.N. Doc. A/48/17 (Sept. 7, 1993).

minimum conditions necessary to enable multi-jurisdictional insolvency proceedings to be conducted with speed and effectiveness.<sup>14</sup> This would be facilitated through the provision of appropriate enabling powers allowing judges to cooperate with their counterparts in other jurisdictions and to grant assistance to foreign representatives acting in insolvency cases.<sup>15</sup>

UNCITRAL, in May 1995, formally decided to pursue the preparation of uniform legislative provisions on judicial cooperation in cross-border insolvencies.<sup>16</sup> The rate of progress achieved by the Working Group was remarkable for its rapidity. By March 1997 a draft version of the Model Law was issued for scrutiny and consultation, and after some consequential revision, the text of the Model Law was adopted by UNCITRAL on May 30 of that same year.<sup>17</sup> Inevitably, some time was needed thereafter for states to absorb the implications of the Model Law and evaluate the case for its enactment, but in due course a steadily growing list of economically significant states, beginning in 2000 with Mexico, introduced legislation based upon its provisions.<sup>18</sup>

Although representatives of both the United States and the United Kingdom had been members of the Working Group, and had played significant roles in shaping the contents of the Model Law itself, the original aspirations of the respective governments of those states to set a positive example by quickly enacting it within their insolvency laws fell vic-

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14. See UNCITRAL, UNCITRAL Model Law on Cross-Border Insolvency, Preamble, U.N. Doc. A/52/17 annex I at 67 (July 4, 1997) [hereinafter UNCITRAL, Model Law].

15. *Id.* ch. IV (arts. 25–27).

16. UNCITRAL, Twenty-eighth Session, May 2–26, 1995, *Report of the United Nations Commission on International Trade Law on the Work of Its Twenty-eighth Session*, paras. 391–92, U.N. Doc. A/50/17 (adopted May 24–26, 1995).

17. UNCITRAL, Thirtieth Session, May 12–30, 1997, *Report of the United Nations Commission on International Trade Law on the Work of Its Thirtieth Session*, para. 221, U.N. Doc. A/52/17 (July 4, 1997) [hereinafter UNCITRAL, *Report on Thirtieth Session*]; see *id.* at 67–77 (Annex I) (UNCITRAL, Model Law).

18. The following countries have adopted legislation based on the Model Law: Colombia, Great Britain, and New Zealand in 2006; the British Virgin Islands and the United States of America in 2005; Serbia in 2004; Poland and Romania in 2003; Montenegro in 2002; Japan, Mexico, and South Africa in 2000; and Eritrea. UNCITRAL, Status: 1997—Model Law on Cross-Border Insolvency, [http://www.uncitral.org/uncitral/en/uncitral\\_texts/insolvency/1997Model\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model_status.html) (last visited May 18, 2007). Countries reported to be actively considering adoption of enacting legislation include Argentina, Australia, Canada, and Pakistan. UNCITRAL, *Developments in Insolvency Law: Adoption and Interpretation of the UNCITRAL Model Law on Cross-Border Insolvency and Developments in Interpretation of “Centre of Main Interests” in the European Union*, para. 3, U.N. Doc. A/CN.9/597 (Apr. 11, 2006).

tims to the cross-currents of domestic political and legislative circumstances. It was not until October 17, 2005 that a new Chapter 15 of the U.S. Bankruptcy Code, embodying the terms of the Model Law as applicable in the United States, was able to enter into force as part of a more widely cast statute containing other reforming provisions whose contents had generated much political controversy.<sup>19</sup> In the United Kingdom, an enabling power was supplied by section 14 of the Insolvency Act 2000 to allow the Model Law to be enacted by means of secondary legislation in the form of a statutory instrument.<sup>20</sup> Despite this license to bypass the severe constraints of the parliamentary legislative timetable, the task of preparation, including a series of consultative processes, was not completed until March 2006.<sup>21</sup> Enactment of the Model Law was effected by the Cross-Border Insolvency Regulations 2006, which entered into force within Great Britain on April 4, 2006.<sup>22</sup>

#### *B. Some New Initiatives Since 1996*

The completion of each of the three major projects which have just been discussed was a matter for celebration as representing a triumph of will in the face of technical and political obstacles. These obstacles would, on the evidence of past history of treaties and agreements in the sphere of international bankruptcy matters, invariably have proved insuperable or, at best, would have resulted in a text of such blandness or opacity that no meaningful benefits could be derived from the finished product.<sup>23</sup> The concrete advances brought about through the American

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19. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (codified in scattered sections of titles 11, 12, 15, and 18 of the United States Code). Title VIII of this act amends Title 11 of the United States Code by inserting Chapter 15 ("Ancillary and Other Cross-Border Cases"), and makes consequential amendments to Titles 11 and 28 of the Code. *Id.* §§ 801–02 (codified in 11 U.S.C. §§ 1501–32 and scattered sections of 11 and 28 U.S.C.).

20. Insolvency Act 2000, c. 39, § 14 (U.K.). This section came into force on the day the Act was passed (November 30, 2000). *Id.* § 16(2).

21. For a key document circulated during the consultative process, see THE INSOLVENCY SERV., IMPLEMENTATION OF UNCITRAL MODEL LAW ON CROSS-BORDER INSOLVENCY IN GREAT BRITAIN (2005), available at [http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/con\\_doc\\_register/registerindex.htm](http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/con_doc_register/registerindex.htm) (last visited May 21, 2007).

22. Cross-Border Insolvency Regulations 2006, S.I.2006/1030 § 1. The delimitation of the territorial effect to "Great Britain" signifies that the Model Law currently applies only within England, Wales, and Scotland. *Id.* § 2. Extension to Northern Ireland will be effected by a further instrument of secondary legislation at a date to be determined.

23. As an example, see the Model Treaty on Bankruptcy adopted by the Fifth Session of the Hague Conference on Private International Law in 1925, reproduced in

Law Institute Transnational Insolvency Project, the EC Regulation on Insolvency Proceedings, and the UNCITRAL Model Law respectively, serve as a reminder of what can be accomplished by a less ambitious quest for pragmatic solutions to specific aspects, rather than embarking on the vain attempt to devise an idealized solution to the totality of the issues of principle and process that are encountered in the field of international insolvency. Significantly, none of the three projects attempted to impose changes to the substantive insolvency laws, and related types of proceeding, contained in the domestic legal orders of the states in which their provisions were destined to apply. The ALI Principles, and the UNCITRAL Model Law, aspire to allow the foreign representative to gain access and recognition before the courts of other states, and thereafter to obtain such relief and assistance as is already available under the laws of the recognizing state in relation to cases initiated under its domestic laws.<sup>24</sup> And while the EC Regulation embodies a regime of overarching rules controlling the exercise of jurisdiction, the choice-of-law process, and the recognition and enforcement of proceedings opened in other Member States,<sup>25</sup> it most emphatically does not purport to rewrite the content of the domestic insolvency laws of the states whose laws are required to be applied substantively in accordance with its controlling provisions.

Diversity of treatment of factually similar situations, as between the laws of two different sovereign states, will thus remain a fact of life for those caught up in a multi-jurisdictional bankruptcy. It will require much effort to minimize the sense of unfairness borne by those parties who experience the effects of asymmetrical outcomes among differently positioned creditors of what is, in functional terms, a single debtor operating on a transnational basis. Instances of such asymmetrical outcomes for functionally similar claimants will continue to occur for as long as the separate sovereign states of the world maintain their individualized approaches to insolvency law and policy. In reality, the elimination of such diversity is unattainable within the foreseeable future. If the otherwise closely aligned states of the European Union have shown themselves unable—indeed unwilling—to countenance the harmonization of their national laws concerning debtor-creditor relations, security, and insolvency, how much more unlikely is it that states from different regions of the world, representing a wide variety of legal traditions, could be in-

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CONFÉRENCE DE LA HAYE DE DROIT INTERNATIONAL PRIVÉ, ACTES DE LA CINQUIÈME SESSION 1925, at 341 (1926). No state ever ratified the Treaty.

24. See AM. LAW INST., PRINCIPLES, *supra* note 5; UNCITRAL, Model Law, *supra* note 14.

25. See Council Regulation 1346/2000, 2000 O.J. (L 160) 1 (EC).

duced to abandon their embedded practices in matters of insolvency and subscribe to a common set of principles and procedures?!

Although any attempt at bringing about a complete harmonization of global insolvency laws in the near future could be dismissed as an exercise in futility, there is a good case to be made for sustaining the momentum generated by the successfully completed projects of recent times. This would be in order to pursue more attainable objectives such as raising the level of awareness among national legislators and policymakers regarding the standards of legal provision currently maintained by states, which are demonstrably in the forefront of economic and commercial activity.<sup>26</sup> Although it would be unrealistic to pretend that less developed states with fewer resources could, or indeed should, instantly renounce their indigenous practices and seek to emulate an alien legal culture for the sake of the supposed economic benefits that might ensue, a long-term approach to the sharing of expertise and skills could enable such states, over time and at a self-determined pace, to assimilate such standards as they deem to be compatible with their social goals and priorities. This line of reasoning (at least in part) seems to lie at the root of a new wave of initiatives which have been promoted by a number of regional and global organizations during the last decade, including the International Monetary Fund (IMF),<sup>27</sup> the Asian Development Bank (ADB),<sup>28</sup> and the World Bank,<sup>29</sup> and also by UNCITRAL.<sup>30</sup> Each in its distinctive way offers an aspirational statement of the norms and standards which are believed by the respective teams of authors to embody the necessary ingredients of a robust and efficient system for regulating debtor-creditor relationships and for administering and distributing the estates of insol-

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26. The policy of "global standard setting" by identifying the currently accepted models of "best practice" is notably exemplified by the initiatives mentioned *infra*, notes 27–30.

27. LEGAL DEP'T, INT'L MONETARY FUND, ORDERLY AND EFFECTIVE INSOLVENCY PROCEDURES: KEY ISSUES (1999).

28. Office of the Gen. Counsel, Asian Dev. Bank, *Insolvency Law Reforms in the Asian and Pacific Region*, 1 LAW AND POLICY REFORM AT THE ASIAN DEVELOPMENT BANK 10–85 (2000).

29. WORLD BANK, PRINCIPLES AND GUIDELINES FOR EFFECTIVE INSOLVENCY AND CREDITOR RIGHTS SYSTEMS (REVISED) (2005), available at [http://www.worldbank.org/ifa/rosc\\_icr.html](http://www.worldbank.org/ifa/rosc_icr.html); WORLD BANK, PRINCIPLES AND GUIDELINES FOR EFFECTIVE INSOLVENCY AND CREDITOR RIGHTS SYSTEMS (2001), available at [http://www.worldbank.org/ifa/rosc\\_icr.html](http://www.worldbank.org/ifa/rosc_icr.html).

30. UNCITRAL, LEGISLATIVE GUIDE ON INSOLVENCY LAW, U.N. Sales No. E.05.V.10 (2005) [hereinafter UNCITRAL, GUIDE], available at [http://www.uncitral.org/pdf/english/texts/insolven/05-80722\\_Ebook.pdf](http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf). Supporting documentation is available at [http://www.uncitral.org/uncitral/en/uncitral\\_texts/insolvency/2004Guide.html](http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/2004Guide.html).

vent debtors. Although there are obvious variations between the four documents in terms of emphasis and nuance, as well as in some matters of substance, a considerable amount of common ground is also discernible which could become a useful starting point in a future search for further synthesis and convergence.<sup>31</sup>

In the cases of the IMF, the ADB, and the World Bank, their involvement in projects to promote a convergence of national insolvency laws in line with perceived “best practice” is far from coincidental. Indeed, there has at times been an appearance of barely concealed dirigisme on the part of some of the financial institutions, due to their tendency to hint at an eventual correlation between their readiness to provide moral and material support for “client countries” and the degree to which said clients are able to demonstrate that their insolvency laws are in alignment with the “benchmarks” specified in the lender’s manual of best practice.<sup>32</sup> Nevertheless, each of the documents generated by the IMF, the ADB, and the World Bank respectively makes a valuable contribution to the process of identifying and articulating the legal provisions and systemic arrangements considered essential for the conduct of orderly financial relationships in support of commerce and development. However, in terms of impact on the global community, comprising both developed and developing states, it is probable that the *UNCITRAL Legislative Guide on Insolvency Law* will receive the closest consideration by policymakers and legislators, both on account of its institutional pedigree and also for the very reason that it appears to adopt a non-prescriptive approach that is free from any overt attempt to impose a legislative matrix upon states as a condition for economic acceptance or access to material benefits for the future. The introductory section of the *Guide* pointedly affirms that its purpose is to assist the user of the document “to evaluate different approaches available and to choose the one most suitable in the national or local context.”<sup>33</sup> With one notable exception, which will be further considered at a later point in this Article,<sup>34</sup> the *Guide* succeeds in its self-imposed limitation to refrain from “provid[ing] a single set of model solutions to address the issues central to an effective and efficient insol-

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31. This theme is explored below in Part II.

32. See, for example, the systematic process known as “Reporting on the Observance of Standards and Codes” (ROSC), developed and operated by the IMF and the World Bank. Details of this can be viewed at [www.worldbank.org/ifa/ros.html](http://www.worldbank.org/ifa/ros.html) (last visited May 21, 2007).

33. UNCITRAL, *GUIDE*, *supra* note 30, at 2, para. 3.

34. The exception referred to, concerning the treatment of matters of choice of law in Part Two, Chapter I, Section C of the *UNCITRAL Legislative Guide*, is considered below in Part II.

veny law”<sup>35</sup> while supplying an eloquently reasoned and quietly authoritative discourse upon ways of supplying the requisite components of a commercially attuned system of insolvency law.

### *C. Summing Up: A Decade of Progress*

Attention has been called above to some of the notable developments in the field of international insolvency during the decade between 1996 and 2006. It has been a period when several important projects came to fruition and subsequently began to make an impact on the day-to-day practice and application of the law. Simultaneously, new projects were embarked upon with the aim of imparting a long-term influence over the shape, and eventual convergence, of insolvency systems on a global or regional basis. It should be noted that this Article has not attempted to provide a comprehensive survey of the latter type of project, and that a number of other initiatives have recently been completed, or are currently ongoing, which have a direct or indirect relation to the refinement and restatement of insolvency law principles.<sup>36</sup> Among the conclusions to be drawn from this impressive display of activity are that, while there is both a need and a desire to bring about an alignment of the insolvency and related laws of as many of the world’s sovereign states as possible, the task will inevitably require much patience and sensitivity, and this alignment is best attained through the pursuit of manageable projects whose goal should be the progressive resolution of specific aspects of this vast and complex field. The dreams of former ages, envisioning a comprehensive solution to the problems of international insolvency by means of a single, grand treaty, have long since been abandoned. In their place, the more realistic cultivation of the “Art of the Possible” has been shown to produce worthwhile results. This approach should be continued, thereby maintaining the momentum generated by past successes without incurring the risks of overextension due to a surfeit of ambition.

## II. NEW INITIATIVES 2006: THE ALI-III GLOBAL PRINCIPLES PROJECT

One example of the “new wave” of initiatives seeking to build on the foundations which are now in place, the ALI-III Global Principles Pro-

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35. UNCITRAL, GUIDE, *supra* note 30, at 2, para. 3.

36. E.g., UNCITRAL, *Draft Legislative Guide on Secured Transactions*, U.N. Doc. A/CN.9/WG.VI/WP.31/Add.1 (Nov. 22, 2006); PRINCIPLES OF EUROPEAN INSOLVENCY LAW (W.W. McBryde et al. eds., 2003). The *Draft Legislative Guide on Secured Transactions* was developed by the UNCITRAL Working Group on Security Interests beginning in 2002. Documentation related to this guide is available at [http://www.uncitral.org/uncitral/en/uncitral\\_texts/security.html](http://www.uncitral.org/uncitral/en/uncitral_texts/security.html) (last visited Apr. 16, 2007).

ject, was inaugurated in the winter of 2006 as a joint venture by the American Law Institute and the International Insolvency Institute.<sup>37</sup> The project seeks to develop global principles for cooperation in international insolvency cases.<sup>38</sup> The author had the honor to be named as co-Reporter for this project, in collaboration with Professor Bob Wessels. The remainder of this Article offers an account of the aims and methods by which the so-called Global Principles Project is being pursued, and the goals which we hope to achieve.

### *A. Background*

In February 2006, the American Law Institute and the International Insolvency Institute (III) announced the inception of a joint dissemination and extension project with respect to the “Principles of Cooperation” developed in the ALI Transnational Insolvency Project.<sup>39</sup> The stated objective of the two bodies was to establish acceptance of the ALI’s *Principles of Cooperation Among the NAFTA Countries (NAFTA Principles)*<sup>40</sup> in jurisdictions across the world, subject to any necessary local modifications, and to obtain the endorsement of leading domestic associations, courts, and other groups in those jurisdictions.<sup>41</sup> The intended time frame for completion was set at within twenty-four to thirty months, thereby envisaging the production of a finalized text before the end of the year 2008.<sup>42</sup> It was also anticipated that the Joint Reporters would carry out their task in collaboration with an International Advisory Group whose membership would be drawn primarily from the international membership of III.<sup>43</sup> Given the specialized nature of the subject matter of the project, and also its international character, the technical expertise and professional stature of the III membership makes them ideally qualified for the task in hand, although it is expected that ALI members with an interest in the field of international bankruptcy will be drawn to par-

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37. See Am. Law Inst., *Council Approves Property Draft for Submission to Annual Meeting; New Project Launched on Transnational Insolvency Principles of Cooperation*, A.L.I. REPORTER, Winter 2006, at 1–2 [hereinafter Am. Law Inst., *Insolvency Project*].

38. See *id.*; see also Am. Law Inst., *Institute Moves Forward with International Insolvency Project*, A.L.I. REPORTER, Summer 2006, at 4 [hereinafter Am. Law Inst., *Institute Moves Forward*].

39. *Id.*; see *supra* notes 3 and 4 and accompanying text.

40. AM. LAW INST., PRINCIPLES, *supra* note 5.

41. See Am. Law Inst., *Institute Moves Forward*, *supra* note 38; Am. Law Inst., *Insolvency Project*, *supra* note 37.

42. AM. LAW INST. & INT’L INSOLVENCY INST., MANIFESTO OF AIMS AND OBJECTIVES (2006) (on file with the author) [hereinafter ALI & III, MANIFESTO].

43. *Id.*

ticipate, even if they do not happen to be members of III.<sup>44</sup> In addition, an ALI Members' Consultative Group will be formed in accordance with the organization's usual procedure for the conduct of projects.<sup>45</sup>

### *B. Defining the Objectives*

The Joint Reporters set about their mission by drawing up a provisional statement of objectives, with a view to launching an interactive discussion with the membership of the Advisory Group and thereafter refining and reshaping the objectives themselves. The Reporters started from the proposition that the *raison d'être* of the Project is already defined, namely to establish the extent to which it is feasible to achieve a worldwide acceptance of the *NAFTA Principles* together with the *Guidelines Applicable to Court-to-Court Communications in Cross-Border Cases* (the *Guidelines*).<sup>46</sup> It thus seemed appropriate to design a systematic consultation exercise, drawing on the expert, first-hand knowledge of members of the Advisory Group, to determine the extent to which the *NAFTA Principles* and also the *Guidelines* are capable of being applied within a wide and representative range of legal systems around the world, and also the extent to which current practice in those countries may be said to conform to those standards.<sup>47</sup> Conversely, to the extent that local circumstances give rise to any obstacles to the acceptance of such standards and practices, these should be identified, and consideration should then be given to possible means of resolving them.<sup>48</sup>

Secondly, the Reporters perceived that the Global Principles Project could provide an appropriate vehicle for exploring further the possibilities for devising global standards to regulate the transnational insolvency process itself. A number of issues which have an important bearing upon the overall quality and efficiency of the international insolvency "process" were either not directly addressed in the context of the *NAFTA Principles* Project or were there dealt with on a somewhat tentative basis. These include the principles and procedures to be applied where insolvency occurs within multinational corporate groups (the subject of Pro-

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44. The Co-Chairs of the International Advisory Group are Professor Jay L. Westbrook, the Reporter for the *NAFTA Principles* Project, and E. Bruce Leonard, who was Chair and Reporter for Domestic Aspects of Canadian Law for the previous Project, and who is currently Chair of the International Insolvency Institute.

45. See AM. LAW INST., CAPTURING THE VOICE OF THE AMERICAN LAW INSTITUTE: A HANDBOOK FOR ALI REPORTERS AND THOSE WHO REVIEW THEIR WORK 16 (2005).

46. AM. LAW INST., PRINCIPLES, *supra* note 5, app. B.

47. ALI & III, MANIFESTO, *supra* note 42.

48. *Id.*

cedural Principles 23 and 24 of the *NAFTA Principles*).<sup>49</sup> Further issues which are self-evidently in need of study and development are the conflict-of-laws aspects of insolvency, including choice-of-law rules and the principles relating to the exercise of jurisdiction, together with the elaboration of internationally tenable definitions of some of the fundamental concepts employed in the standardized principles.<sup>50</sup> Also of direct relevance to the goal of promoting effective cooperation in international cases are some very practical questions, including how to overcome the inevitable problems where the respective courts are operating concurrently in different regions and time zones and have different working languages. In such situations, direct communication between courts may be impracticable, but it may be that some alternative means of achieving cooperation through one or more designated intermediaries could be established.

Thirdly, the Reporters considered this a timely opportunity to take account of the considerable volume of work that had already been developed in this field in recent years. As already indicated in Part I of this Article, the number of recent projects and studies which either directly or indirectly relate to insolvency matters amount to a striking demonstration of the globalization of commercial activity in the present era, and the raised awareness internationally of the need to address insolvency-related issues which arise in a cross-border context. It would therefore seem useful to enlist the collective wisdom of the International Advisory Group to try to distill, and if possible synthesize, the fruits of recent activity, and hopefully thereby provide a legislative tool which can be a point of reference in the future.<sup>51</sup>

A meeting with the inaugural members of the Advisory Group was convened at Columbia University School of Law on June 14, 2006, attended by judges, practitioners, and academics from more than ten countries.<sup>52</sup> The meeting reviewed the Reporters' provisional statement of objectives and discussed a number of associated themes which could po-

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49. *Id.* Following the decision by UNCITRAL at its meeting in July 2006, see *infra*, note 57 and accompanying text, to undertake a project dealing with the insolvency of groups of companies, the Co-Reporters concluded that this subject would not be retained as one of the main concerns of the Global Principles Project.

50. ALI & III, MANIFESTO, *supra* note 42. As of May 2007, these subjects continue to be included within the Objectives of the Global Principles Project.

51. With this task in mind, a *Taxonomy of Guidelines and Principles in International Insolvency* was drawn up with the assistance of Dr. Paul Omar. This document (currently unpublished) provides a synoptic display of the principles formulated by eight different studies, arranged thematically (copy on file with the author).

52. See Am. Law Inst., *Institute Moves Forward*, *supra* note 38.

tentially be included within the revised objectives.<sup>53</sup> There was a consensus on the need to maximize the opportunities presented by the assembling of a globally drawn group of experts by examining, within the limits of reasonableness, certain related issues which those engaged in the *NAFTA Principles* Project had not managed to resolve. For example, it was considered that some of the practical aspects of cross-border cooperation should be addressed, including, as already mentioned, the resolution of differences of working languages of the courts involved, and of the time zones in which the respective courts are located.<sup>54</sup> There was also some support for the suggestion that the special difficulties encountered in insolvencies of multinational groups of companies are in urgent need of attention, although it was quickly realized that the complexity of the subject could pose problems of balanced allocation of the available resources.<sup>55</sup> The subsequent decision by UNCITRAL, at its meeting in July 2006, to establish a working group to consider the treatment of corporate groups in insolvency<sup>56</sup> has obviated the need for this topic to be brought within the main objectives of the Global Principles Project, although it need not altogether preclude our consideration of some aspects where appropriate. As a consequence of this development, it is likely that the Project can address some of the more pressing issues in the area of private international law which to date have defeated the attempts of international organizations to devise clear and workable solutions.

### *C. The Continuing Challenge of Private International Law*

When courts engage in cross-border cooperation, it can scarcely be supposed that they do so under circumstances where each court is blind to the international implications of the action it is being invited to take at the request of its foreign counterpart or of interested parties including, most prominently, the foreign representative. As has already been noted, existing instruments which regulate aspects of international insolvency, even including the EC Regulation on Insolvency Proceedings, have stopped short of seeking to unify the domestic insolvency laws of the states affected. For the foreseeable future, therefore, it will continue to be relevant to know in which jurisdiction a given debtor is capable of becoming subject to insolvency proceedings, and what the substantive consequences will be of those proceedings for all concerned. For the pur-

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53. *Id.*

54. *Id.*

55. *Id.*

56. UNCITRAL, Thirty-ninth Session, June 19–July 7, 2006, *Report of the United Nations Commission on International Trade Law on the Work of Its Thirty-ninth Session*, paras. 207–09(a), U.N. Doc. A/61/17 (July 14, 2006).

poses of international recognition and enforcement of the results of insolvency proceedings, as well as for the purpose of obtaining the cooperation and assistance of foreign courts pursuant to such arrangements as are put in place following enactment of the UNCITRAL Model Law, the court hearing the foreign request must evaluate the circumstances in which the foreign proceedings came to be opened, and may also need to establish such questions as the precise time at which proceedings are to be treated as having been opened.

Regrettably, at present there is an absence of clear, universally agreed-upon rules to determine these issues, so that the outcome of such crucial legal questions is unpredictable at best. This is unfortunately the case even with respect to the EC Regulation and the UNCITRAL Model Law, whose recourse to a near-common vocabulary by the use of key concepts such as “centre of main interests”<sup>57</sup> and “establishment”<sup>58</sup> seemed initially to herald a significant leap forward in the standardization of rules of jurisdiction. Despite the enormous efforts expended in negotiating and drafting them, neither the EC Regulation nor the Model Law succeeded in providing a clear and precise definition of “centre of main interests,”<sup>59</sup> while their respective definitions of “establishment” may also prove to be difficult to apply in relation to some forms of commercial activity.<sup>60</sup> This definitional deficit has already proved to be the source of troublesome and costly uncertainty in the operation of the EC Regulation, as it has given rise to disputes between interested parties as to the legitimacy of attempts to open proceedings in a given jurisdiction.<sup>61</sup> Similar difficulties, bringing in their wake a plethora of legal uncertainties, have resulted from the lack of technical precision in the drafting of the EC Regula-

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57. See Council Regulation 1346/2000 art. 3(1), Recital (13), 2000 O.J. (L 160) 1 (EC); UNCITRAL, Model Law, *supra* note 14, arts. 2(b), 16(3).

58. See Council Regulation 1346/2000 arts. 2(h), 3(2), 2000 O.J. (L 160) 1 (EC); UNCITRAL, Model Law, *supra* note 14, arts. 2(c), 2(f).

59. The statement in Recital (13) to the EC Regulation, to the effect that “[t]he ‘centre of main interests’ should correspond to the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties,” is more appropriately classified as an indicative description, rather than as a technical definition of the term referred to. There is no comparable statement in the UNCITRAL Model Law.

60. Compare Council Regulation 1346/2000 art. 2(h), 2000 O.J. (L 160) 1 (EC) with UNCITRAL, Model Law, *supra* note 14, art. 2(f). The two definitions are closely similar, but not identical in their wording.

61. See, e.g., Case C-341/04, Eurofood IFSC Ltd., 2006 E.C.R. I-3813; *Re Daisytek-ISA Ltd.*, [2003] B.C.C. 562 (Ch.); Cour d’appel [CA] [Court of Appeal] Versailles, Sept. 4, 2003, 2003 WL 22936778, [2003] B.C.C. 984 (*Klempka v. ISA Daisytek SA*), *aff’d*, Cour de cassation, 2006 WL 3427682, [2006] B.C.C. 841 (Fr.).

tion's definition of "time of the opening of proceedings."<sup>62</sup> This is a serious defect in view of the notorious problem of the "race to the courthouse," which has a long history in the realm of cross-border insolvency.

The fraught questions of jurisdiction in international insolvency cases, and the vital matter of definition in respect of the concepts embodied in any jurisdictional rule, are inextricably linked to the process of allocating the substantive law by which any insolvency proceedings (or any aspects of such proceedings) are to be governed. The EC Regulation seeks to control these issues by declaring, in its Article 4(1), that "the law applicable to insolvency proceedings and their effects shall be that of the Member State within . . . [whose] territory . . . such proceedings are opened."<sup>63</sup> However, this basic rule is subject to specific exceptions prescribed in Articles 5 to 15 of the EC Regulation.<sup>64</sup> The extent to which such extensive exceptions to the controlling effect of the *lex concursus* have proven necessary, under current circumstances of diversity even among the laws of such closely aligned states as those belonging to the European Union, demonstrates the need for extreme caution when attempting to design a scheme of choice-of-law rules for application on a wider, global canvas.

In the author's estimation, it would be politically naïve to suppose that sovereign states would be prepared, at any time in the foreseeable future, to abandon all possibility of maintaining the benefits of localized rules, under which parties may have based their expectations in their dealings with a debtor, by conceding complete and overarching control to the provisions of some foreign insolvency law under which the debtor's global estate comes to be administered. For this reason it is especially disappointing that the authors of the *UNCITRAL Legislative Guide*, when dealing with the linked subjects of jurisdiction and choice of law, chose to abandon their otherwise admirable policy of refraining from an overly prescriptive presentation of their advice by proclaiming their preference for an unvarying application of the *lex concursus*.<sup>65</sup> While some of the provisions of the EC Regulation which create exceptions to the applica-

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62. See Council Regulation 1346/2000 art. 2(f), 2000 O.J. (L 160) 1 (EC). The meaning of this provision was one of the issues referred to the European Court of Justice in the *Eurofood* case. The court abstained from deciding all aspects of this issue of interpretation, leaving further uncertainties about the full effects of the provision.

63. Council Regulation 1346/2000 art. 4(1), 2000 O.J. (L 160) 1 (EC).

64. *Id.* arts. 5–15.

65. UNCITRAL, GUIDE, *supra* note 30, at 67–72 (Part 2.I.C. ("Applicable Law in Insolvency Proceedings")). For the author's criticism of the approach taken in that section of the *Guide*, see IAN F. FLETCHER, *INSOLVENCY IN PRIVATE INTERNATIONAL LAW* paras. 9.13–9.16 (2d ed. 2005).

tion of the *lex concursus* are also not without difficulty in terms of their conception and drafting,<sup>66</sup> it is surely premature—and not a little presumptuous—for the authors of the *Legislative Guide* to suggest that there is a consensus among economically advanced nations that the unchallenged domination of the *lex concursus* currently represents “best practice” in the selection of the law to govern all aspects of an international insolvency case.

For all the foregoing, it would be useful to devote some time during the conduct of the Global Principles Project towards ascertaining the extent to which agreement can be reached on such matters as the definition of key terms employed in the rules governing jurisdiction and choice of law and in the actual content of the rules for selection of the applicable law in cross-border cases.

#### *D. Taking the Project Forward*

Following a period of reflection in the wake of the initial meeting with the Advisory Group, the Reporters’ next goal was the augmentation of the membership of the Group with a view to its being as widely representative as possible. Concurrently, a systematic questionnaire has been designed to enable us to test the degree of acceptance of the *NAFTA Principles* among the states whose systems can be interrogated via the collective expertise of the Group. Additional questions will be included to try to gather reliable data concerning the additional issues referred to above, and afterwards to yield insights into the readiness of the global community of states to embrace even a limited number of standardized rules and practices which would bring greater stability to debtor-creditor relations.

Going forward, the Reporters wish to emphasize their belief in the need to maintain an open-minded spirit of inquiry, and a transparent process of debate, to ensure that any aspects of the *Principles* which may give rise to difficulties of transposition into the legal culture of a particu-

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66. An example would be the provisions of Article 6 of the EC Regulation, concerning the availability of set-off in cases where this would be precluded under the provisions of the *lex concursus*. During the formative process of the Draft Convention on Insolvency Proceedings (the textual precursor to the current Regulation), several alternative versions of what is currently Article 6 were produced, based on a variety of approaches to the central problem of how to accommodate the legitimate expectations of parties dealing with the debtor under circumstances where mutual debits and credits would or might be produced. The rule finally adopted—whereby set-off is claimable if it is “permitted by the law applicable to the insolvent debtor’s claim,” Council Regulation 1346/2000 art. 6(1), 2000 O.J. (L 160) 1 (EC)—is by no means self-evidently the most appropriate solution to the issues of principle which arise in relation to international set-off. The subject undoubtedly merits a re-examination as part of the process of devising rules which are intended to be applied as globally accepted norms.

lar country or region can be properly and sensitively considered. If any particular issue cannot be resolved on the basis of a text of universal application acceptable to all, an accommodation may be sought by means of a proviso to allow the main principle to operate subject to certain necessary local modifications. In the course of this process, the extant array of internationally generated texts which were referred to above will be studied with a view to ascertaining additional, complementary principles of law and practice which are considered to command general support. In this way it is hoped that the final text embodying the Global Principles will obtain the approbation of governmental authorities, domestic and international organizations, practitioners, and (most importantly) courts in their approach to the conduct of international insolvency matters in the future.

# THE MYTH (AND REALITIES) OF FORUM SHOPPING IN TRANSNATIONAL INSOLVENCY

John A. E. Pottow\*

## I. INTRODUCTION

A decade ago, in 1996, the landscape of transnational insolvencies was vastly different from today. The UNCITRAL Model Law had not been finished, the efforts at the E.U. Insolvency Treaty were jeopardized by mad cows, and no one had heard of Chapter 15. Now, all three universalist projects are up and running,<sup>1</sup> putting universalism in a comfortable state of ascendancy. The paradigm has not been without critics, however, the most persistent and eloquent of which has been Professor Lynn LoPucki.<sup>2</sup> LoPucki has periodically attacked universalism on a number of grounds. These grievances include a sovereigntist complaint of universalism's insensitivity to the differences in local bankruptcy laws<sup>3</sup> (a refrain now picked up in the recent writings of John Chung),<sup>4</sup> as well as an operational skepticism regarding universalism's capacity to consolidate corporate groups<sup>5</sup> (which is further explored by Irit Ronen-

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1. See U.N. COMM'N ON INT'L TRADE LAW [UNCITRAL], MODEL LAW ON CROSS-BORDER INSOLVENCY WITH GUIDE TO ENACTMENT, U.N. Sales No. E.99.V.3, United Nations Commission on International Trade Law, 30th Sess., at 3, U.C. Doc A/CD.9/442 (1999) [hereinafter UNCITRAL MODEL LAW]; Council Regulation 1346/2000; European Union Regulation on Insolvency Proceedings, 2000 O.J. (L 160) 1–4 [hereinafter EU Regulation]; 11 U.S.C. §§ 1501–1532 (2007) [hereinafter Chapter 15].

2. See, e.g., LYNN M. LOPUCKI, COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS (2005) [hereinafter LOPUCKI, COURTING FAILURE]; Lynn M. LoPucki, *Universalism Unravels*, 79 AM. BANKR. L.J. 143 (2005) [hereinafter LoPucki, *Universalism Unravels*]; Lynn M. LoPucki, *The Case for Cooperative Territoriality in International Bankruptcy*, 98 MICH. L. REV. 2216 (2000) [hereinafter LoPucki, *Cooperative Territoriality*].

3. See, e.g., LoPucki, *Cooperative Territoriality*, *supra* note 2, at 2237–38; see also Frederick Tung, *Passports, Private Choice, and Private Interests: Regulatory Competition and Cooperation in Corporate, Securities, and Bankruptcy Law*, 3 CHI. J. INT'L. L. 369, 375–76 (2002).

4. See John J. Chung, *The New Chapter 15 of the Bankruptcy Code: A Step Toward Erosion of National Sovereignty*, 27 NW. J. INT'L L. & BUS. 89, 90 (2006).

5. See LOPUCKI, COURTING FAILURE, *supra* note 2, at 221–25; Lynn M. LoPucki, *Cooperation in International Bankruptcy: A Post-Universalist Approach*, 84 CORNELL L. REV. 696, 716–17 (1999).

Mevorach).<sup>6</sup> There is also his argument regarding universalism's inability to pick a jurisdiction-selecting choice of law rule,<sup>7</sup> although the increasing prevalence of the center of main interests (COMI) test has undermined this pessimism somewhat.<sup>8</sup> But the most vociferous attack of late—perhaps inspired by LoPucki's path-breaking work on domestic forum shopping—revolves around universalism's purported potential to facilitate, and even exacerbate, what he denigrates as transnational bankruptcy “forum shopping.”<sup>9</sup> Indeed, this allegation prompted a spirited written debate just last year between Professor LoPucki and Ninth Circuit Bankruptcy Judge (and scholarly author) Samuel Bufford in the pages of the *American Bankruptcy Law Journal*.<sup>10</sup>

The purpose of this Article is to take issue with LoPucki's characterization of universalism as a harbinger of rampant forum shopping. This is not to imply that Judge Bufford's response was lacking. On the contrary, Bufford makes some excellent points and, even more interestingly, proposes specific doctrinal recommendations to shore up the areas where universalist instruments might tempt forum shoppers.<sup>11</sup> The goal of my contribution to the literature is to take a slightly broader, more theoretical response than Bufford's in defending universalism against accusations of

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6. See Irit Mevorach, *The Road to a Suitable and Comprehensive Global Approach to Insolvencies Within Multinational Corporate Groups*, 15 NORTON J. BANK. L. & PRAC. 455 (2006).

7. See LOPUCKI, *COURTING FAILURE*, *supra* note 2, at 217–21; LoPucki, *Universalism Unravels*, *supra* note 2, at 143–44.

8. COMI's robustness is seen by its adoption across a number of international insolvency instruments (e.g., the EU Insolvency Regulation, the UNCITRAL Model Law, Chapter 15 of the U.S. Code), as well its carriage into other commercial areas as a functioning jurisdiction-selecting rule. For example, the Cape Town Receivables Convention uses the COMI of the assignor as a choice of law rule. Convention on International Interests in Mobile Equipment ch. xxiv, art. 1(ii), Nov. 16, 2001, *available at* [http://www.dgca.nic.in/int\\_conv/Chap\\_XXIV.pdf](http://www.dgca.nic.in/int_conv/Chap_XXIV.pdf). COMI is here to stay.

9. LOPUCKI, *COURTING FAILURE*, *supra* note 2, at 200. “The potential for economic harm from international forum shopping is greater than the potential for harm from domestic shopping. . . . If [universalists] succeed, they will unleash the international system's full potential for harm.” *Id.* at 207.

10. See Lynn M. LoPucki, *Global and Out of Control?*, 79 AM. BANK. L.J. 79 (2005); Samuel L. Bufford, *Global Venue Controls Are Coming: A Reply to Professor LoPucki*, 79 AM. BANK. L.J. 105 (2005) [hereinafter Bufford, *Global Venue Controls*]; LoPucki, *Universalism Unravels*, *supra* note 2.

11. Bufford's recommendations include adding a temporal “domicile” qualifier to COMI and a due process-animating probationary period to an initial COMI determination. See Bufford, *Global Venue Controls*, *supra* note 10, at 133, 139. LoPucki, in fairness, replies with some problems with the Bufford proposals (some of which are well taken and some of which are overstated, but that is a topic for another day). See LoPucki, *Universalism Unravels*, *supra* note 2.

fostering forum shopping. I also take a more pointed stance by contending that not only is universalism's capacity to encourage forum shopping misunderstood and overstated—a myth—but that *territorialism's* potential for forum shopping has hitherto escaped unnoticed and may be much worse.

The analysis proceeds by first considering the theoretical prerequisite to forum shopping—choice of law predictability—and contends that territorialism is worse for forum shopping on that ground.<sup>12</sup> It then discusses the second condition—manipulability—and again expresses concerns with territorialism. It finally explores what it calls the “real” cross-border bankruptcy forum shopping: inter-system arbitrage between territorialist and universalist courts in a world of both types of jurisdictions. While acknowledging that this is the exclusive fault of neither territorialism nor universalism, the analysis suggests that universalism's recent legislative efforts, such as Chapter 15, have made strides to combat the problem. The discussion concludes with final reflections.

## II. FORUM SHOPPING'S THEORETICAL PREREQUISITE: PREDICTABILITY

For purposes of this discussion, the reader is presumed to know the differences between the universalism and territorialism paradigms, including their respective “modified” cognates.<sup>13</sup> At an important level, these two paradigms can be seen as endorsing competing private international law rules regarding the selection of governing bankruptcy law in cross-border proceedings.<sup>14</sup> Territorialism follows the *lex situs* rule of having the substantive bankruptcy law derive from the physical location of each of the bankrupt's assets. Universalism follows, generally (but not precisely), the *lex fora* idea of the bankruptcy law deriving from the location of the debtor's bankruptcy proceeding (assuming that that proceeding is in the debtor's “home” jurisdiction). The arguments as to which choice of law regime is normatively preferable have been well developed in

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12. See *infra* note 20 on the diction choice of “prerequisite.”

13. See generally Robert K. Rasmussen, *Resolving Transnational Insolvencies Through Private Ordering*, 98 MICH. L. REV. 2252 (2000) [hereinafter Rasmussen, *Resolving Transnational Insolvencies*].

14. See LOPUCKI, *COURTING FAILURE*, *supra* note 2, at 200–04 (generalizing that courts apply their own bankruptcy “laws, procedures, and priorities” but recognizing that this is not invariably so “at the margins”); see also *Stonington Partners v. Lernout & Hauspie Speech Prods.*, 310 F.3d 118 (3d Cir. 2002) (Belgian and U.S. courts insisting on application of their own bankruptcy laws in parallel proceedings); *In re Treco*, 240 F.3d 148, 158–59 (2d Cir. 2001) (rejecting deference to Bahamian proceeding due to dissimilarity of its bankruptcy law).

previous scholarship.<sup>15</sup> One advantage that universalists repeatedly trot out is that their rule yields more “predictability” (and hence efficiency) from the ex ante perspective of lenders: lenders have no need to follow assets around the world to keep track of shifting governing law; they know that if they lend to a Canadian-centered business, Canadian bankruptcy law will govern the adjudication of all assets everywhere in the event of financial distress.<sup>16</sup>

The universalists are generally correct in their claim to greater predictability, at least on a theoretical level (the sheer number of applicable bankruptcy laws under a territorial regime almost makes the case on its own). Yet they should not necessarily trumpet their predictability so enthusiastically for at least two reasons. First, as we shall see, while on a *theoretical* level universalism should yield greater predictability than territorialism, *as it has been operationalized* (through the Model Law, Chapter 15, and so on), that potential predictability has been curtailed.<sup>17</sup> Secondly, and more fundamentally, celebration of “predictability” may actually be misguided, especially in a world now sensitive to the perceived evils of forum shopping.<sup>18</sup>

This second point may be heresy to many bankruptcy readers—to question the holy grail of “predictability.”<sup>19</sup> But for all the encomium predictability receives by scholars in our community, its seedy underbelly needs to be exposed to have a meaningful and frank discussion of bankruptcy forum shopping. This is due to the straightforward but nevertheless important point that predictability is a necessary prerequisite to forum shopping.<sup>20</sup> If “case placers”<sup>21</sup> do not know which forum’s laws

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15. See, e.g., Rasmussen, *Resolving Transnational Insolvencies*, *supra* note 13.

16. See, e.g., Andrew T. Guzman, *International Bankruptcy: In Defense of Universalism*, 98 MICH. L. REV. 2177, 2208 (2000); Jay L. Westbrook, *A Global Solution to Multinational Default*, 98 MICH. L. REV. 2276, 2292–93 (2000). Note that if the universalism vs. territorialism contest is collapsed into a choice-of-law debate, then the “predictability” benefits of universalism are chronologically upstreamed, such that universalists contend transactional planners will know which insolvency law will govern distribution and priority if and when the debtor ever files for bankruptcy.

17. Cf. LoPucki, *Universalism Unravels*, *supra* note 2, at 158–63 (arguing that territorialism accords greater predictability than universalism as implemented).

18. See *infra* Part VIII (discussing normative desirability of forum shopping).

19. LoPucki aptly needles that “predictability,” when used by bankruptcy case placers, is sometimes nothing more than a codeword for “case placer solicitude.” LOPUCKI, *COURTING FAILURE*, *supra* note 2, at 249–50.

20. See Nita Ghei and Francesco Parisi, *Adverse Selection and Moral Hazard in Forum Shopping: Conflicts Law as Spontaneous Order*, 25 CARDOZO L. REV. 1367, 1373 (2004) (“[U]ncertainty about which jurisdiction’s law applies would actually reduce forum shopping.”); see also Kaplow, *infra* note 36 (noting that predictable rules regarding form make fraud easier for transactional planners and hence that “standards may be pref-

will apply to a filed bankruptcy case, they cannot shop that case for attractive law.<sup>22</sup> Indeed, this is likely the animation behind random as-

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erable in some contexts"). Strictly speaking, "prerequisite" may technically be an overstatement. One can always forum shop, even in a highly unpredictable choice of law environment; the uncertainty costs, however, associated with shopping will rise with unpredictability and may eventually cross a prohibitive threshold. At the absolute case, the proposition of a prerequisite holds: it is impossible to forum shop (at least for law) if knowledge of applicable law is unavailable. This semantic qualification duly noted, I will continue to deem predictability a "prerequisite" to forum shopping.

21. This is LoPucki's term. See LOPUCKI, *COURTING FAILURE*, *supra* note 2, at 249.

22. As mentioned, *see supra* note 20, this statement characterizes the absolute case at the extreme: if choice of law is truly random, forum shopping is impossible. Relaxing that extremism, if we say merely that the choice of law rule is "highly unpredictable," then forum shopping, while not impossible, is "highly risky," because that unpredictability undermines the transactional planner's efforts to select desired law. Compare a more predictable choice of law rule (the forum selected by the parties to the contract) to a more unpredictable one (the forum selected by the parties to the contract, if appropriate). The forum shoppers in the second case are uneasier than their first case counterparts because they face the risk that their desired choice will be unsettled. A middlingly predictable rule (the forum selected by the parties to the contract, unless manifestly contrary to the public policies of the *lex fori concursus*) would be of correspondingly middling comfort to the forum shopper. Thus, along this simple axis of analysis, more predictability is preferable to putative forum shoppers, in part because it gets *ex post* judges out of their hair.

Now complicate matters by relaxing the assumption of objective judges dispassionately interpreting a choice of law rule and inject case-scroungers of the sorts over which Professor LoPucki (and not without reason) frets. In that case, diminished predictability—at least if arising through ambiguity in the choice of law rule—may actually foment, rather than discourage, forum shopping. Take a highly ambiguous rule (the fairest jurisdiction's laws to resolve the contractual dispute). Such a rule might inspire case placers, in an environment of solicitous judges, to seek friendly courts with any plausible argument that their desired forum is the fairest. Here, the forum shopping is focused less on upstream transactional planning and more on *ex post* filing in a desired courtroom. The ambiguity of the choice of law rule gives the case placers cover in this competitive judicial environment and hence actually facilitates their shopping impulses. Ironically, to cabin the discretion of these judges requires clearer, more predictable rules—rules that unfortunately offer clear guidance to the upstream transactional planner seeking to shop for attractive law. *See also infra* text accompanying note 31 (discussing difference between jurisdiction-selecting rule's exclusivity and clarity).

This Article proceeds on the simplifying assumption of judicial objectivity and hence of unpredictability generally working to frustrate forum shopping, *see* Ghei & Parisi, *supra* note 20, but the reason for this assumption is more expositional ease and aspired clarity than substantive rejection of Professor LoPucki's corruption concerns (a debate I defer major participation in for a later day). As I do mention briefly below, however, *see infra* notes 50 and 111, although I think Professor LoPucki uncovers a serious problem in the U.S. domestic venue rules, he and I diverge when we turn to the international front, both because of the exclusivity of the COMI rule in contrast to the multiplicity of the domestic venue rules, and, more relevant to the instant issue, because of our differing assessments of the vagueness of the COMI rule. I openly admit that the COMI

signment in bankruptcy venues with multiple judges, such as the Southern District of New York, where the clerk “spins the wheel” in assigning which judge will sit on a case after its filing: a presumable effort to diminish intra-district judge shopping. If an international debtor had to spin a wheel to determine which bankruptcy law would apply in the event it filed for reorganization, forum shopping would be very difficult indeed. To be sure, lenders might be horrified by such a system—the death of predictability!—and they would consequently add a hefty legal risk premium in pricing credit, but it would certainly end forum shopping as we know it (or at least sublimate it into wheel-spinner bribing). Accordingly, concern about forum shopping cannot proceed in the absence of a recognition that a necessary prerequisite is predictability and, therefore, that there is an inherent trade-off between predictability, which is traditionally viewed positively in bankruptcy circles, and “shopability,” which is presumably more negative.<sup>23</sup>

This relationship between predictability and forum shopping means that earlier territorialist criticism of the imperfections of universalism’s choice of law rules may actually, and perhaps ironically, be praise for a certain flexibility that may inhibit forum shopping.<sup>24</sup> As will be discussed below, the very genius of the universalist COMI rule is its fact-sensitivity. While it sacrifices a degree of clarity, it comes at the gain of an ability to stifle putative forum shoppers. This dawning realization may be why territorialists have changed the thrust of their critique in trying to discredit universalism. Initially, territorialists complained that proposed jurisdiction-selecting rules under universalism, such as COMI, would be vague and unpredictable, pointing to the crispness of the competing situs rule.<sup>25</sup> Now, likely as a result of the new concern about forum shopping,

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rule has some unpredictability inherent in it (its juxtaposition to the alternative jurisdiction-selecting rule of place of incorporation exposes this attribute), but see this vagueness as limited (“bounded vagueness” perhaps). Professor LoPucki sees the play in the joints as much greater and hence much more ominous—perhaps scarcely better than my stylized unpredictable choice of law rule of the “fairest” jurisdiction. See LoPucki, *Universalism Unravels*, *supra* note 2, at 143 (“[The COMI] standard is intentionally vague and practically meaningless.”).

23. Compare the discussion on normative desirability, *infra* Part VIII. Another necessary prerequisite is meaningful difference in law; one can only shop if one has more than one product from which to choose. Cf. LOPUCKI, *COURTING FAILURE*, *supra* note 2, at 231 (worrying that universalism will foment, undesirably in his view, substantive harmonization of bankruptcy laws).

24. See LoPucki, *Universalism Unravels*, *supra* note 2, at 143.

25. See, e.g., Frederick Tung, *Skepticism About Universalism: International Bankruptcy and International Relations* 1, (Berkeley Program in L. & Econ., Working Paper No. 43, 2002), available at <http://repositories.cdlib.org/blewp/43>.

the tone has changed: denigration of universalism's *difficulty* in crafting a choice of law rule has been replaced with concern over the *ease* with which the universalist COMI rule has taken grip and will undergird a pandemic of forum shopping.<sup>26</sup>

### III. UNIVERSALISM VS. TERRITORIALISM'S "PREDICTABILITY" REGARDING CHOICE OF LAW

Ten years ago, there was still debate over which choice of law rule would anchor a universalist paradigm (place of incorporation? location of most assets?). Now, it is clear that COMI has emerged the winner. But what is COMI? Is it a bright-line rule? A standard? A mid-point along a rule-standard continuum? If a mid-point, where precisely does it lie?<sup>27</sup> LoPucki at times equates home country with place of incorporation, rendering the impression that they are interchangeable.<sup>28</sup> They are not.<sup>29</sup> They are quite distinct—importantly, in a manner that implicates the forum-shopping attribute of “predictability.” While one may call COMI a rule, to call it a “bright line” would probably be a stretch, even for its proponents.<sup>30</sup> To be clear, this is not a comment on the rule's *exclusivity*.

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26. See LOPUCKI, *COURTING FAILURE*, *supra* note 2, at 210–12 (chronicling universalism's growing acceptance); *id.* at 217–218 (“All the case placer need do to forum shop in a universalist system is make a plausible argument that the chosen court is at the centre of the debtor's main interests.”) (internal quotation marks and alterations omitted); LoPucki, *Universalism Unravels*, *supra* note 2, at 147–48. In other words, in the earlier, more abstract academic discussions, territorialists doubted universalists would be able to get their act together sufficiently to agree upon a jurisdiction-selecting rule (would they pick incorporation? Location of major assets? COMI?). Now that COMI has emerged triumphant, the territorialist concern seems to be that the forum shopper has clear guidance and hence an easy task. Knowing the dominant rule, he can take steps to establish or move his COMI in or into a preferred jurisdiction.

27. Presumably at the middle, but nobody likes a smartass. *Cf.* FLETCH (Universal Pictures 1985) (“Fletch: Well, we're in kind of a grey area. Frank: How grey? Fletch: Charcoal.”).

28. LOPUCKI, *COURTING FAILURE*, *supra* note 2, at 196 (“[T]hroughout most of the world, a debtor corporation's country of incorporation is considered an appropriate venue—if not *the* appropriate venue—for the corporation's bankruptcy case.”); *id.* at 198 (listing place of incorporation as “one of the three tests commonly applied” to determine home country); *id.* at 218 (listing place of incorporation as one of four plausible bases for COMI that is “routinely” accepted).

29. See *id.* at 218 (conceding that “[i]f incorporation is the debtor's only contact with the forum country, the [COMI] argument may not be plausible”).

30. For example, Professor Jay Westbrook defends its clarity, but with circumspect language:

[T]he principal place of business standard in one formulation or another is commonplace throughout American law—state and federal—and is found else-

That is, there should be one and only one “center” of main interests. But exclusivity and clarity are different.<sup>31</sup> Consider, as a hypothetical, that universalism selected controlling bankruptcy law as the “fairest” jurisdiction to administer the debtor’s global assets.<sup>32</sup> Only one jurisdiction can be the fairest of them all (an exclusive criterion), but surely fairness is less akin to a rule than a standard (a malleable criterion). The same comparison holds in differentiating COMI<sup>33</sup> from its logical rival, place of incorporation. Universalism could have selected the governing bankruptcy law by the much brighter-line test of the place of the debtor’s incorporation. Such a decision would have resulted in considerably more predictability.<sup>34</sup> (Indeed, underscoring the nexus between clarity of rule and forum shopping capability is corporate law’s internal affairs doctrine, which determines applicable substantive corporate law by place of incorporation; only with such a clear foundation choice of law rule can there be a meaningful jurisdictional “race,” either to the top or the bottom.)<sup>35</sup> Yet universalism did not pick place of incorporation as its juris-

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where as well. That sort of standard has produced some litigation, but I am unaware of any widely held view that it is so imprecise as to be impractical or to maim any important legal objective. The center-of-main-interests standard was adopted in the EU Convention and the Model Law, with no substantial claim asserted that the standard was too difficult to enforce. A similar standard has been applied by the United States courts in applying section 304 of the Bankruptcy Code in the choice of forum context without provoking substantial litigation.

Westbrook, *Global Solution*, *supra* note 16, at 2316. Other scholars are less enthusiastic. See IAN F. FLETCHER, *INSOLVENCY IN PRIVATE INTERNATIONAL LAW: NATIONAL AND INTERNATIONAL APPROACHES* 260 (1999); Ian F. Fletcher, *Maintaining the Momentum: The Continuing Quest for Global Standards and Principles to Govern Cross-Border Insolvency*, 32 BROOK. J. INT’L L. 767 (2007). For an atypical case, but an interesting one, struggling with a difficult-to-determine COMI, see *In Re Bank of Credit and Commerce Int’l SA*, [1996] 4 All E.R. 796 (U.K.); *In re Bank of Credit & Commerce International S.A. (No. 2)* [1992] B.C.L.C. 715 (U.K.) [hereinafter *BCCI*].

31. Although, to be sure, they may be related. See, e.g., Guzman, *supra* note 16, at 2207 n.113 (suggesting that exclusivity of home country rule would enhance clarity).

32. Compare the interest-based choice of law analysis from Restatement (Second) of Choice of Law. See RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 145 (1971).

33. The U.S. civil procedure analogue is “principal place of business.”

34. LoPucki indirectly touches on this when he argues that multiple plausible claims exist to COMI. See LoPUCKI, *COURTING FAILURE*, *supra* note 2, at 217–18; see also Luca Enriques and Martin Gelter, *Regulatory Competition in European Company Law and Creditor Protection*, 7 EUROP. B. ORG. L. R. 417, 431 (2006) (describing COMI as “fuzz[y]”) (internal quotation marks and citations omitted).

35. See G. Marcus Cole, *Delaware Is Not a State: Are We Witnessing Jurisdictional Competition in Bankruptcy?*, 55 VAND. L.REV. 1845, 1857–58 (2002) (canvassing corporate law “racing” literature and critiquing its applicability to purported “Delawarization”

diction-selecting rule. Instead, it opted for COMI, a more fact-dependent “standardish” criterion.<sup>36</sup>

To be sure, a debtor’s place of incorporation is not independent from its COMI. Indeed, it is closely related. For example, under Chapter 15, the Model Law, and the EU Insolvency Regulation, COMI is legally presumed to be at a corporate debtor’s registered office (i.e., its place of incorporation).<sup>37</sup> But precisely because the presumption is rebuttable, COMI and incorporation are only usually, but not always, in the same place. Thus courts are invited to consider instances in which the brass plate (or “file drawer”)<sup>38</sup> corporate office points to COMI in one jurisdiction on a bright-line, formalistic analysis, but a functional, realistic inquiry of business contacts finds COMI elsewhere.<sup>39</sup> In other words, the presumption of COMI being place of incorporation is rebutted when the incorporation location is a mere sham, *which is a robust proxy for when a corporate debtor is shopping for attractive applicable law.*<sup>40</sup> Accord-

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of corporate reorganizations); *see also* Rasmussen, *Resolving Transnational Insolvencies*, *supra* note 13, discussed *infra* Part VIII.

36. *See* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 618 & n.180 (1992) (arguing that laws relating to form should be predictable but noting that fraud may be “easier to commit if there are known rigid rules that a fraudulent actor can carefully circumvent” such that “standards may be preferable in some contexts”); *see generally id.* at 562 (defining determinations as “standard-like” if their content is filled subsequent to relevant conduct). For European authors calling COMI a “standard,” *see* Enriques & Gelter, *supra* note 34, at 419.

37. *See* 11 U.S.C. § 1516(c) (2007); UNCITRAL MODEL LAW, *supra* note 1, art. 16.3; EU Regulation, *supra* note 1, art. 3.1.

38. LOPUCKI, *COURTING FAILURE*, *supra* note 2, at 195.

39. These sorts of “letterbox” companies were of express concern to the European Court of Justice, which issued an opinion offering some interpretative guidance to the COMI rule. *See* Case 341/04, Eurofood IFSC Ltd., 2006 E.C.R. I-3813, *available at* <http://curia.europa.eu/en/content/juris/index.htm>. For an excellent analysis of these proceedings, *see* Samuel L. Bufford, *Center of Main Interests, International Insolvency Case Venue, and Equality of Arms: The Eurofood Decision of the European Court of Justice*, 27 NW. J. INT’L L. & BUS. 351 (2007).

40. Consider as a comparison the “real seat” doctrine used in some civil law systems in which a corporation is governed under the laws of its “real seat” (which would likely translate into “principal place of business” as U.S. analogue), regardless of its place of incorporation. *See* Gabriel Moss, *Group Insolvency—Choice of Forum and Law: The European Experience Under the Influence of English Pragmatism*, 32 BROOK. J. INT’L L. 1005 (2007); Nick Segal, *The Effect of Reorganisation Proceedings on Security Interests: the Position under English and US Law*, 32 BROOK. J. INT’L L. 927 (2007); Jay Lawrence Westbrook, *Locating the Eye of the Financial Storm*, 32 BROOK. J. INT’L L. 1019 (2007). For example, companies often try to select into the tax laws of havens by “reincorporat[ing]” and setting up “nominal headquarters.” LOPUCKI, *COURTING FAILURE*, *supra* note 2, at 199 (discussing tax-animating expatriation of Commodore International decades before its ultimate bankruptcy). It is doubtful the Bahamas could be Commodore’s

ingly, viewing COMI and the incorporation presumption together, a more accurate way of casting the jurisdiction-selecting choice of law rule of the Model Law and its universalist progeny is that the choice of law rule actually *is* place of incorporation, but that the rule is subject to an important anti-forum-shopping caveat: that the place of incorporation house the debtor's COMI.<sup>41</sup> In this regard, rather than view *Daisytek* and similar cases as the "unraveling" of the COMI system,<sup>42</sup> I see them as the vindication of a realistic approach to place of incorporation as a baseline choice of law rule for universalism. It works well as a jurisdiction-selecting criterion for most cases, but cannot stand when it points to a

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COMI, which seems to prove the point that haven-induced incorporations may work for bright-line tax rules but not for COMI-based universalism.

41. Miguel Virgós & Etienne Schmit, *Report on the Convention on Insolvency Proceedings*, in *THE EC REGULATION ON INSOLVENCY PROCEEDINGS: A COMMENTARY AND ANNOTATED GUIDE* 263, 281 (Gabriel Moss, Ian F. Fletcher & Stuart Isaacs eds., 2002) [hereinafter *Virgós-Schmit Report*] ("The concept of 'centre of main interests' must be interpreted as the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties."); *see also* EU Regulation, *supra* note 1, recital 13, at 2 (replicating Virgós & Schmit's language).

42. *Re Daisytek-ISA Ltd.*, [2003] B.C.C. 562 (Ch. D) (U.K.); *see also* LoPucki, *Universalism Unravels*, *supra* note 2, at 150 (criticizing *Daisytek* as illustration of courts' inclination to hoard jurisdiction). In *Daisytek*, the Leeds court found the United Kingdom to be the COMI of each of the European subsidiary corporations, notwithstanding many incorporations on the Continent, because most of the suppliers and creditors who did business with them negotiated contracts with the British head office in Bradford and hence expected to be subject to British commercial law. Thus, the vindication of creditors' expectations was important in determining COMI. An interesting hypothetical would be to ask whether the United States (home of the corporate grandparent and great-grandparent) could have been the COMI of these French and German subsidiaries. Here, the answer is probably not under the most recent thinking of universalists, who are moving toward crafting an "economic integration" test as a principled means to combat the nettlesome question of corporate groups. *See* Mevorach, *supra* note 6 (exploring, in 115 pages of painstaking detail, insolvency considerations of cross-border corporate groups, including, *inter alia*, the role corporate letterhead should play in mediating the expectations of creditors). Mevorach's formulations are beyond the scope of this Article; suffice it to say she rolls up her sleeves and confronts some of the difficult obstacles territorialists challenge are insurmountable in allocating jurisdiction among corporate affiliates under universalism. Thus, for example, were Toyota's U.S. subsidiary ever to file for bankruptcy, the question whether its COMI would be in the United States or Japan would depend "dominantly," in Mevorach's estimation, on whether its financial affairs were interwoven with the parent (in an analysis reminiscent of substantive consolidation in domestic U.S. insolvency law; for a recent treatment, *see In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005), *cert. denied*, 126 S.Ct. 1910 (2006)) and whether that interconnection were readily detectible to outside creditors.

jurisdiction other than a debtor's COMI, because such aberration reeks of (presumably unwelcome)<sup>43</sup> forum shopping.

By contrast, territorialism's choice of law rule is unrelenting in its brightness: it is where the assets are physically located on the nanosecond of bankruptcy. There is neither qualification nor caveat. That predictability, of course, comes at the cost of clear guidance to the putative forum shopper. There is no "presumption" in the way that registered office is only presumed to be a debtor's COMI. The asset's physical location is more analogous as a legal construct to the debtor's place of incorporation than to its COMI. Accordingly, a more apt comparison to the COMI rule would be if territorialism chose law based on the asset's "abode," which could be presumed to be its place of physical location. Yet this is exactly the sort of qualification that is anathema to the simplicity sought by the territorialist model.<sup>44</sup> To be sure, there are necessarily some cases in which uncertainty might arise as to asset location,<sup>45</sup> but we have no reason to think they will be common. In the main, territorialism thrives on its purported choice of law clarity and predictability; consequently, it must acknowledge its concomitant invitation, at least regarding these attributes, to forum shoppers.

Two conclusions flow from this suggestion that territorialism leads to the clearer (or more "predictable") choice of law rule—at least as universalism has been currently implemented with the COMI rule/incorporation presumption. First, universalism is not as clear in its choice of law ambitions as its proponents would like to say it is.<sup>46</sup> I say this as an unabashed universalist.<sup>47</sup> Again, one need only point to the

43. See normativity discussion, *infra* Part VIII.

44. See LoPucki, *Universalism Unravels*, *supra* note 2, at 160 ("Cooperative territoriality can provide greater predictability [because of the clear rule that] bankruptcy administration of a multinational's assets and operations within a given country is governed by the laws of that country."). The advantage of this rigidity, in its supporters' eyes, is that it permits one and only one country—that of the asset's location—to enforce legal control through force. Yet when concerns arise over asset flight, qualifications to this simplicity become necessary: agreement is now required between more than one country—the abode jurisdiction and the situs jurisdiction—and so exclusive reliance on the use of force by one country alone, so valued by territorialist theory, is no longer possible. See *also infra* text accompanying notes 115–18.

45. See, e.g., *Underwood v. Hilliard (In re Rimsat, LTD)*, 98 F.3d 956, 959 (7th Cir. 1996) ("[Rimsat's] principal place of business is in Fort Wayne, Indiana. Most of its financial assets are there, but its nonfinancial assets, principally leaseholds in satellites, have no terrestrial site.").

46. See *supra* note 30.

47. In this regard, I somewhat agree with Professor LoPucki's claim that the COMI rule (compared to territorialism's situs rule) is a "vague" standard. LOPUCKI, *COURTING FAILURE*, *supra* note 2, at 221. He's right, and it would behoove universalists to admit it.

declined alternative of place of incorporation as the universalism choice of law rule to appreciate the foregone clarity. As an olive branch to win my way back into the universalism fold, I offer the further observation that while territorialism, as implemented, has the clearer choice of law rule, that is only a rule for asset-by-asset adjudication. The *cumulative* consequence of these multiple (clearer) choices of bankruptcy law may be, for example, that there are seven applicable bankruptcy laws to one multinational debtor's bankruptcy proceedings. That may result in confusion and expensive legal knowledge costs—the foundational sort of unpredictability that universalists (rightly) bemoan. Moreover, as mentioned, this lack of predictability to the choice of law rule—or, more precisely, this sub-maximal, but perhaps optimal, level of predictability to the choice of law rule—is not anything over which universalists should fret. It could well be a sensible retrenchment from predictability to address concerns of forum shopping.

The second point is an elaboration regarding the proposition that the brighter the choice of law rule, the more manipulable it is by strategic venue-seekers. As mentioned, predictability of the choice of law rule is a necessary condition—a prerequisite—to forum shopping, but it may not be a sufficient one. While there is likely a high correlation between the clarity of the rule and its ease of manipulation in forum shopping,<sup>48</sup> it is at least theoretically possible to envision a rule that is clear but difficult to exploit—due to, for example, high costs. For example, one can (unhealthily) imagine a clear, bright rule regarding choice of bankruptcy law—the jurisdiction in which the debtor's president has bludgeoned the most puppies—that, while clear, may not actually be that “manipulable” due to inordinate reputational costs or other concerns. Thus while the predictability aspect of territorialism points toward more prevalent forum shopping, a second question remains open whether the rule, while clear,

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Where we universalists should dig in, however, is on the normative desirability of that indeterminacy. If indeterminacy dampens forum shopping, and if forum shopping is pernicious, then the vagueness may be nothing to fear. Nor should we despair that this vagueness will condemn commercial transactions to a quagmire of uncertainty. It is “bounded vagueness” at worst. *See supra* note 22. As Jay Westbrook correctly observes, the relevant subset of possible jurisdictions is likely to be a small one. *See infra* note 61. Thus creditors will know *ex ante* which laws will apply for most cases and will face only a small zone of possibilities for the marginal ones. They fare no worse than having to calculate the probabilities of asset movement in lending transactions under territorialism.

48. *See Guzman, supra* note 16, at 2207 (“[A] test based on place of incorporation would be inappropriate. A test such as the principal place of business, on the other hand, is much more difficult for the debtor to manipulate.”).

can be easily manipulated.<sup>49</sup> And the more pointed comparative question is whether the rule is any more manipulable than universalism's alternative of COMI.

#### IV. UNIVERSALISM VS. TERRITORIALISM'S MANIPULABILITY REGARDING CHOICE OF LAW

The answer to the question whether it is easier to manipulate the choice of law rules in universalism or territorialism ultimately boils down to an empirical inquiry whether it is easier to move a debtor's COMI or its assets.<sup>50</sup> To "shop" for favorable bankruptcy law, a decisionmaker would have to shift (or establish) the debtor's COMI under universalism into (or in) the jurisdiction—the self-styled haven—with the attractive law. By contrast, under territorialism, the debtor would need to move (or situate) the assets into (or in) the favored jurisdiction. Which is easier? In his book and other recent scholarly writings, Professor LoPucki, perhaps building on earlier expressed suspicions,<sup>51</sup> assumes that it is virtually effortless for a sophisticated global actor with fancy lawyers to move its COMI.<sup>52</sup> He presents several examples of bankruptcy proceedings where he contends this has happened.<sup>53</sup> But what he does not explore in any

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49. In sum, it is a two-dimensional interaction. Conceivably, a clear but difficult-to-manipulate choice of law rule could result in less total forum shopping than a fuzzier but easier to manipulate one. (The two vectors may not be fully orthogonal, thus further complicating the analysis.) Cf. LOPUCKI, *COURTING FAILURE*, *supra* note 2, at 208 ("Universalists and their opponents agree that a system that allowed multinational companies a last-minute choice of law would not be viable."). See also *supra* note 22.

50. This is a distinct issue from the amenability of judges to seize or retain cases once a case placer selects her courtroom. Unlike domestic U.S. bankruptcy venue, see 28 U.S.C. § 1408, in which multiple, parallel permissible bases of venue exist—and hence for which there can be a wide pool of judicial suitors for corporate case placers—the COMI standard for allocating primary jurisdiction is an exclusive criterion. There can be only one COMI (just as, under territorialism, there can be only one location of an asset). Case placers do not get to pick from the broad array of options they enjoy under U.S. domestic venue rules.

51. See Lynn M. LoPucki, *The Death of Liability*, 106 *YALE L.J.* 1 (1996).

52. See LoPucki, *Universalism Unravels*, *supra* note 2, at 155–58 ("Regardless which characteristics of a company determine a multinational's COMI, the multinational can easily change them. . . ."). For an interesting analysis about how many COMIs in Europe would actually engage substantial costs and "severe obstacles," see Enriques & Gelter, *supra* note 34.

53. See LOPUCKI, *COURTING FAILURE*, *supra* note 2, at 226–30. Note that one of his key examples, *Derby Cycle*, was a case of value-maximizing corporate divestiture of a profitable Dutch subsidiary that no party in subsequent litigation (at least to my knowledge) ever suggested was animated by forum shopping. True, it shows how a COMI can arguably change after a major corporate divestiture, but COMI-shift as an ancillary result of the return-maximizing sale of an economically discrete foreign division should not

depth is the corollary issue: the ease with which sophisticated global actors can shift their assets. (His brief consideration of movable assets speculates that they are likely to constitute a small portion of the debtor's estate, to be slow-moving, and to be highly visible to outsiders; he consequently dismisses asset movement as a concern.)<sup>54</sup>

I do not presume to offer an answer to this empirical question, as that would require an empirical study, which I have not done.<sup>55</sup> I will, however, offer two reflections. First, I will challenge LoPucki's inherent assumption that moving COMI involves little more than clever paper shuffling.<sup>56</sup> While moving *place of incorporation* requires only glorified paperwork, moving *COMI*, by definition, requires more.<sup>57</sup> Indeed, this is the very reason why registered office is merely a presumption of COMI. Eve-of-bankruptcy re-incorporation would likely be the quintessential example of when the presumption would be rebutted. The closest example to a fast-paced move of COMI—not just of incorporation—in the transnational insolvency setting of which I am aware involved BCCI.<sup>58</sup>

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cause distress. *See also* LoPucki, *Universalism Unravels*, *supra* note 2, at 160 (recognizing not all asset or COMI movement is nefarious). Indeed, for a very recent example where both German and U.K. courts agreed that the COMI of a German construction company that had been swallowed up by a U.K. investment conglomerate (including its “delisting” as a separate corporation) did not shift COMI from Germany to the United Kingdom, see *Hans Brochier Holdings Ltd.* EWIR2007, 177; NZI2007, 187 (U.K. proceedings before High Court in London); EWIR2007, 177, ZIP2007, 81; NZI2007, 185 (German proceedings before Insolvency Court at Nuremberg).

54. *See id.* at 160–61.

55. There is an interesting corpus of empirical research on domestic forum shopping outside the bankruptcy context. For two recent offerings, see Kevin M. Clermont & Theodore Eisenberg, *Exorcising the Evil of Forum-Shopping*, 80 CORNELL L. REV. 1507 (1995) (analyzing Administrative Office of U.S. Courts data to find 58% win rate of federal civil cases tried in their court of origin versus 29% win rate in venue-transferred cases); Michael E. Solimine, *The Quiet Revolution in Personal Jurisdiction*, 73 TUL. L. REV. 1 (1998) (analyzing 1,000 published federal appellate and state supreme court cases to find that most plaintiffs file suit—be it in federal or state court—in their state of residence). *Cf.* LoPucki, *Universalism Unravels*, *supra* note 2, at 160 (acknowledging that some COMI shifts are innocent).

56. LOPUCKI, *COURTING FAILURE*, *supra* note 2, at 229 (“But even the multinational’s center of assets and operations can be changed—without moving any assets and operations.”); *id.* at 230–31 (“[T]he ability of both corporations and corporate groups to quickly and easily relocate make forum shopping easy in a universalist system.”).

57. It is by definition because COMI is only rebuttably presumed (not irrebuttably presumed) to be the place of incorporation. *See, e.g.*, 11 U.S.C. § 1516(c) (2007).

58. *BCCI* is LoPucki's strongest example. *See Re Bank of Credit and Commerce Int'l SA*, [1996] 4 All E.R. 796 (U.K.). Other examples he offers of shifted COMIs are less compelling for a variety of reasons. For example, in *Fruit of the Loom*, the COMI (arguably) moved years before bankruptcy. In *Singer*, the COMI of a far-flung operation with

BCCI was a Luxembourg-incorporated global banking and investment empire with main offices in London. Shortly before mounting fraud made bankruptcy inevitable, the principal decision-makers decamped London for their home back in the United Arab Emirates. Thus while the operations back office of the empire stayed in London, the key “brains” had moved home. Consequently, the COMI of this far-flung organization possibly moved just before bankruptcy, or at the very least it became more ambiguous. Indeed, BCCI’s main insolvency proceeding was actually opened in neither the United Kingdom nor the United Arab Emirates; it was opened of all places in Luxembourg. The United Kingdom—the presumably aggrieved “rival” jurisdiction by the case’s opening in Luxembourg—went along by recognizing the Luxembourg main proceeding and pseudo-cooperating.<sup>59</sup> Even under these facts, however, it is still not clear BCCI’s COMI moved on short notice. What happened is that an already unstable COMI of a far-flung investment and banking empire was rendered even more unstable by a last-minute move of personnel. Indeed, note that it was never suggested in the litigation that COMI (to be sure a counter-factual, as the term was not even used at the time) moved from London to the Mideast. Rather, the move had the narrower effect of “de-selecting” the United Kingdom by making its arguable case for COMI weaker. Moreover, as LoPucki himself concedes, the movement of the principals was not an attempt to forum shop bankruptcy law but an attempt to flee criminal personal jurisdiction.<sup>60</sup> Thus, the worst-case possible example of COMI-shopping available in published opinions (again, COMI-shopping, not mere re-incorporation) demon-

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assets and workers in Africa, Europe, the Middle East, and Asia was (in LoPucki’s estimation) moved from the Netherlands Antilles to the United States by a post-bankruptcy U.S. reincorporation. But LoPucki himself admits that *Singer* had hired a new CEO in New York who was trying to run the global enterprise from U.S. headquarters well before bankruptcy. Indeed, it was by no means clear that the Netherlands Antilles-incorporated holding company didn’t have its COMI in the United States already. See *LOPUCKI, COURTING FAILURE*, *supra* note 2, at 227–28. My point is not to spar with LoPucki on a case-by-case basis; on the contrary, I am actually trying to find the case that makes his argument best for him—*BCCI*—and confront it head on.

59. The pseudo-cooperation was because after a back-and-forth litigation regarding the jurisdiction and discretionary powers of bankruptcy judges in the United Kingdom, the British administrators cooperated with Luxembourg after holding back certain assets to satisfy (presumably mostly British) set-off claimants whose claims would not have been recognized under Luxembourg law. *Re Bank of Credit and Commerce Int’l SA*, [1996] 4 All E.R. 796 (U.K.). Indeed, the British administrators tried to cooperate with Luxembourg and were apparently broadsided by their own court, which in its voluminous analysis ultimately decided the proposed plan was impermissible under British law.

60. See *LOPUCKI, COURTING FAILURE*, *supra* note 2, at 220.

strates at most an ability to destabilize relevant factors within a very narrow band of plausible jurisdictions.<sup>61</sup>

The second and perhaps more important observation regards the unasked (and unanswered) corollary: can assets also be moved relatively easily on the eve of bankruptcy? The answer seems to be yes. To be sure, hard assets cannot get up and walk away,<sup>62</sup> and some highly salient recent cases involve some very hard assets indeed, such as oil refineries.<sup>63</sup> But not all assets are hard. Indeed, in one sector that has spawned a good amount of cross-border insolvency work—insurance—most of the assets are liquid and hence readily movable.<sup>64</sup> To be clear, this is not just about cross-border preferences, which are eve-of-bankruptcy asset transfers to a favored foreign creditor—although there are plenty of those filling up the pages of the bankruptcy reporters.<sup>65</sup> This is equally about eve-of-bankruptcy, intra-debtor transfers across national borders that exploit the

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61. Indeed, *Eurofood, Daisytek, et al.* show that incorporation in another jurisdiction is not enough to move COMI. Much more is required, such as non-trivial exercise of decisionmaking or operations. See *In re Eurofood IFSC Ltd.*, [2005] 1 I.L.R.M. 161 (Ir.); *In re Daisytek-ISA Ltd.*, [2003] B.C.C. 562 (Ch. D) (U.K.). As Jay Westbrook points out, in many cases where there is serious COMI doubt, the relevant short list is likely to be short indeed: “[I]n most countries the standard for locating a corporation on a basis other than its place of incorporation is likely to be built on one of two concepts: the corporation’s headquarters (e.g., ‘chief executive offices’ or ‘real seat’) or its operations (e.g., ‘principal assets’).” Westbrook, *supra* note 40, at 1035; see also Enriquez & Gelter, *supra* note 34, at 444 (noting “only a limited number of jurisdictions will be within the set of available options”). LoPucki himself recognizes this point. See *LOPUCKI, COURTING FAILURE*, *supra* note 2, at 218. He simply expresses deep-seated skepticism that judges and courts of the incorporation jurisdiction will rebut the presumption vigorously. See *id.* at 219. *But cf.*, e.g., Case C-1/04, Susanne Staubitz-Schrieber, 2006 E.C.R. I-701, discussed *infra* notes 126–27. For a very recent transnational insolvency undermining LoPucki’s pessimism, consider the *Hans Brochier Holdings Ltd.* case, litigated in the United Kingdom and Germany. There, a German construction company was purchased by a U.K. conglomerate and had its corporate status “delisted” and subsumed into the U.K. parent. After some false starts, the courts in *both* Germany *and* the United Kingdom agreed that the COMI was, and always had been, in Germany. See *supra* note 53.

62. *LOPUCKI, COURTING FAILURE*, *supra* note 2, at 229 (“Numerous examples in this book have already shown the ease with which multinational companies can change their place of incorporation and the location of their headquarters. The location of assets and operations are more difficult to change.”).

63. See, e.g., *In re Yukos Oil Co. (Yukos II)*, No. 06-B-10775-RDD, 2006 WL 3026024 (Bankr. S.D.N.Y. Oct. 25, 2006).

64. See, e.g., *In re SPhinX, Ltd.*, 351 B.R. 103 (Bankr. S.D.N.Y. 2006); *In re Refco-Inc.*, 336 B.R. 187 (Bankr. S.D.N.Y. 2006).

65. See, e.g., *Maxwell Commc’n Corp. v. Barclays Bank (In re Maxwell Commc’n Corp.)*, 170 B.R. 800, 801 (Bankr. S.D.N.Y. 1994); *In re A. Tarricone, Inc.*, 80 B.R. 21, 22 (Bankr. S.D.N.Y. 1987); *In re Metzeler*, 78 B.R. 674, 675 (Bankr. S.D.N.Y. 1987).

choice of law rule of territorialism.<sup>66</sup> Global companies can transfer assets before filing for bankruptcy, even if not to any particular creditor. And this happens. Consider the recent case of *National Warranty Insurance*, in which \$24 million of its reserves from the United States (where it faced some disgruntled creditors) were wired to its accounts in the Cayman Islands just before filing for winding up there under Cayman law. Accordingly, for highly liquid and mobile assets—which are likely to be of the most interest to creditors—it is by no means evident territorialism is any less manipulable than universalism.<sup>67</sup> In fact, it may be more. Assets, at least important assets, may fly as fast as a bank wire.<sup>68</sup>

In sum, it is far from clear that universalism's anchoring choice of law rule that has been implemented over the past decade—COMI—provides more temptation for jurisdictional mischief than territorialism's situs rule. From the perspective of forum shopping's necessary prerequisite, predictability, COMI's comparative flexibility (less fashionably, “unpre-

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66. The inevitable breaches of covenant by such moves simply add more unsecured claims to the bankrupt debtor's estate—cold comfort for the aggrieved creditors.

67. At one point, LoPucki speculates that while assets can move under territorialism, at least their movement is “highly visible.” LoPucki, *Universalism Unravels*, *supra* note 2, at 160. Leaving aside the unexplained basis for his intuition, I am not sure how much comfort that would offer an aggrieved creditor (other than the virtue of seeing the bullet coming). In any event, the Virgós-Schmit Report makes clear that COMI is supposed to be determined based on objectively ascertainable data to third parties on “where the debtor conducts the administration of its interests on a regular basis;” covert COMI shifts seem definitionally foreclosed. *Virgós-Schmit Report*, *supra* note 41, at 281; *see also* EU Regulation, *supra* note 1, recital 13, at 2 (replicating Virgós-Schmit Report).

68. LoPucki initially suggested that international conventions regarding asset return could minimize forum shopping under territorialism, *see* Lynn M. LoPucki, *Cooperation in International Bankruptcy: A Post-Universalist Approach*, 84 CORNELL L. REV. 696, 749 (1999), but has since retreated from that claim, instead pointing to the common law hotchpot rule as an indirect policing mechanism. *See* LoPucki, *Universalism Unravels*, *supra* note 2, at 161. Reliance on the hotchpot rule is unpersuasive, because the hotchpot rule is a negative injunction, not an affirmative disgorgement remedy. (For an excellent analysis of hotchpot, *see* Ulrik Rammeskov Bang-Pedersen, *Asset Distribution in Transnational Insolvencies: Combining Predictability and Protection of Local Interests*, 73 AM. BANKR. L.J. 385, 429 (1999)). LoPucki's last-ditch response to forum shopping under territorialism—and I give him great credit for acknowledging the problem and responding to it—is that courts can always agree to cooperate *ex post* when they realize it is in their best interest. *See* LoPucki, *Universalism Unravels*, *supra* note 2, at 162 (arguing that the inducements for cooperation under territorialism are “obvious” because “[i]f the assets of the multinational would bring a higher price if sold together, it will be in the interests of the administrators to sell them together and split the proceeds among them.”). Unfortunately, that response is like saying creditors will agree to forego their individual collection rights when they realize it is in their best interests to respond collectively. They don't, and for holdout and other reasons we have a compulsory bankruptcy law. *See* THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* (1986).

dictability”) renders it less amenable to strategic exploitation. From the probably related but theoretically distinct perspective of manipulability, COMI is no more changeable than asset location; regarding at least some important assets, it may even be less. Taken together, these considerations suggest that the recent *alarum* of universalism’s purported facilitation of forum shopping may be nothing more than a myth. Moreover, it may be displacement. Territorialism may actually create the more fertile environment for would-be forum shoppers.

#### V. THE REAL FORUM SHOPPING

The previous discussion has tried to explain why a territorialist system might be just as bad as, if not worse, than a universalist system in terms of cross-border bankruptcy forum shopping. But that has been a largely theoretical discussion—an important one, to be sure, for setting the record straight, but one that has considered only a conceptually pure regime of either full universalism or full territorialism. This does not reflect the current state of the world in 2007. This is not to imply that we have yet to see any forum shopping. Far from it. Indeed, there has been plenty.<sup>69</sup> Rather, the claim is that the problem of *today’s* forum shopping—the real forum shopping, on the ground—is in cases where the current disconnect between universalism and territorialism has been exploited by savvy litigants. It is this discrepancy in the status quo of the incomplete embrace of universalism that has left a lopsided environment, with jurisdictional loopholes embedded in the asymmetry. This problem is an intrinsic fault of neither universalism nor territorialism.<sup>70</sup> It is a problem of bankruptcy transition where only some countries are universalist but others remain territorialists. This is where the *real* forum shopping of today lies.

Stepping back, one must first define what it means for a country to be “universalist” or “territorialist.” After all, these terms refer to a system of transnational insolvency administration (on one view, a choice of law paradigm), so one country, on its own, can’t technically be anything. It can only support the adoption of one private international law regime. Nevertheless, states have domestic law cognates to universalism and territorialism that reflect their affiliations. For example, the reach of a country’s bankruptcy laws—extraterritorial or territorial—maps generally to

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69. See e.g., *Yukos I & Yukos II*, discussed *infra* note 89.

70. To be petulant, I could blame the backward states who have yet to embrace universalism for creating a protracted transition period. The problem with such snarkiness is that territorialists could retort that it was the universalists who wanted transition in the first place and we were all fine in the good old days.

an affinity with universalism or territorialism respectively. A home country under universalism has to believe in the extraterritorial reach of its bankruptcy laws, as seen in, for example, § 541 of the U.S. Bankruptcy Code, if it is to enable the debtor's bankruptcy to be resolved under one substantive bankruptcy law.<sup>71</sup> By contrast, countries with strict territorial restrictions on the scope of their bankruptcy laws, such as South Korea before its most recent round of insolvency law reform, clearly support territorialism.<sup>72</sup>

In an uneven world of some universalists and some territorialists, a number of problems can develop. The first set comes from when a country is "unprincipled" (or perhaps, "pushy"). This would result from facially asymmetric territorial reach of laws. For example, a territorialist state should not only refuse to acknowledge the reach of a foreign state's bankruptcy laws into its own jurisdiction (through non-recognition of judgments), but should also, to be "principled," restrict its own law's reach into other jurisdictions (for example, by disavowing adjudication of foreign assets). Similarly, a universalist country with extraterritorial application of its own bankruptcy laws must countenance the extraterritorial reach of other countries' laws into its own jurisdiction (with jurisdiction-selecting rules, like COMI, to resolve the conflict presented by the overlap).

Many countries' bankruptcy laws are indeed "principled" in this regard, from both the universalist and territorialist schools. For example, the broad reach of the U.S. assertion of bankruptcy jurisdiction under § 541 is offset by a generous policy of deference to foreign proceedings (of course with inevitable exceptions). This was even so under the less-universalist predecessor to Chapter 15, § 304.<sup>73</sup> Similarly, countries such as South Korea and Hong Kong (at least under their prior, territorialist laws) were strict in their territorial application. While they gave a cold shoulder to foreign bankruptcy judgments purporting to regulate assets located within their jurisdictions, they would similarly stop the reach of their own bankruptcy laws at their own borders.<sup>74</sup>

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71. 11 U.S.C. § 541 (defining bankruptcy estate as encompassing all property "wherever located").

72. See John A. E. Pottow, *Procedural Incrementalism: A Model for International Bankruptcy*, 45 VA. J. INT'L L. 935, 945 (2005) (discussing Korean insolvency law and recent amendments); Samuel L. Bufford & Kazuhiro Yanagida, *Japan's Revised Laws on Business Reorganization: An Analysis*, 39 CORNELL INT'L L.J. 1 (2006).

73. See, e.g., *In re Koreag, Controle et Revision S.A.*, 961 F.2d 341, 348 (2d Cir. 1992) (U.S. ancillary proceeding to attach debtor's New York bank account during Swiss main insolvency proceeding).

74. See Bufford & Yanagida, *supra* note 72, at 56–57 (referencing South Korea's territorial application in Mika Maeda, *Nikkan No Rensa Tosan To Minji Saisei Jiken* [A

On the other hand, confirming the fears of game theorists such as Professor Frederick Tung,<sup>75</sup> there were less principled countries. One such example (a territorialist one, which is not to suggest there weren't universalist transgressors as well) was the Netherlands, where Dutch courts would try to control foreign assets under Dutch bankruptcy law while at the same time refusing to acknowledge foreign bankruptcy courts' powers to do the same regarding Dutch-situated assets. This "one-way" territorialism has already been criticized, and rightly so, by commentators, including respected Dutch insolvency expert Professor Bob Wessels.<sup>76</sup> (This state of affairs is likely improved under the new E.U. Insolvency Regulation.)

This "unprincipledness" is one problem of asymmetry, and it certainly creates difficulties, but it is not a pervasive one, because even territorialists would castigate these "rogue states" for being too pushy and not following the true spirit of territorialism.<sup>77</sup> Moreover, traditional requirements of reciprocity have checked this defection impulse under some foreign relations norms.<sup>78</sup> Accordingly, while there are within-system asymmetry problems under either a universalism or territorialism regime by "defectors," those are not the thrust of the present concern. It is the

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*Bankruptcy Chain in Japan and Korea and a Civil Rehabilitation Case*], 105 JIGYOSAI SEI TO SAIKENKANRI [TURNAROUND & CREDIT MGMT.] 180, 183 (2004)); Charles D. Booth, *Recognition of Foreign Bankruptcies: An Analysis and Critique of the Inconsistent Approaches of United States Courts*, 66 AM. BANKR. L.J. 135, 227–28 (1992) (addressing the territorial approach taken by Hong Kong in *Am. Express Int'l Banking Corp. v. Johnson*, [1984] H.K.L.R. 372 (H.C.)).

75. See Tung, *supra* note 25.

76. See Bob Wessels, *The Comity Principle in Amice*, in BIJDRA GE AAN LIBER AMICORUM VOOR PROF RUTGERS 347–59 (2005) ("In foreign and Dutch literature[,] the Dutch model of claiming universal effect for Dutch insolvency proceeding in the Netherlands itself has been severely criticized.").

77. LoPucki provides a good discussion of how territorialists can police over-reaching through non-recognition of judgments. See LOPUCKI, *COURTING FAILURE*, *supra* note 2, at 204–05.

78. Reciprocity requirements were included in, for example, the South African adoption of the UNCITRAL Model Law. See Cross-Border Insolvency Act 42 of 2000 s. 2(1), available at <http://www.info.gov.za/gazette/acts/2000/a42-00.pdf>. See also Law of the People's Republic of China on Enterprise Bankruptcy (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective Jun. 1, 2007), ch. I art. 5, translated in <http://www.globalturnaround.com/cases/PRCnewBankruptcyLaw.pdf> (2006) (P.R.C.) (providing for reciprocity). Note that the United States is actually trying to get away from the Alphonse/Gaston impasse of reciprocity. See RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW § 481 cmt. d (1987) ("A judgment otherwise entitled to recognition will not be denied recognition or enforcement because courts in the rendering state might not enforce a judgment of a court in the United States if the circumstances were reversed.").

*between-system* asymmetry problems that create a greater danger. This occurs when litigants unhappy with the restrictions of a “principled” territorialist country seek to relitigate matters by sneaking into a “principled” universalist country’s courtroom. This is the real forum shopping of the current world of incomplete universalism.

This concern is not mere theory. It has happened in actual cases. One striking example of this type of forum shopping can be seen with the *Maruko* proceedings.<sup>79</sup> Maruko was a Japanese developer. Japan (again, at least until its most recent set of reforms) was a territorialist jurisdiction, and “principledly” so; it restricted the scope of its own bankruptcy proceedings to assets within its physical jurisdiction. When Maruko filed for bankruptcy in Japan (its uncontested COMI), the proceedings did not reach its myriad foreign assets, including a hotel in Australia’s sun-drenched Gold Coast. From the perspective of Japanese bankruptcy law, this was not a problem: Australian law would apply to those assets if and when proceedings were opened there. Indeed, as expected, legal action did commence in Australia; a collection proceeding was brought by a commercial lender who was understandably unhappy with the state of its mortgage with Maruko. Disinclined to work out a restructuring plan, the creditor instituted foreclosure to liquidate the property.<sup>80</sup> The problem for Maruko was that Australian substantive bankruptcy law gave the mortgagee too powerful a negotiating endowment for its liking: a secured creditor in Australia can proceed to foreclose in the event of bankruptcy, unfettered by a stay.<sup>81</sup> While this may upset Professor Jackson, it is certainly a commonplace legal protection for secured creditors in Commonwealth jurisdictions.<sup>82</sup>

Maruko’s “solution” to the “problem” of Australia’s policy decision to accord super-protection to secured creditors in bankruptcy was for Maruko to open insolvency proceedings in the (universalist) United States and invoke its (universalist) worldwide stay. It did, and the stay had real pinch due to in personam general jurisdiction over the lender; the Australian foreclosure ground to a halt. Did the United States have a legitimate

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79. See *In re Maruko, Inc.*, 200 B.R. 876 (Bankr. S.D. Cal. 1996).

80. This of course is the classic creditor’s bargain problem, where a trigger-happy creditor can seize an available asset at the potential expense of all creditors—hence the need for collective resolution in bankruptcy. See JACKSON, *supra* note 68.

81. See Corporate Law Reform Act, 1992, §§ 440A (secured creditors with substantially all of a debtor’s property under a lien), 440B (secured creditors who have acted to enforce their claims before the appointment of an administrator), 440C (secured creditors who have a lien on perishable property) (Austl.).

82. See e.g., Bankruptcy Act, R.S.C., ch.B-3, §69 (1985) (Can.); see also LoPucki, *Universalism Unravels*, *supra* note 2, at 164.

interest in regulating the insolvency estate of a Japanese debtor's Australian assets? Doubtful. Yet universalists celebrated the *Maruko* outcome, extolling the "value-preserving" capacity of the U.S. stay that rescued the Australian resort from liquidation at the hands of an impatient creditor while a consensual restructuring could be approved.<sup>83</sup> Territorialists, by contrast, spluttered over the "intimidation" of the Australian courts by the U.S. courts and cast *Maruko* as a black eye, rather than cap feather, for universalism.<sup>84</sup>

The territorialists are right, but not for the reasons they think they are. They are correct that *Maruko* is a bad case, notwithstanding its arguably sympathetic outcome, and that in an ideal world the United States would have butted out (as a doctrinal matter, this could have been done under § 305).<sup>85</sup> But they are wrong to paint *Maruko* as an indictment of universalism.<sup>86</sup> The skewed outcome of *Maruko* was neither the fault of the United States nor universalism. Rather, the "fault," to the extent it even makes sense to ascribe fault to a bankruptcy proceeding, is equally Japan's and territorialism's. Had Japan subscribed to a system of universalism, none of this would have (or should have) happened. Under such a scenario, Japanese law would have controlled, per the COMI of Maruko, and Australia (assuming it supported universalism too) would have complied with a request for assistance by convening an ancillary proceeding. Without getting into the safeguard protections for local creditors under a more modified form of universalism,<sup>87</sup> the point is that the only plausible case for the application of U.S. law was due to the necessarily incomplete scope of the Japanese proceedings in the first place. Thus to say that *Maruko* shows how universalist jurisdictions distort transnational insolvencies is not just inaccurate; by refusing to shoulder equal responsibility on the territorialist home state, it is unfair.<sup>88</sup> Had all three jurisdictions been universalists (equally, had all three jurisdictions been terri-

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83. See Bufford, *Global Venue Controls*, *supra* note 10, at 116.

84. See LoPucki, *Universalism Unravels*, *supra* note 2, at 163–64 ("What [universalists such as Bufford] refer to as deference to the U.S. stay was actually intimidation by it.").

85. 11 U.S.C. § 305(a)(2) (2006) (permitting abstention of cases properly brought within the jurisdiction of the U.S. courts to assist foreign proceedings); *see also* LoPucki, *Universalism Unravels*, *supra* note 2, at 164 ("The *Maruko* transaction was entirely domestic to Australia . . .").

86. See LoPucki, *Universalism Unravels*, *supra* note 2, at 164 ("*Maruko* demonstrates the potential for unpredictability in a universalist regime.").

87. 11 U.S.C. § 1522 (2006).

88. Thus LoPucki's criticism of universalism as "fail[ing]" the *KPNQwest* bankruptcy in the Netherlands may be similarly unfair. *See* LOPUCKI, *COURTING FAILURE*, *supra* note 2, at 226.

torialists), this cross-global forum shop would have failed. It was only the interaction between territorialist Japanese law and universalist U.S. law that created this (realized) opportunity for forum shopping and relitigation.<sup>89</sup>

#### VI. UNIVERSALISM'S RESPONSE TO THE REAL FORUM SHOPPING

If the true problem of forum shopping is caused by exploitation of differences between universalist and territorialist states' jurisdictional rules, is there anything that can be done today, in the real world, before the complete acceptance of universalism?<sup>90</sup> There is reason to think that the answer is yes, and that universalism, as implemented by Chapter 15, has already started. Recall that the problem in *Maruko* was that a U.S. stay extraterritorially blocked seizure of a Japanese debtor's assets located in Australia. Because Chapter 15 now expressly recognizes jurisdictional hierarchy (a necessary foundation of universalism),<sup>91</sup> the U.S. bankruptcy regime has adjusted the scope of its automatic stay accordingly. Specifically, § 1520(a)(1) now confines the automatic stay that is triggered by recognition of a foreign main proceeding, i.e., when the United States has been determined *not* to be the COMI of the debtor. This is the sort of recognition, and hence "light-form" stay, that would have occurred had *Maruko* been brought as a Chapter 15 proceeding. The new

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89. The most dramatic recent example of this same sort of forum shopping is (both installments of) the *Yukos* insolvency, in which unhappy litigants in quasi-territorialist Russian proceedings tried to get a U.S. stay to stymie unwelcome legal developments both in and outside Russia. The first U.S. hearing saw through this maneuver as an impermissible collateral attack—adding an excellent counterpoint to the *Maruko* case, because here the court's decision reached an unsympathetic outcome—and bit the bullet to dismiss the U.S. case. See *In re Yukos Oil Co. (Yukos I)*, 321 B.R. 396 (Bankr. S.D. Tex. 2005). The second U.S. hearing fell for the trap, asserted jurisdiction, and vindicated the re-biting of the apple by foreign litigants who had already lost in their home courts. See *In re Yukos Oil Co. (Yukos II)*, No. 06-B-10775-RDD, 2006 WL 3026024 (Bankr. S.D.N.Y. Oct. 25, 2006).

90. Or before a complete abandonment of universalism back to territorialism—although that would require quite some winding back of the clock: U.S. courts have been recognizing the binding nature of Canadian court restructurings of Canadian debtors for over a century, even against U.S. creditors who invest in, but do not want to litigate in, Canada. See *Canada S. Ry. Co. v. Gebhard*, 109 U.S. 527, 536 (1883) ("That the laws of a country have no extraterritorial force is an axiom of international jurisprudence, but things done in one country under the authority of law may be of binding effect in another country.").

91. 11 U.S.C. § 1517 (2006) (distinguishing between "foreign main" and "foreign non-main" proceedings and attaching hierarchical legal consequence to each, such as, e.g., imposition of an automatic stay for the former but only discretionary stay for the latter).

limitation to the U.S. stay in these circumstances is that it only applies to assets within the physical jurisdiction of the United States.<sup>92</sup> Indeed, even if a full-blown plenary proceeding is opened under Chapter 11 (which would implicate § 541's reach of an extraterritorial estate) after recognition of a foreign main proceeding, § 1528 now provides that such a plenary proceeding, albeit conducted under U.S. substantive law, is still generally limited to the assets within the physical territory of the United States. In other words, *Maruko* would not have been possible under Chapter 15. This is because the solution, from the universalist perspective, of territorialist-jurisdiction litigants trying to forum shop into universalism's necessarily extraterritorial reach of law, is to make it clear ex ante that the existence of non-U.S. COMI proceedings will preclude the extraterritorial reach of U.S. bankruptcy law.

Chapter 15's approach arguably codifies what some courts were already struggling to do when facing inter-system friction: respect the home jurisdiction's intended scope of its bankruptcy law. One such case was the *Axona* decision from the early 1990s.<sup>93</sup> In *Axona*, a Hong Kong debtor filed for liquidation in Hong Kong, which had ("principled") territorialist bankruptcy laws. Because there were assets in the United States, the Hong Kong liquidator opened U.S. proceedings (his Hong Kong territorialist proceedings having disavowed jurisdiction over the U.S. assets), with an eye to recovering a transfer that was preferential under U.S. bankruptcy law.<sup>94</sup> Case law of a universalist bent in the United States had crafted a rule that § 304 ancillary proceedings should apply the avoidance law of the debtor's home jurisdiction.<sup>95</sup> The liquidator, however, wanted to use U.S. law because Hong Kong law would have insulated the payment from recovery. Accordingly, the liquidator side-stepped § 304 and opened a full plenary proceeding in the United States, successfully voiding the transaction that would have been unassailable under strictly universalist application of Hong Kong law. Adding insult to injury to the U.S. preference recipient, the liquidator then dismissed the proceedings under § 305 "in deference" to the Hong Kong proceeding, which had the effect of returning the assets to Hong Kong, a jurisdiction in which they would have never been recoverable under local bankruptcy law.<sup>96</sup>

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92. 11 U.S.C. § 1520(a)(1) (2006).

93. See *In re Axona Int'l Credit & Commerce Ltd.*, 88 B.R. 597 (Bankr. S.D.N.Y. 1988); *Am. Express Int'l Banking Corp. v. Johnson*, [1984] H.K.L.R. 372 (H.C.).

94. See *Axona*, 88 B.R. at 602-03.

95. See *In re Metzeler*, 78 B.R. 674, 677 (Bankr. S.D.N.Y. 1987).

96. See *Axona*, 88 B.R. at 618-19 (Bankr. S.D.N.Y. 1988).

While some universalists begrudged the application of U.S. avoidance law to what was a Hong Kong-COMI bankruptcy,<sup>97</sup> Professor Charles Booth came to the defense of *Axona*.<sup>98</sup> The universalists, Booth implied, were assuming that Hong Kong law was universalist and intended its preference law to apply extraterritorially to transfers of assets in the United States. But that was not the case. On the contrary, Hong Kong expected U.S. avoidance law to apply to any U.S. assets and would have been surprised by § 304's application of Hong Kong law. As such, it was not forum shopping (or "section shopping" as Booth called it)<sup>99</sup> by the Hong Kong liquidator—although to be sure he achieved the substantive result he desired—but scrupulous adherence to the jurisdictional restrictions of Hong Kong law. *Axona* is not a case without problems,<sup>100</sup> but it serves as a counterpoint to *Maruko* to show how universalist and territorialist jurisdictions were supposed to interact in an imperfect environment. Chapter 15's new restrictions on the U.S. stay may be seen as a related effort to codify appropriate measures to address inter-system issues in an interregnum world.

Accordingly, whatever the steps taken to combat forum shopping under § 304 in the past, I contend Chapter 15 now prevents *Maruko*-style forum shopping due to the recalibration of the automatic stay. Has this brave claim been put to the test in the first year of Chapter 15's early life? It has, and it was shown spectacularly wrong. This comeuppance

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97. See, e.g., Jay Lawrence Westbrook, *The Lessons of Maxwell Communication*, 64 *FORDHAM L. REV.* 2531, 2540 (1996).

98. Booth, *supra* note 74, at 227–28.

99. *Id.* at 229.

100. It is not clear, for example, whether it was appropriate to distribute the proceeds of the U.S. avoidance action according to Hong Kong distribution law; there is a case to be made that the law of distribution should track the law of avoidance. See Jay L. Westbrook, *Choice of Avoidance Law in Global Insolvencies*, 17 *BROOK. J. INT'L L.* 499 (1991). In *Axona*, however, all creditors participated and so choice of distribution law was likely irrelevant, but the problem persists at a theoretical level. More broadly, a potential problem with *Axona* is that the choice of a § 304 (Hong Kong preference law) proceeding versus a Chapter 11 (U.S. avoidance law) proceeding essentially gave the liquidator an option on substantive law, which some might see as unfair. But fairness is tricky in this context, because while it may seem unfair to allow a Hong Kong debtor a second crack at more favorable U.S. law, it should not seem unfair to subject a U.S. creditor to U.S. law. Moreover, one's view of fairness may depend on whether one is the creditor whose transfer is under attack or the rank-and-file creditor who seeks increased estate funds for distribution.

Note that for all its improvements, Chapter 15 would actually seem to permit an *Axona* repeat. See *Axona*, 88 B.R. at 597; 11 U.S.C. § 1528 (2005).

occurred in the case of *Yukos II*.<sup>101</sup> In these 2006 proceedings, a Russian debtor had been petitioned into an involuntary bankruptcy proceeding in its home country, which appears to have a territorialist or at least quasi-territorialist bankruptcy law.<sup>102</sup> The Russian administrator in *Yukos II* then traveled to the Netherlands (another territorialist jurisdiction) to intervene in unfolding legal proceedings there regarding collection on a corporate subsidiary's assets. For reasons that are too complicated and painful to explain here, the administrator did not get the substantive outcome he wanted in the Netherlands, much like the unhappy *Maruko* debtor in Australia. And also like the *Maruko* loser, the Russian administrator wanted a second bite at the apple. The only way he could do so was to try a "Hail Mary" filing in a universalist jurisdiction elsewhere that might throw a wrench into the disappointing Dutch proceedings. He did just that: perhaps having read *Maruko*, the Russian administrator came to America and opened a Chapter 15 proceeding in the Southern District of New York.

Under Chapter 15, the result should have been either recognition of the Russian proceeding as a main or a non-main foreign proceeding (or, more likely, dismissal for public policy reasons beyond the scope of this discussion).<sup>103</sup> If the Russian proceeding had been recognized as a main proceeding (the corporate formalism of Russian law made even that a confusing question), the most invasive U.S. law could have gotten would have been through imposition of the new territorially limited "light-form" stay of § 1520(a)(1). The substantive decisions of the Dutch proceedings, and the assets under its jurisdiction, should have been unaffected. Sadly, that did not happen. On the contrary, the U.S. court took

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101. See *In re Yukos Oil Co. (Yukos II)*, No. 06-B-10775-RDD, 2006 WL 3026024 (Bankr. S.D.N.Y. Oct. 25, 2006).

102. Characterizing Russia as territorialist is uncertain at best; there is some suggestion that it might expect extraterritorial application of Russian bankruptcy law but not recognize foreign bankruptcy orders, in which case it would be an "unprincipled" territorialist. What is known about Russian commercial law is that it is strictly formalist in its treatment of the corporate form, and so the conceptual rigidity of territorialism seems plausibly related. See Holger Muent and Francesca Pissarides, *Impact of Collateral Practice on Lending to Small and Medium-sized Enterprises*, Law in Transition, Fall 2000: Secured Transactions 64 (EBRD Autumn 2000), available at <http://www.ebrd.com/pubs/legal/lit002c.pdf>.

103. 11 U.S.C. § 1506 (2006). The *Yukos* debacle is a brazen display of confiscatory taxation. The Russian government renationalized this strategic energy resource by concocting dubiously legal "back taxes" against the company and then seizing its assets for non-payment of these taxes. Litigation is unfolding before the European Court of Justice regarding this confiscation as an allegedly uncompensated taking. It is a melodramatic affair, with criminal intrigue on the part of *Yukos* officers too. Suffice it to say that political opposition to the Kremlin is ill-advised for those uninterested in Siberia.

the bait and granted a temporary restraining order (possibly *ultra vires*) to block the Dutch proceedings, and, as in *Maruko*, in personam jurisdiction over the defendants made that order stick. Accordingly, the Dutch action, like the Australian foreclosure action in *Maruko*, ground to a halt by command of a remote U.S. court sitting far away from the debtor's COMI.

The *Yukos II* outcome was no fault of Chapter 15. It was the fault of a court that did not fully understand Chapter 15's design and the mandatory jurisdictional role of "recognition." (In fairness to the court, one way to read *Yukos II* is that the judge was stretching the law—or at least deferring reaching an inevitable decision on the law that would have foreclosed jurisdiction—in a noble attempt to pressure the parties to settle.)<sup>104</sup> *Yukos II* has already been criticized academically, so there is no point to repeat an airing of the grievances.<sup>105</sup> Its inclusion in the instant discussion is in the spirit of full disclosure of contrary authority. The reader should feel comforted that it would probably not have survived appellate review,<sup>106</sup> which allows reinstatement of the claim from above: *Maruko*-style forum shopping should be impossible—or at least require the sort of judicial back-breaking of *Yukos II*—under Chapter 15. This is universalism's solution to the real forum shopping of inter-system jurisdictional arbitrage between territorialist and universalist venues.

#### VII. REPRIS: THE SCOPE OF FORUM SHOPPING UNDER UNIVERSALISM VS. TERRITORIALISM

There is a final forum-shopping complaint against universalism by territorialists concerning not the ease, but the scope, of the problem. Initially, Professor LoPucki makes two seemingly contradictory predictions. The first is that as universalism's choice of law rule—COMI—becomes more entrenched, it will be harder for ancillary jurisdictions to hold onto cases (and hence assets), because it will become harder to contest primary jurisdiction. In other words, universalism's "precommitment" to the cession of jurisdiction pursuant to the COMI rule will remove the ex post check available to judges to hold onto cases under ad hoc territorial-

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104. And even so the court eventually got fed up and dissolved the stay. *See Yukos II*, 2006 WL 3026024. Notwithstanding the charitable interpretation of the case, the criticism remains that it is not the place of judges to distort doctrines of jurisdiction simply to come up with seemingly attractive results.

105. At least I criticized it. *See* John A. E. Pottow, *Cutting Chapter 15's Teeth: The Yukos Adventure* (Presentation Paper to INSOL 2006 Academic Conference, May 2006).

106. Although the reader's comfort may be tempered by the scarcity of such appeals in practice.

ism.<sup>107</sup> The second claim is that because judges and courts “compete” for jurisdiction—holding themselves out as attractive venues to case placers—they will not readily relinquish jurisdiction to main proceedings under the COMI rule if they lose the competition.<sup>108</sup> Leaving aside the apparent tension of these positions,<sup>109</sup> each requires response. Actually, the first point has already been responded to above in the discussion of the role choice of law clarity plays in forum shopping: the COMI rule is crisp, but not as crisp as others. As for the second point, regarding the temptation of courts to shade ambiguous jurisdictional claims at the margin and a disinclination to cede control *ex post*, I am in full agreement with Professor LoPucki and have written so elsewhere regarding the pride of courts.<sup>110</sup> The solace I take under the early case law of Chapter 15 is that this margin may be a narrow one. For example, in one recent case, the U.S. court after a thorough and methodical analysis deferred to St. Vincent as the COMI of a foreign insurance company debtor, notwithstanding the objection of U.S. creditors and the presence of sizable (and seizable) U.S. assets that would have made a “corrupt” U.S. judge salivate.<sup>111</sup>

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107. See LoPUCKI, *COURTING FAILURE*, *supra* note 2, at 205 (“[Universalism] seeks to precommit the countries of the world to recognize and enforce each other’s bankruptcy decisions. If universalists succeed, they will eliminate the need for after-the-fact, case-by-case recognition . . .”).

108. *Id.* at 209 (“In thinking that the home country standard will be sufficient to control international forum shopping, the universalists have underestimated . . . the pressures on courts and countries to win at least a share of the world’s multibillion-dollar bankruptcy industry for themselves.”); *id.* at 217–18, 223–24; see also LoPucki, *Universalism Unravels*, *supra* note 2, at 152.

109. One way to resolve the contradiction is to distinguish *ex ante* from *ex post* competition. Jurisdictions compete *ex ante* by drafting substantively attractive bankruptcy laws. Jurisdictions compete *ex post* by saying that once a bankruptcy case is filed in their venue—once they have won the spoils of attracting cases—they will relinquish or cede jurisdiction to another venue over the judge’s dead body.

110. John A. E. Pottow, *Greed and Pride in International Bankruptcy: The Problems of and Proposed Solutions to “Local Interests,”* 104 MICH. L. REV. 1899, 1918–19 (2006).

111. See *In re Tri-Continental Exchange Ltd.*, 349 B.R. 627 (Bankr. E.D. Cal. 2006). Perhaps then LoPucki and I differ only by degree rather than kind regarding the inclination judges will have to shade jurisdiction. I see problems at the margin but see the margin as not overly wide. By contrast, LoPucki’s skepticism is deep-seated. See, e.g., LoPucki, *Universalism Unravels*, *supra* note 2, at 152 (“Judge Bufford bases his solution on the assumption that judges will be disinterested and unbiased—an assumption he makes little attempt to justify or explain.”). Perhaps a cynic might explain *Tri-Continental* as a consequence of the Eastern District of California being a sleepy backwater unattuned to (or unable to compete meaningfully in) the heady world of jurisdictional

But this latter point ties into the broader concern LoPucki has with the scope of forum shopping under universalism. LoPucki worries that even if it is just as easy to move assets as it is to move COMI (which he never concedes),<sup>112</sup> it is still more troubling to move COMI because, in essence, the stakes are higher.<sup>113</sup> Under territorialism, if some assets can be moved out of jurisdiction to shop favorable law, then there is a definite, but only partial loss. By contrast, if COMI is successfully shopped, then the loss is a complete one—*all* assets will be adjudicated subject to the haven’s bankruptcy laws, not just the assets that were able to be moved there.<sup>114</sup> In other words, universalism puts all the choice of law eggs in one basket. This argument is a legitimate one, and universalists should not pretend that it isn’t. The forum shopping stakes *are* higher under universalism. What is not conceded, however, is that it is easier or as easy to forum shop under universalism as it is under territorialism, as discussed above. Thus, for now, LoPucki and I draw to an empirical stalemate.<sup>115</sup>

While the empirics may be an open question, theory leaves one mark against territorialism in the final analysis of forum shopping. It is what might be called the “attitudinal” issue: that territorialism is worse disposed than universalism to deal with its forum shopping problems. One of the key advantages territorialism purports to wield over universalism is that it does not need to rely upon international cooperation, goodwill, and other such namby-pamby values.<sup>116</sup> It is set to deal with the rough and tumble insolvency state of nature. That may be so, at least as a first cut. But when one introduces concerns of forum shopping, which under territorialism entails the improper movement of assets across borders, then solutions need to be designed to relocate assets to their “proper”

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competition. Even the cynic, however, might find it difficult not to be encouraged by *Hans Brochier Holdings Ltd.*, *supra* note 53.

112. In fact, he seems to countenance asset movement with great sanguinity. *See* LoPucki, *Universalism Unravels*, *supra* note 2, at 160–61.

113. *See id.* at 148 (“Universalism is an all-or-nothing system. A single court gets the case, and runs it worldwide.”).

114. *See id.* at 160 (“In today’s territorial system, eve-of-bankruptcy transfers can alter creditor priorities, but *only in the assets transferred*. [A change in the debtor’s COMI] could alter creditor priorities *in all the debtor’s assets*. . .”).

115. It is interesting that the European Union Insolvency Regulation’s Preamble focuses on the movement of assets in expressing a desire to diminish forum shopping. *See* EU Regulation, *supra* note 1.

116. *See e.g.*, Lopucki, *Cooperative Territoriality*, *supra* note 2, at 2243–45; *see also* LoPucki, *Universalism Unravels*, *supra* note 2, at 164 (“[T]erritoriality requires no cooperation. . .”).

locations.<sup>117</sup> And these solutions, as territorialists concede, include conventions and treaties (presumably from an ex ante perspective, because ex post it will be impossible for the very competitive forces LoPucki fears),<sup>118</sup> which are the very sorts of cooperative international efforts territorialism disdains.<sup>119</sup> This raises the question: if an asset return convention needs to be negotiated to shore up territorialism against forum shopping, why not just continue to negotiate a choice of law convention to empower universalism?<sup>120</sup>

#### VIII. FINAL REFLECTION: IS FORUM SHOPPING ALL THAT BAD?

The final question that bears mention in an analysis of bankruptcy forum shopping is the degree to which one should even worry about it. After all, the whole paradigm of contractualism is premised upon ex ante forum shopping, animated by a belief that such shopping is good and will be more of a race to the top than a race to the bottom.<sup>121</sup> If so, then is forum shopping in the international bankruptcy arena something to worry about in the first place?<sup>122</sup>

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117. See Lynn M. LoPucki, *Cooperation in International Bankruptcy: A Post-Universalist Approach*, 84 CORNELL L. REV. 696, 749 (1999) ("Implementing this rule would necessitate treaties that require the return of fleeing assets . . ."). As I have written elsewhere, I am skeptical that the sorts of jurisdictions likely to style themselves as havens will be enthusiastic about joining these conventions. See Pottow, *supra* note 72, at 955 n.83.

118. See *infra* note 120.

119. See LoPucki, *Universalism Unravels*, *supra* note 2, at 164 ("[T]erritoriality requires no cooperation beyond that which already occurs.").

120. In his earlier writings, LoPucki embraced treaties and conventions as the way to return fleeing assets to their proper location. See LoPucki, *supra* note 117. He may have backed off his earlier support as suggesting (I think) not that states should negotiate such treaties ex ante, but rather that they should do them ad hoc and ex post—if and when an asset flight dispute arises. See LoPucki, *Universalism Unravels*, *supra* note 2, at 164 ("Judge Bufford strains to make my proposal for a cooperative territorial regime dependent on treaties and conventions. I repeat here that it is not. . . . Territoriality . . . provides a stable platform for treaties and conventions dealing with specific opportunities for mutual benefit, such as the return of fleeing assets."). I may be misreading his most recent articulation of his position. If he has indeed changed his stance, this new position is unlikely to generate many agreements. Agreements after the assets have flown are likely to interest the country whence the assets flew much more than the country where they landed.

121. See Rasmussen, *Resolving Transnational Insolvencies*, *supra* note 13.

122. The most recent and eloquent proponent of this comfort with forum shopping has been Professor Rasmussen. See, e.g., Robert K. Rasmussen & Randall S. Thomas, *Whither the Race? A Comment on the Effects of the Delawarization of Corporate Reorganizations*, 54 VAND. L. REV. 283, 291 (2001) ("Competition can be a good thing."); Robert K. Rasmussen & Randall S. Thomas, *Timing Matters: Forum Shopping by Insol-*

Clearly courts worry.<sup>123</sup> Consider the contortions one court recently worked on Chapter 15 and the concept of jurisdiction to frustrate what it saw as naked forum shopping.<sup>124</sup> Clearly Professor LoPucki, who literally wrote the book on it, worries too.<sup>125</sup> Nor is the worry exclusively domestic.<sup>126</sup> I confess, however, to being more conflicted.<sup>127</sup> Perhaps the

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*vent Corporations*, 94 NW. L. REV. 1357 (2001) (applauding jurisdictional competition in certain contexts, such as “prepackaged” bankruptcies).

123. See *Wells v. Simonds Abrasive Co.*, 345 U.S. 514, 521 (1953) (Jackson, J., dissenting) (describing forum shopping as “evil”). For a thorough recent discussion of forum shopping, see Debra Lyn Bassett, *The Forum Game*, 84 N.C. L. REV. 362 (2006).

124. See *In re SPhinX, Ltd.*, 351 B.R. 103, 121–22 (Bankr. S.D.N.Y. 2006). While the court’s concern over forum shopping may have been well placed, it is not clear why the court could not have recognized the proceeding as a foreign main proceeding and then lifted the automatic stay thereby imposed (under 11 U.S.C. § 1520(a)(1)) by resorting to 11 U.S.C. § 362(d)(1), which permits lifting the stay for “cause” and illustrates a non-exhaustive example of cause as inadequate protection of a security interest. 11 U.S.C. § 362(d)(1) (2006). Also, if the automatic stay was really the true, nefarious purpose for bringing the Chapter 15 proceeding, it is unclear why the same effect could not have been achieved by filing a full-blown Chapter 11, which would have imposed an automatic stay without need for recognition (although then the foreign representatives would have attorned to U.S. jurisdiction, which they may have been trying to avoid by using Chapter 15 under the most suspicious read of the case’s facts). For criticism of the *SPhinX* case, see Daniel M. Glosband, *SPhinX Chapter 15 Opinion Misses the Mark*, AM. BANKR. INST. J., Dec.–Jan. 2007, at 44.

125. See, e.g., LOPUCKI, *COURTING FAILURE*, *supra* note 2, at 193 (“Thus, the downward spiral of international competition has already begun. . . . Besides the United States, the big winners from international forum shopping have been the offshore havens, most notably Bermuda and the Cayman Islands.”).

126. The European Court of Justice recently decided a case in which it held that post-filing relocation of an individual debtor from Germany to Spain (and hence change of her COMI) did not divest the German court of jurisdiction over main proceedings. Case C-1/04, *Susanne Staubitz-Schreiber*, 2006 E.C.R. I-701 (Judgment of the Court). One of the primary reasons supporting its ruling was a concern about forum shopping. See *id.* ¶¶ 3, 25 (noting that European Union Insolvency Regulation’s Preamble’s Fourth Recital expressly mentions intent of law “to avoid incentives for the parties to transfer assets or judicial proceedings from one Member State to another, seeking to obtain a more favourable legal position” (derived from the Virgós-Schmit report, see *supra* note 41)). *Id.* ¶ 25. Indeed, the recital actually defines this incentive, in parentheses, as “forum shopping.” EU Regulation, *supra* note 1, pmb. ¶ 4. Note that in this case, contrary to forum shopping intuitions, Germany was trying to dismiss the action in her courts, and the Spanish (erstwhile German) debtor—who had moved COMI—was fighting to keep the applicability of German law. *Susanne Staubitz-Schreiber*, 2006 E.C.R. I-701 ¶ 16.

127. Cf. Case C-1/04, *Susanne Staubitz-Schreiber*, 2006 E.C.R. I-701 (Opinion of the Advocate-General), ¶¶ 70–73.

[I]n general, lawyers regard the term [“forum shopping”] as pejorative. If forum shopping is defined as the search by a plaintiff for the international jurisdiction most favourable to his claims, there is no doubt that, in the absence of

matter is one of notice. If the purpose of having a debtor's COMI "ascertainable by third parties"<sup>128</sup> is to prevent unfair jurisdictional surprise by seemingly domestic companies having brass plate headquarters in Havenland, then presumably a well disseminated notice system of applicable bankruptcy law could allow an efficient choice regime. The lingering worry I have regards systemic bias between those likely to have, process, and credit-adjust to that notice and those likely to not.<sup>129</sup> Thus I flag the issue of contractualism for consideration, but leave its case to be made by its more eloquent proponent, Professor Rasmussen.<sup>130</sup>

#### IX. CONCLUSION

In 2007, forum shopping remains a concern in transnational bankruptcy. Attempting to dispel the myth that universalism facilitates forum shopping, this Article has advanced arguments why territorialism may be just as bad, if not worse, both in terms of the predictability of its choice of law rule as well as the likely (but not yet empirically tested) greater ease with which assets can be moved than COMIs. It has also argued that the real problem of forum shopping in today's world of incomplete universalism lies in cases such as *Maruko* and *Yukos II*, where unhappy territorialist-country suitors try to have a second crack under the bankruptcy law of a remote universalist jurisdiction. This is not a flaw with universalism any more than it is a flaw with territorialism; it is a necessary by-

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legal uniformity in the different private international law systems, that phenomenon must be accepted as a natural consequence which is not open to criticism. . . . Forum shopping is merely the optimisation of procedural possibilities and it results from the existence of more than one available forum, which is no way unlawful. However, where forum shopping leads to unjustified inequality between the parties to a dispute with regard to the defence of their respective interests, the practice must be considered and its eradication is a legitimate legislative objective.

*Id.* (citations omitted). The Advocate General's remarks hearken back to Professor Friedrich Jeunger's reminder that "not all forum shopping merits condemnation" and warning "not to let a disparaging term becloud our thinking." Friedrich K. Jeunger, *Forum Shopping, Domestic and International*, 63 TUL. L. REV. 553, 570-71 (1989); see also Rasmussen & Thomas, *supra* note 122 (arguing generally, on efficiency grounds, for warmer embrace of "forum shopping" with prepackaged bankruptcies than with traditional bankruptcies).

128. See *Virgós-Schmit Report*, *supra* note 41, at 281; see also also EU Regulation, *supra* note 1, recital 13, at 2.

129. See LOPUCKI, *COURTING FAILURE*, *supra* note 2, at 232 ("The losers will be the corporate outsiders who have no means of controlling their debtor's choice of courts: tort victims, employees, suppliers, customers, other stakeholders with small interests, and—as with every strategy game—the less sophisticated players.")

130. And his occasional co-author Professor Thomas. See *supra* note 122.

product of an interim regime. The solution to this more complex type of forum shopping is to make it more difficult, if not impossible, to open extraterritorial proceedings in universalist jurisdictions for debtors whose COMIs lie elsewhere. And that is what, notwithstanding the misunderstanding of some courts, Chapter 15 in the United States has tried to do.

## UNIVERSAL PROCEDURALISM

*Edward J. Janger\**

Eight years ago, I published an Article entitled *Predicting When the Uniform Law Process Will Fail: Article 9, Capture, and the Race to the Bottom*.<sup>1</sup> The Article focused on the effects of capture and jurisdictional competition on the uniform law drafting process in the United States. I concluded that the desire for uniform and universal adoption of their work product would force uniform law drafters to anticipate (and acquiesce to) the possibility that state legislatures might be captured by affected interest groups or engage in a race to the bottom.<sup>2</sup> Accordingly, I argued that the uniform lawmaking process should: (1) limit its aspiration to seeking procedural and transactional efficiencies; (2) promote legislation based only on broad-based consensus; and (3) shy away from legal questions with important distributional consequences.<sup>3</sup> These are, of course, broad prescriptions, and the devil is in the details. Nevertheless, subsequent events appear to have borne out my predictions about the limits of domestic harmonization efforts.<sup>4</sup>

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\* Professor, Brooklyn Law School. The author would like to thank participants in the INSOL Academics Conference in Scottsdale Arizona, participants in a faculty workshop at the University of Georgia School of Law, and participants in this symposium for comments on earlier drafts. Particular thanks are due to Dean Joan Wexler, for support from the Dean's Summer Research Fund, and more importantly, for her wholehearted support of this symposium. Finally, thank you to Jeb Singer and Shannon Sneed for able and tireless research assistance. Mistakes are, of course, mine alone.

1. Edward J. Janger, *Predicting When the Uniform Law Process Will Fail: Article 9, Capture, and the Race to the Bottom*, 83 IOWA L. REV. 569 (1998) [hereinafter Janger, *Uniform Law Process*]; see also Alan Schwartz & Robert E. Scott, *The Political Economy of Private Legislatures*, 143 U. PA. L. REV. 595 (1995); Robert E. Scott, *The Politics of Article 9*, 80 VA. L. REV. 1783 (1994); Kathleen Patchel, *Interest Group Politics, Federalism and the Uniform Laws Process: Some Lessons from the Uniform Commercial Code*, 78 MINN. L. REV. 83 (1993); Edward L. Rubin, *Thinking Like a Lawyer, Acting Like a Lobbyist: Some Notes on the Process of Revising UCC Articles 3 and 4*, 26 LOY. L.A. L. REV. 743 (1993).

2. Janger, *Uniform Law Process*, *supra* note 1, at 630–31.

3. *Id.*

4. See, e.g., Robert K. Rasmussen, *The Uneasy Case Against the Uniform Commercial Code*, 62 LA. L. REV. 1097, 1100-01 (2002) (reviewing the most recent efforts to revise U.C.C. Articles 2, 3, 4 and 9); Richard E. Speidel, *Revising UCC Article 2: A View from the Trenches*, 52 HASTINGS L.J. 607, 608 (2001) (describing the Article 2 revision process); see also Neil B. Cohen, *Taking Democracy Seriously*, 52 HASTINGS L.J. 667, 670 (2001) (describing interest group participation in the Article 2 revision process); Linda J. Rusch, *A History and Perspective of Revised Article 2: The Never Ending Saga of a Search for Balance*, 52 S.M.U. L. REV. 1683, 1689 (1999) (stating that “interest groups have been very active in the Article 2 revision process”).

As soon as I finished the Article, I started thinking about its implications for efforts to harmonize international law. It seemed to me that there was a useful insight there somewhere. I held back, however, out of lack of knowledge and a sense that the efficiencies to be obtained from international harmonization might be greater than the comparatively marginal benefits associated with revising the Uniform Commercial Code. A few years ago, Jay Westbrook tried to nudge me into writing on the subject of transnational insolvency by inviting me to a conference at the University of Texas. Much to his chagrin, I chose to present, instead, on the subject of data privacy in bankruptcy.<sup>5</sup> Even then, however, a different type of reticence was causing me to hold back. By this time, the poles of the transnational insolvency debate had been defined: Universalism on one side and Territorialism on the other.<sup>6</sup> With Jay manning one battlement and Lynn LoPucki the other—two scholars I consider friends and, on many things, intellectual fellow travelers—it was like watching one's parents fight. Choosing sides in such situations is frightening, seeking to mediate, dangerous. Better to wait; better to make sure that I knew where I stood. I'm still not 100% sure where I stand, but I am ready to break my silence.

My goal in this Article is to shift the terms of the debate somewhat by using the tools I identified almost a decade ago to ask a more nuanced pair of architectural questions: "When are universalism and harmoniza-

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5. See Edward J. Janger, *Muddy Property: Generating and Protecting Information Privacy Norms in Bankruptcy*, 44 WM. & MARY L. REV. 1801 (2003).

6. Compare Jay L. Westbrook, *A Global Solution to Multinational Default*, 98 MICH. L. REV. 2276, 2299 (2000) [hereinafter Westbrook, *Global Solution*] ("[T]he proper long-term, theoretical solution to the problem of multinational insolvency is universalism, whether or not such a solution is achievable in the foreseeable future."), Jay L. Westbrook & Jacob S. Ziegel, *The American Law Institute NAFTA Insolvency Project*, 23 BROOK. J. INT'L L. 7, 24 (1997) ("[R]egional agreements may be the best first step in solving many of the problems of legal harmonization and cooperation coincident to the globalization of trade and investment."), and Jay L. Westbrook, *Choice of Avoidance Law in Global Insolvencies*, 17 BROOK. J. INT'L L. 499, 503 (1991) ("I believe that traditional approaches are simply unsuited to current realities. The formal manipulation of rules that purport to make "territorial" distinctions in multi-territorial transactions offers scant help in analyzing conflicts questions arising from modern multinational enterprise."), with Lynn M. LoPucki, *Cooperation in International Bankruptcy: A Post-Universalist Approach*, 84 CORNELL L. REV. 696, 750 (1999) [hereinafter LoPucki, *Cooperation*] ("Cooperative territoriality . . . eliminates the tension between countries by vesting each with bankruptcy power congruent with its sovereignty. No nation need recognize foreign authority over domestic assets or sacrifice the interests of local debtors or creditors in particular cases. The elimination of that universalist tension provides the foundation for cooperation among courts and representatives that will be mutually beneficial in each case.").

tion desirable, and when should territorialism and non-uniformity govern?" Neither Jay nor Lynn take pure positions in favor of universalism or territoriality. Jay now advocates a position of modified universalism,<sup>7</sup> and Lynn has always advocated cooperative rather than pure territorialism.<sup>8</sup> Both, however, view their moderation as a concession. Jay hopes the world will eventually be ready for true universalism, and views "modified universalism" as a camel's nose under the tent.<sup>9</sup> Lynn wishes to head off jurisdictional competition and forum shopping, and views cooperative territoriality as a concession to globalization. Jay seeks one case under one law.<sup>10</sup> Lynn prefers many cases under many laws.<sup>11</sup> I start from a more neutral perspective and conclude pragmatically that the most we should hope for is one case under many laws. I advocate a regime that I call "universal proceduralism."<sup>12</sup> Such a regime would consist of "universal" but minimally harmonized rules of transnational bankruptcy procedure, harmonized choice of law, and non-uniform substan-

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7. Westbrook, *Global Solution*, *supra* note 6, at 2277 ("Modified universalism . . . is the best answer because its pragmatic flexibility provides the best fit with the problem presented by the current patchwork of laws in the global market, and because it will foster the smoothest and fastest transition to true universalism.").

8. LoPucki, *Cooperation*, *supra* note 6, at 696 ("A system of cooperative territoriality is optimal even though it potentially requires multiple filing and prosecution of claims, cooperation among courts and administrators with respect to particular reorganizations and liquidations, and international agreements to control fleeing assets.").

9. See Westbrook, *Global Solution*, *supra* note 6, at 2299 ("Although I am more optimistic than others, universalism may not be obtainable in the foreseeable future."); see also John A. E. Pottow, *Procedural Incrementalism: A Model for International Bankruptcy*, 45 VA. J. INT'L L. 935, 992 (2005) (The Model Law's "gentle incrementalism regarding indirect, non-core areas of the law likely assuaged some hesitant, territorialism-inclined states skeptical about universalism's benefits, and perhaps even tricked (to their paternalistic betterment) some troglodyte states prejudiced against universalism altogether.").

10. See Westbrook, *Global Solution*, *supra* note 6, at 2292 ("There are two elements necessary to a universalist convention for international bankruptcy: a single law and a single forum to govern each multinational case. These two elements are distinct and need not necessarily be conjoined in an international bankruptcy system, although ideally they would be.").

11. LoPucki, *Cooperation*, *supra* note 6, at 742 ("[T]he system I propose . . . is a system in which each country would administer the assets located within its own borders.").

12. As I will discuss later, I think that the UNCITRAL Model Law is an excellent first step toward such a regime. See UNCITRAL Model Law on Cross-Border Insolvency, U.N. GAOR, 52d Sess., 72d plen. mtg. at 11, U.N. Doc. A/52/PV.72 (Dec. 15, 1997) [hereinafter Model Law]. The UNCITRAL Model Law has been enacted by the United States, and Chapter 15 incorporates the Model Law into the Bankruptcy Code with relatively few modifications. See 11 U.S.C. §§ 1501–1532 (2006).

tive law.<sup>13</sup> Moreover, I propose this not as a palliative, but as a normatively preferred regime.

The analysis is divided into four parts. In the first part, I will briefly review the state of the debate between Jay and Lynn, and stake out my reservations about both approaches—the risks associated with Jay’s aspiration to universality and harmonization of bankruptcy law, and the over-emphasis by Lynn on the problem of pernicious forum shopping. In the second part, I will develop my model for minimal transparent harmonization, a model that seeks to head off pernicious forum shopping while harnessing the benefits of jurisdictional competition where they exist. I will seek to articulate a minimal set of universal rules for bankruptcy cases that will, to the extent possible: (1) harmonize the few sets of procedures that are necessary to facilitate international bankruptcy cases (and no more); (2) allow jurisdictional competition as to efficient procedures; (3) render the choice of forum irrelevant/transparent as to the substantive law governing the entitlements of parties; and (4) limit the extent to which global economic integration will interfere with local choices about how to structure and govern business affairs. In the third part, I will argue for the normative preferability of my model to either of the “polar” approaches, and explain why I hold an entirely different view with regard to domestic insolvency law. Finally, in the fourth part, I will conclude with an evaluation of Chapter 15 of the U.S. Bankruptcy Code and the E.U. Insolvency Regulation in light of my approach.

#### I. COMPETING VISIONS OF CROSS-BORDER BANKRUPTCY LAW

When insolvency law was simply a local law for winding up a failed business and distributing its assets, local procedures for liquidation were sufficient, and local law governed.<sup>14</sup> Insolvency law had little to offer, and the law was, for all relevant purposes, harmonized. “Grab-law” prevailed.<sup>15</sup> Starting in the nineteenth century with railroad receiverships,<sup>16</sup>

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13. I do not oppose convergence or standardization of substantive bankruptcy law per se, though I do have reservations with regard to the proper scope of harmonization. These comments are not meant to indict or criticize the efforts under way at UNCITRAL and the World Bank to promulgate legislative guides for insolvency law. See, e.g., U.N. COMM’N ON INT’L TRADE LAW, UNCITRAL LEGISLATIVE GUIDE ON SECURED TRANSACTIONS, U.N. Doc. A/CN.9/WG.VI/WP.31/Add.1 (2007).

14. Indeed, this is still the default. See, e.g., Jennifer Greene, Note, *Bankruptcy Beyond Borders: Recognizing Foreign Proceedings in Cross-Border Insolvencies*, 30 BROOK. J. INT’L L. 685, 704–05 (2005); Sara Isham, Note, *UNCITRAL’s Model Law on Cross-Border Insolvency: A Workable Protection for Transnational Investment at Last*, 26 BROOK. J. INT’L L. 1177, 1180–81 (2001).

15. Bruce Mann describes the early U.S. debt collection process as follows:

and maturing in the last quarter of the twentieth century with the adoption of Chapter 11 of the U.S. Bankruptcy Code, a legal architecture developed, premised on two ideas: (1) the value of an insolvent enterprise might be maximized for the benefit of its creditors by continuing to operate the business as a going concern rather than selling it off piecemeal; and (2) the market might need a little bit of help in arranging such “efficient” reorganizations.<sup>17</sup> Going concern reorganizations are difficult enough to achieve where a business operates in one place, with one establishment and one corporate governance structure. The procedures used for accomplishing such reorganizations are highly contested.<sup>18</sup> The complexities and controversies multiply when a corporate group is involved, and multiply exponentially when the enterprise crosses jurisdictional boundaries. The challenge for the practitioners of transnational

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Since priority among unsecured creditors was determined by the order in which they served process on the debtor, and among secured creditors by the order in which they took security in the same property, time was, indeed, money. Creditors who acted earlier took precedence over creditors who acted later. Once one creditor sued, all creditors had to sue to claim a place in line.

BRUCE MANN, *REPUBLIC OF DEBTORS: BANKRUPTCY IN THE AGE OF AMERICAN INDEPENDENCE* 48 (2002).

16. See DAVID A. SKEEL, JR., *DEBT’S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA* 48–70 (2001) (also discussing railroad receiverships); Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Property Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921, 925–31 (2001) (discussing railroad receiverships).

17. See Douglas G. Baird, *A World Without Bankruptcy*, 50 LAW & CONTEMP. PROBS. 173, 181–86 (1987).

18. Compare Ted Janger, *Crystals and Mud In Bankruptcy Law: Judicial Competence and Statutory Design*, 43 ARIZ. L. REV. 559 (2001), and Elizabeth Warren & Jay Lawrence Westbrook, *Contracting Out of Bankruptcy: An Empirical Intervention*, 118 HARV. L. REV. 1197 (2005), with Barry E. Adler, *A World Without Debt*, 72 WASH. U. L.Q. 811 (1994), Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751 (2002), Douglas G. Baird, *Bankruptcy’s Uncontested Axioms*, 108 YALE L.J. 573 (1998), Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1078–79 (1992) (“Chapter 11 should be repealed, abolishing court-supervised corporate reorganizations and, in effect, precluding residual claimants from participating in any reorganization of the firm.”), Robert K. Rasmussen, *Debtor’s Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 53–54 (1992), and Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1821–22 (1998). For a response to Schwartz, see Lynn M. LoPucki, *Contract Bankruptcy: A Reply to Alan Schwartz*, 109 YALE L.J. 317 (1999), and for a surreply, see Alan Schwartz, *Bankruptcy Contracting Reviewed*, 109 YALE L.J. 343 (1999).

insolvency law is to figure out how to achieve the benefits of reorganization across national boundaries.<sup>19</sup>

*A. Universalism (Jay) Versus Territorialism (Lynn)*

For Jay, the answer lies in a bankruptcy regime that is symmetric with the market it governs.<sup>20</sup> Under such a regime, one case, and one bankruptcy regime would govern the insolvency of a transnational entity.<sup>21</sup> As a pragmatic transitional approach, he advocates what he calls “modified universalism.” Under a modified universalist regime, the insolvency case is governed from the debtor’s center of main interest (COMI). Assets in multiple jurisdictions are administered (at least in the first instance) by the local courts, but those courts defer to the main proceeding for administration of the case.<sup>22</sup> This is the approach embodied in the UNCITRAL Model Law on Cross-Border Insolvency (the “Model Law”)<sup>23</sup> enacted as Chapter 15 of the United States Bankruptcy Code (“Chapter 15”) and also by the E.U. Regulation on Cross-Border Insolvencies (the “E.U. Reg.”).<sup>24</sup>

For Lynn, universalism is a quixotic dream and modified universalism a dangerous Trojan horse, likely to do more harm than good. His principal concern is forum shopping.<sup>25</sup> Lynn has done path-breaking research on the effect of jurisdictional competition and forum shopping in the United States, and concludes that, on balance, cases that are forum shopped to Delaware or New York do worse for their stakeholders than cases that are handled in other courts.<sup>26</sup> The reason for these poor results

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19. It is important, as a preliminary matter, to distinguish the goal of allowing efficient transnational reorganizations from the goal of “exporting” a U.S. model for Chapter 11. While the U.S. model is perhaps the most advanced, it is no longer unique, and it is far from perfect. The question we all pose is whether an international effort to harmonize insolvency law can facilitate efficient reorganizations, and, if they can, are related costs excessive. I propose to remain agnostic (at least for the purposes of this piece) on the “best” way to run a reorganization.

20. Westbrook, *Global Solution*, *supra* note 6, at 2283 (“The central theoretical point is ‘market symmetry’: the requirement that some systems in a legal regime must be symmetrical with the market, covering all or nearly all transactions and stakeholders in that market with respect to the legal rights and duties embraced by those systems.”).

21. *Id.* at 2292.

22. *Id.* at 2300.

23. See Model Law, *supra* note 12, arts. 15–24.

24. See Council Regulation 1346/2000, 2000 O.J. (L 160) 1 (EC).

25. LYNN M. LOPUCKI, *COURTING FAILURE* 30 (2005).

26. *Id.* at 137–81 (finding that bankruptcy cases handled by Delaware and New York courts were prone to several abuses, including exaggerated professional fees, rubber-stamping of prepackaged plans, and retention of failed and corrupt managers).

turns, in his view, on an agency problem coupled with a race to the bottom.

The dynamic works this way. Under U.S. bankruptcy law, incumbent management chooses the bankruptcy attorneys and continues to operate the debtor in bankruptcy. They therefore have control over venue choice. Accordingly, the venue chosen is likely to be the one most favorable to incumbent management and/or its attorneys.<sup>27</sup> Bankruptcy judges, according to Lynn, enjoy handling large, high-profile cases more than a steady diet of consumers and failed real estate partnerships.<sup>28</sup> These courts therefore compete for large cases by offering the best package to the “case placers”—incumbent management and their attorneys.<sup>29</sup>

Under Lynn’s view, this competition among courts in the United States has had a pernicious effect on bankruptcy law and upon the results in actual cases. His concern is that universalism in international bankruptcy will simply take judicial competition global and replicate the poor results of Delaware in the 1990s internationally.<sup>30</sup> For this reason he opposed the adoption of Chapter 15, and opposes further enactment of the UNCITRAL Model Law.<sup>31</sup>

I have concerns about both Jay’s and Lynn’s approaches to transnational insolvency law—about modified universalism *and* cooperative territorialism. On the one hand, my articulated concerns about uniform lawmaking are applicable to international harmonization efforts and make me worry about the universalist approach. On the other hand, I think that Lynn’s concerns are overdrawn, and that the benefits of efficient reorganization of corporate groups across jurisdictional lines are considerable. Because Lynn and I are both motivated by concerns about jurisdictional competition, I will first lay out the differences between my views and his.

#### *B. LoPucki and the Oversimplification of Jurisdictional Competition*

Lynn has a point. The possibility of jurisdictional competition is an important dynamic that must be considered when seeking to harmonize any area of law. However, it is not enough to say, “Jurisdictions will compete, therefore we must not create a regime that will facilitate forum shopping.” There are two intuitive problems with this assertion. First,

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27. *Id.* at 138.

28. *See id.* at 248–49.

29. *Id.* at 249–51.

30. *Id.* at 183–205.

31. *See id.* at 207–232 (arguing that forum shopping and its failures will flourish under the UNCITRAL Model Law).

competition is not always bad.<sup>32</sup> Second, harmonization generally reduces rather than increases the stakes of forum shopping.<sup>33</sup>

The common wisdom views competition among market participants as a good thing. Markets are not perfect, but when they work, they reward efficiencies and punish inefficiency.<sup>34</sup> Competition among jurisdictions can fit this model. LoPucki, however, analogizes jurisdictional competition in the bankruptcy context to the competition for corporate charters by Delaware, and labels it a “race to the bottom.”<sup>35</sup> He does this by administering a powerful one-two punch to the usual assumptions about competition. First, he introduces an agency problem: incumbent management will choose the jurisdiction that will most willingly allow them to loot the company.<sup>36</sup> Second, he strips away the principal institution situated to prevent such looting—judges applying the law.<sup>37</sup> Lynn abstracts the judges away by branding the Delaware and New York judges as corrupt and antinomian competitors for big case business.

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32. See Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 256 (1977) (arguing that competition among states to attract corporations results in a “race to the top” which actually benefits shareholders); see also Roberta Romano, *The Need For Competition In International Securities Regulation*, 2 THEORETICAL INQUIRIES L. 387, 392–93 (2001).

Regulatory competition subjects government agencies to fluctuating inflows and outflows of regulated entities as firms transfer their activities to come under the jurisdiction of the regulator whose regime they prefer. Such competition is desirable because it reduces the possibility that a regulator will be able to transfer wealth across different regulated entities or redistribute wealth from the regulated sector to preferred individuals or organizations.

*Id.*

33. See Gregor C. Heinrich, *Funds, Transfers, Payments, and Payments Systems—International Initiatives Towards Legal Harmonization*, 28 INT'L LAW. 787, 788 (“[H]armonization of rules reduces the risk that a problem will be treated and solved differently in other countries, thus curtailing a tendency towards ‘forum shopping.’”)

34. See, e.g., Arthur R. Pinto, *The Internationalization of the Hostile Takeover Market: Its Implications for Choice of Law in Corporate and Securities Law*, 16 BROOK. J. INT'L L. 55, 63 (1990) (stating that “increased competition within and between [securities] markets provides benefits, such as lower costs of capital for firms, and allows investors to further diversify their investments”).

35. See LOPUCKI, *supra* note 25, at 243 (“[T]here was no longer any reason to believe that the courts were engaged in a race to the top. . . . The bankruptcy court competition is not a market but a market failure.”).

36. *Id.* at 241–42 (“Most managers facing bankruptcy . . . seek a court that will not investigate them too carefully, will pay them bonuses, and will allow them to negotiate a graceful exit.”).

37. *Id.* at 247–49.

Lynn extends both concerns to the international context by analogy, and tars universalist harmonization efforts with the “Delaware” brush. He assumes that jurisdictional and judicial competition in the international context will be uniformly pernicious, and he fears that adoption of the Model Law will facilitate this competition by centralizing the control of a case in one court. The same centralizing force that creates the ability to reorganize an international entity may increase the harm that a judge can do if he or she answers to the interests of incumbent management rather than the best interests of the estate.<sup>38</sup> Whether or not Lynn’s descriptions of U.S. law and, in particular, U.S. judges are correct, I leave to another day.<sup>39</sup> Still, one certainly cannot assume their accuracy in the international context. In my view, both Lynn’s economic and his institutional critiques of the Model Law are important but overstated. While he may be right about the results of forum shopping in Delaware in the 1990s, Lynn’s proclamation that forum shopping leads inevitably to a “race to the bottom” is debatable; he fails to distinguish good competition from bad, and he ignores the existence of competing institutions in the international context that might operate as brakes on the pernicious competition that he fears.

My initial focus will be on Lynn’s economic account of jurisdictional competition. I will offer a more nuanced account of the effects of jurisdictional competition on legal harmonization efforts, and will seek to show that Lynn is drawing too many conclusions about the Model Law from the Delaware example.

### *C. The Model*

Where efforts to harmonize international law are involved, jurisdictional competition does not operate overtly. It enters by the back door—through concerns about enactability. When international organizations such as UNCITRAL or UNIDROIT promulgate model laws, their enactments are not self executing. Therefore, the drafters must consider the

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38. *See id.* at 231.

39. I am considerably more sanguine about the ethics and abilities of U.S. bankruptcy judges than Lynn, who describes the judicial appointment process as follows:

When a bankruptcy judgeship becomes available, the community seeks to install one of its own. More often than not, the effort succeeds. As with any position of leadership, the one chosen incurs a debt to his or her supporters. Those supporters expect a certain amount of loyalty. If a judge forgets how he or she got the job, the judge will be reminded if and when the judge seeks a second term.

*Id.* at 20.

possible effects of jurisdictional competition and interest group capture on national legislatures. It is by now, therefore, axiomatic that model or uniform laws only achieve wide adoption in two circumstances: (1) where they provide considerable benefits over the status quo<sup>40</sup>; and (2) where there is a consensus about what the right rule is.<sup>41</sup> In my earlier

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40. See James J. White, *Ex Proprio Vigore*, MICH. L. REV. 2096, 2096 (1991).

The National Conference of the Commissioners on Uniform State Laws (NCCUSL) is a legislature in every way but one. It drafts uniform acts, debates them, passes them, and promulgates them, but that passage and promulgation do not make these uniform acts law over any citizen of any state. These acts become the law of the various states only *ex proprio vigore*—only if their own vitality influences the legislatures of the various states to pass them.

*Id.*

41. See Homer Kripke, *The Principles Underlying the Drafting of the Uniform Commercial Code*, U. ILL. L. F. 321, 327 (1962) (“Difficult legislation like this without a popular appeal can seldom be passed without a broad consensus of agreement of interested parties.”). However, the consensus may be the product of a strong interest group with disorganized opposition. See Alan Schwartz & Robert E. Scott, *The Political Economy of Private Legislatures*, 143 U. PA. L. REV. 595, 638–43 (1995) (discussing the influence that banks had on the creation and revisions of Articles 3 and 4); Robert E. Scott, *The Politics of Article 9*, 80 VA. L. REV. 1783, 1822–47 (1994) (examining the influence of interest groups on the Article 9 revision process); see also Edward Janger, *Predicting When the Uniform Law Process Will Fail: Article 9, Capture, and the Race to the Bottom*, 83 IOWA L. REV. 569, 584–88 (1998) (discussing the impact of capture by interest groups upon the ALI and NCCUSL uniform law drafting process). In a previous Article, I made this point in the following manner:

[Uniform law drafters must] draft a statute where state competition will not induce states to enact nonuniform versions of the code. On the one hand, this competition will encourage drafters to produce a good product—a statute that is well drafted and substantively superior to competing nonuniform laws regulating the same subject matter. However, they must also anticipate the likely results of interstate competition and neutralize it. In the uniform law drafting process, the desire for universal and uniform adoption drives the drafters to predict and follow the direction that state competition will lead. If state competition will encourage a race to the top, the drafters will be driven to create an efficient rule. But if competition will yield a race to the bottom, the drafters, if they are to preserve uniformity, *must* scrape the bottom as well.

Janger, *Uniform Law Process*, *supra* note 1, at 591. This idea has been similarly seconded by Robert Rasmussen:

[T]he U.C.C. competes not against academic visions of optimal regulation but against products of other flawed institutional processes. Bringing interest group analysis to the private legislature has not removed interest groups from public legislatures. With our new understanding of the drafting process of the U.C.C., the question becomes one of comparative political economy—which of the many imperfect institutions should have the primary authority for crafting

Article, I borrowed from Lucian Bebchuk's 1992 Article on jurisdictional competition for corporate charters to discuss how the desire for uniform enactment can interact with the dynamics of jurisdictional competition for both good and ill.<sup>42</sup> Bebchuk argues that competition is generally a good thing, but that it goes awry in the face of "interjurisdictional" externality and intra-firm agency problems.<sup>43</sup> Where a small state can attract firms through legal rules that harm people in other states, or where one corporate constituency (managers, shareholders, or secured creditors) can advantage themselves at the expense of a disenfranchised constituency within a firm, competition will be pernicious.

Where the effects of competition are likely to be pernicious, the desire of harmonizers for uniform enactment compounds the mischief. First, if the "benefits" of a proposed law are narrowly concentrated on a particular interest group and the costs are widely disbursed, the perceived consensus behind a proposed uniform or model law may actually reflect rent

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commercial law. Here, the U.C.C. does have advantages over public legislatures that have been under appreciated in the recent debate. Primarily, the structure of the U.C.C. drafting and revision process suggests that it will produce a more technically competent set of laws than would a public legislature. Much legislation produced by public legislatures is a slapdash affair. On average, it is going to have more gaps and internal inconsistencies than legislation produced via the U.C.C. process. In addition, the U.C.C. may reduce rent extraction by public legislatures. The need to adhere to the U.C.C. constrains the ability of legislators to offer favors to interest groups. Finally, even in areas where interest group dynamics suggest that there will be predictable flaws in the rules generated by the U.C.C. drafting process, the current situation which allows selective intervention by the federal government may be preferable to one that lodged initial lawmaking responsibility either in the state legislatures or the federal government.

Rasmussen, *supra* note 4, at 1104.

42. Janger, *Uniform Law Process*, *supra* note 1, at 589–90 (citing Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992) for the proposition that competition in state rule-making can lead to either a race to the top or a race to the bottom).

43. Bebchuk, *supra* note 42, at 1484; *see also* Edward J. Janger, *The Death of Secured Lending*, 25 CARDOZO L. REV. 1759, 1779–80 (2004).

[I]t is possible to predict whether state competition will be efficient or inefficient by asking two questions about the statute. First, does it give rise to the possibility of intra-firm externality by allowing one corporate constituency (such as shareholders or managers) to impose costs on another (such as creditors or rank and file employees)? Second, does the statute give rise to the possibility of interstate externality, by allowing one state to impose costs on the citizens of another state?

*Id.*

seeking by a particular group, rather than a universally recognized social benefit. Enactment of a proposed uniform law under these circumstances benefits the interested group virally, at the expense of the general public. Second, problems can arise where a small state can impose costs on the rest of the world. Where one jurisdiction can benefit itself at the expense of others, the harmonizers must anticipate the effect of captured legislatures and jurisdictional competition in order to obtain or preserve universal adoption. Uniform laws are helpless in the face of, and may even further, these effects.<sup>44</sup>

By contrast, in the absence of these perverse dynamics, competition is a good thing. States may seek to compete based on various criteria: procedural innovations, well-run courts, economic infrastructure, well-trained work force, legal predictability, or legal creativity.<sup>45</sup> These types of competition should be encouraged, even though they may pose problems for harmonization. Uniformity should not, where possible, stand in the way of innovation or experimentation.

Harmonizers must therefore anticipate these dual dynamics when constructing a law for which they seek uniform adoption. They must beware of pernicious competition and avoid facilitating it, while either anticipating beneficial competition or, better yet, permitting it to flourish. This is not an inevitable indictment of harmonization efforts. Instead, it raises questions. First, can the scope and content of a harmonization effort be designed to foster beneficial competition and head off pernicious competition? Second, is the pernicious competition a permanent or transitory problem that will ultimately be forestalled or corrected by other institutions? Even 'pernicious' jurisdictional competition is not likely to succeed in the long run unless it is linked to a permanent (or at least persistent) agency problem.<sup>46</sup> Where a jurisdiction is adopting an inefficient rule in order to compete for some form of business, market discipline should correct the problem over time. Only where there is an interested

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44. See Janger, *Uniform Law Process*, *supra* note 1, at 578 (noting that competition exists among states to enact uniform laws that will enhance a state's attractiveness to business).

45. See generally Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J. L. ECON. & ORG. 225 (1985).

46. Since in the corporate context the corrective to the race to the bottom is the market for corporate control, Bebchuk is particularly skeptical about Delaware laws that undercut transparency or discourage takeovers. Bebchuk, *supra* note 42, at 1462–63. In the Article 9 context, I argued that a race to the bottom may be created by the disenfranchisement of certain non-consensual and non-adjusting creditors. Janger, *Uniform Law Process*, *supra* note 1, at 592 ("The problem of intrafirm externality exists whenever there is a conflict of interest between corporate managers and one corporate constituency that cannot make its voice heard.").

group that is consistently on the receiving end of an externality (because it lacks a voice in the choice of forum) will forum shopping lead to the permanent adoption of an inefficient rule.<sup>47</sup>

*D. Applying the Model—Territoriality, Constrained Venue Choice, Choice of Law, and the Benefits of Competition*

With these principles in mind, I argued that domestically, in the context of commercial law, the uniform law process ought to focus on procedural efficiencies and avoid distributive choices.<sup>48</sup> Distributive questions should be addressed at the local (non-uniform) level to allow for competition and diversity of approach, or, where uniformity is necessary or pernicious competition inevitable, at the federal level.<sup>49</sup>

When evaluating an international harmonization effort in this light, it is crucial to identify the key attributes of the legal scheme and to allocate them to the appropriate lawmaking level—local or harmonized. Unlike lawmaking in the United States and European Union, there is no “federal” or supranational authority that can command uniformity.<sup>50</sup> My concerns about both Lynn and Jay’s positions turn on the failure to distinguish among: (1) rules for choice of forum (which carries with it choice of procedure); (2) rules for choice of law; and (3) rules creating substan-

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47. Of course, the short-run/long-run argument does nothing in the abstract. If short run costs can be prevented through regulation (without adverse consequences), so much the better.

48. My argument went as follows:

Because the uniform law process appears to have both relative advantages and disadvantages over the federal and nonuniform law drafting processes, it might seem wise to self-consciously adopt an approach of selective abstention. When there is no reason to expect the uniform law process to fail, it should be allowed to function and do what it does well. However, when capture, anticipated capture, or an anticipated race to the bottom are likely to drive the uniform law process, the ALI/NCCUSL should decline to regulate the area and leave the question to federal law or nonuniform state law.

Janger, *Uniform Law Process*, *supra* note 1, at 593.

49. *Id.*

50. Where transnational insolvency is concerned, a crucial element of the calculus is that there is no federal government that can compel the compliance of all participants across jurisdictions. On the other hand, a second institution is present in the international context, which is missing in the United States—strong states (not subject to the supremacy clause or commerce clause) willing to defend their sovereignty.

tive entitlements.<sup>51</sup> Jay and Lynn both collapse these three types together, and therefore draw their prescriptions too broadly.

The UNCITRAL Model Law focuses on the first question and does not speak to the last two.<sup>52</sup> As John Pottow has pointed out, this narrow procedural focus is politically expedient.<sup>53</sup> For Jay, it is only a first step in a larger program to harmonize both procedure and substance.<sup>54</sup> For Lynn, it is already a step too far.<sup>55</sup> For me, it is also a first step on the way to an even more important second step, harmonizing choice of law principles, but I would, for the most part, stop there.<sup>56</sup>

It is here that I think Lynn's critique takes a wrong turn. Lynn sees the Model Law as enhancing the power of the debtor's chosen forum, and hence increasing the stakes of jurisdictional competition.<sup>57</sup> He is right that the universalist aspects of the Model Law increase the importance of the "main" forum, but Lynn ignores the fact that the Model Law simultaneously constrains forum choice. Lynn's mistake here is to ignore (or at

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51. For our purposes, while choice of forum, rules for choice of procedure, and rules of procedure can be conceptually distinguished, jurisdictions always apply their own procedures. Choice of forum, therefore, carries with it choice of procedure.

52. See Pottow, *supra* note 9, at 995 ("[T]he Model Law sought to focus on matters of procedure and thereby . . . minimized the likelihood it would be perceived as a substantial threat to sovereignty.").

53. *Id.*

54. See Westbrook, *Global Solution*, *supra* note 6, at 2279 ("While the current reforms are only first steps, they go well beyond what most observers would have predicted just five years ago.").

55. See LOPUCKI, *supra* note 25, at 222 ("The problem [of jurisdiction in multinational bankruptcies] cannot be solved merely by providing that all members of the group should file in the home country of the group."). For LoPucki, harmonization (even procedural harmonization) is likely to have undesirable substantive consequences:

*Harmonization* is a euphemism for forcing commercially less important countries to adopt the remedies and priorities of the commercially more important countries. (Some Machiavellians may have endorsed universalism in the first place hoping it would lead to this forced harmonization.) That harmonization would be painful for people in countries that would be forced to change the basic rules of their economic cultures—for example, elevating secured banks to priority over employees. Such harmonization would greatly reduce the incentives for forum shopping. But it would hardly eliminate the international competition for cases.

*Id.* at 231–32.

56. With regard to efforts to achieve international convergence in bankruptcy law currently under way at UNCITRAL and the World Bank, I have reservations. However, both projects appear to be moving forward with a healthy recognition of the risks I articulate here. I hope to discuss them in a later article.

57. LOPUCKI, *supra* note 25, at 231.

least minimize) the limit imposed by the requirement that the main case be located at the debtor's center of main interest. He therefore overstates the change worked by the Model Law. Lynn also underestimates the independent importance of choice of law in the forum shopping equation. Just because a single court administers a case does not necessarily mean that the court will apply its own law of substantive entitlements. First, a court must decide what substantive law applies to the dispute. Courts do this all the time. In this regard, I think that Lynn's concerns about pernicious forum shopping are excessive.<sup>58</sup> Lynn also fails to appreciate the fact that competition, to the extent that it focuses on and is limited to issues of procedure and efficiency, is actually a good thing.

*E.. Applying the Model—Universalism and the Risks of Excessive Harmonization*

My concerns with the universalist approach to international insolvency also derive from the model discussed above, but they are not as complicated. While I think that Lynn's concern about the Model Law and Chapter 15 is excessive, because he ignores its limited focus on choice of forum and procedure, Jay has frequently described modified universalism as a stopping point on the way to true universalism, where substantive law would be harmonized and true market symmetry attained.<sup>59</sup> I do not

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58. Here, however, I differ with the views articulated by Jay in his contribution to this symposium, Jay Lawrence Westbrook, *Locating the Eye of the Financial Storm*, 32 BROOK. J. INT'L L. 1019 (2007), and with the approach taken by the UNCITRAL Legislative Guide on Insolvency with regard to choice of law for bankruptcy cases. Jay argues that once a main case has been identified, that choice should carry with it what he calls the "big four" choice of law decisions associated with a bankruptcy case—control, priority, avoidance, and reorganization policy. Recommendation 31 of the UNCITRAL Legislative Guide on Insolvency follows a similar approach. UNCITRAL, LEGISLATIVE GUIDE ON INSOLVENCY LAW 69, 73 (2004), available at [www.uncitral.org/pdf/english/texts/insolven/05-80722\\_Ebook.pdf](http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf). For reasons that I will explore in a subsequent Article, I believe that this approach places too much power in the hand of the forum court and will place undue stress on the nascent cross-border architecture.

59. Westbrook, *Global Solution*, *supra* note 6, at 2283; Jay Lawrence Westbrook, *Multinational Enterprises in General Default: Chapter 15, the ALI Principles, and the EU Insolvency Regulation*, 76 AM. BANKR. L.J. 1, 9 (2002).

There is no doubt that national insolvency laws differ greatly, especially as to priority in distribution, and that these differences will continue to exist for some time. Modified universalism responds to this difficulty by proposing a pragmatic development of universalism, moving toward the ultimate goal within the practical limits established by the markets and by local laws at any particular time and place.

*Id.*

share Jay's broader aspiration. Like Lynn, Jay tries to analogize in the international context from a domestic model, and the analogy does not work for him either. When Jay speaks of market symmetry, he envisions and aspires to a world that works like one country, indeed, like the United States, with a national bankruptcy law that allows an enterprise's failure to be adjudicated by one court under one law.<sup>60</sup> Jay wishes for something—attainable in the United States because we have a strong federal government—that is simply not attainable internationally. No such strong central government exists, nor is one likely to exist any time in the foreseeable future.

Seeking the ideal of "one law" is a dangerous aspiration where it cannot practically be attained. In the international context, uniform laws can only be accomplished through harmonization and convergence. Such harmonization is only possible where there is consensus around a single rule. Such consensus is difficult to obtain, so the scope of harmonization will necessarily be narrow. Moreover, some consensus may be misleading. When one group benefits from harmonization, the consensus may be driven by the disenfranchisement of other affected groups (usually because of collective action problems). Therefore, in my view, the aspirations of international harmonization efforts should be kept minimal, both for pragmatic reasons (consensus is difficult to obtain), and for normative ones (consensus, where it exists, is often driven by a dominant interest group).

#### *F. Minimal Transparent Harmonization*

Unlike Lynn, I am not compelled by my concerns about jurisdictional competition to abandon an aspiration for efficient reorganization of corporate groups coordinated by a court at the entity's center of main interest. Unlike Jay, I do not seek more than that. My goal is an international bankruptcy regime that I call "universal proceduralism." By choosing a forum, one elects a particular bankruptcy procedure, but that procedure should be "transparent" with regard to substantive rights across national boundaries. Through a regime of harmonized "choice of law," the effects of forum choice on substantive rights can and should be minimized. Like Jay, I think Chapter 15 is a welcome first step toward my preferred regime.

## II. UNIVERSAL PROCEDURALISM

When one defines a system of insolvency laws, one starts with a nation's rules for creating and enforcing substantive entitlements. In the

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60. Westbrook, *Global Solution*, *supra* note 6, at 2292.

absence of special insolvency rules, parties have a strong incentive to grab whatever they can, as quickly as possible, off the carcass of a failing business.<sup>61</sup> In this guise, insolvency law is indistinguishable from the law of contracts and the law of property. Judgments are obtained, judgments are enforced. First in time is first in right—end of story. Insolvency law morphs into bankruptcy law when one envisions a collective system for liquidating claims and distributing the proceeds under court supervision.<sup>62</sup> With this additional layer, one adds rules for determining the priority of property claims and for prioritizing contractual debt claims. Up to this point, the system is largely one of substantive entitlements defined by local law. One procedural mechanism is added, a stay of actions that preserves the status quo, allows the various claims to be adjudicated, and allows the various assets to be distributed in an orderly fashion.<sup>63</sup> If an entity is being liquidated piecemeal, no particular efficiencies are created by global administration.

The need for market symmetry, for a bankruptcy regime that is coextensive with the reach of the business entity, emerges when reorganization merges with governance. At some point in the development of a modern bankruptcy system, somebody asks the question, “Wouldn’t we be better off continuing to run the business rather than liquidating?” So long as an entity is solvent, this governance problem is submerged, because the firm is governed by its shareholders and managers. Once it goes into default, the entity faces a practical and legal governance problem.<sup>64</sup> Creditors, who have no governance rights, do have the power to

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61. See Edward J. Janger, *Privacy Property, Information Costs, and the Anticommons*, 54 HASTINGS L.J. 899, 925 (2003) (“When a debtor with a viable business becomes insolvent, creditors face a coordination problem. Unless they act quickly to grab the assets of the debtor, others may get there first.”).

62. See Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738, 749–50 (1988) (“Because bankruptcy is a collective proceeding, the bankruptcy judge has the power in some cases to bind nonconsenting parties. Without such a power, there would be no way to overcome the collective action problem that is the justification for bankruptcy in the first instance.”); Eric A. Posner, *The Political Economy of the Bankruptcy Reform Act of 1978*, 96 MICH. L. REV. 47, 50–51 (1997) (noting that the state law collective action problem creates a need for bankruptcy law).

63. See 11 U.S.C. § 362(a) (2006) (automatic stay provision).

64. See *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 WL 277613, at \*34 (Del. Ch. Dec. 30, 1991) (stating that “where a corporation is operating in the vicinity of insolvency,” its officers and directors owe a duty to creditors as well as shareholders). New York law takes a similar approach to the management of insolvent companies. See *New York Credit Men’s Adjustment Bureau v. Weiss*, 110 N.E.2d 397, 398 (N.Y. 1953) (“If the corporation was insolvent . . . it is clear that defendants, as officers and directors thereof, were to be considered as though trustees of the property for the

pull apart an insolvent business. The creditors are diffuse and face coordination problems. The insight of modern bankruptcy systems is that by barring the exit door and giving creditors governance rights, the stakeholders are more likely to continue the firm in business where it is efficient to do so than they are to force an inefficient liquidation.<sup>65</sup> The puzzle of transnational bankruptcy law is how to facilitate efficient going concern reorganization without encouraging pernicious forum shopping, driven by a favorable set of priorities or governance rules. To complicate matters further, such a regime should also allow courts to compete over procedural efficiencies, and allow legal systems to make substantive choices about how to define entitlements within their own jurisdictions. This puzzle and the model described above suggest a typology for evaluating laws that are candidates for harmonization: (1) procedures where uniformity is not necessary and competition (and innovation) is likely to be helpful; (2) procedures where coordination is required in order to obtain the benefits of reorganization; (3) choice of law rules which should be harmonized where possible; (4) substantive provisions where convergence is desirable; (5) substantive provisions where local variety is tolerable or even desirable. Harmonization is desirable in categories 2, 3, and 4, and undesirable in categories 1 and 5.

According to Lynn, the Model Law is an attempt to harmonize procedural rules that fall into the first category.<sup>66</sup> Lynn's critique of Delaware focuses on the principal reason for pernicious forum shopping—agency problems.<sup>67</sup> The unsung anti-heroes in his story are what he calls the “case placers,” an unholy alliance between incumbent management, lawyers at a few select New York law firms, and the bankers who finance the cases.<sup>68</sup> For them, the beauty of Delaware is that the courts have

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corporate creditor-beneficiaries.”); *see also* Cooper v. Parsky, 1997 WL 242534, at \*22 (S.D.N.Y. Jan. 8, 1997) (“Under New York law, creditors are owed a fiduciary duty by officers and directors of a corporation only when the corporation is insolvent.”).

65. In the United States, this governance decision is facilitated through a number of devices that straddle the line between procedure and substance. While the automatic stay can be viewed as procedural, insofar as it seeks to preserve the status quo by stopping collection efforts, regulation of governance is substantive. U.S. law places the power of governance in the debtor in possession, supervised by committees and the court. *See* 11 U.S.C. § 1107(a) (2006).

66. LOPUCKI, *supra* note 25, at 221–26.

67. *Id.* at 255 (“Instead of squeezing failed executives out, the [Delaware] courts allowed more of them to stay and even approved multimillion-dollar bonuses to ‘retain’ them.”).

68. *Id.* at 17 (“The lawyers, corporate executives, banks, and investment bankers who chose the courts for their cases—the ‘case placers’—had the power to make winners or

demonstrated a willingness to allow incumbent management and its helpers to maintain control of the case, and hence of the company.<sup>69</sup> Lynn's concern about the Model Law is that by centralizing the administration of a case in the court located at the debtor's COMI,<sup>70</sup> the Model Law gives jurisdictions something to compete over and the power to deliver benefits to the parties who place cases with them.<sup>71</sup>

In my view there are four responses to Lynn's concerns about Chapter 15. In articulating this response to Lynn with regard to the Model Law, I will develop these four responses into the four guiding principles of the "universal proceduralist" approach. This approach is generally consistent with, though not coextensive with the approach taken in Chapter 15 and the Model Law. It seeks to harness jurisdictional competition where it is beneficial and render it pointless where it is pernicious. The four principles are: (1) minimal procedural harmonization; (2) legal transparency through choice of law principles; (3) COMI-based venue choice; and (4) comity principles including limited articulated bases for non-cooperation. I will discuss each of these in order.

#### *A. Minimal Procedural Harmonization*

The first principle that Universal Proceduralism offers in response to LoPucki is minimal procedural harmonization. For Lynn, even the procedures created by the Model Law, centralizing an international bankruptcy case at the debtors COMI, create too much of an opportunity for pernicious competition. Lynn is right that there are risks to procedural harmonization, but Lynn focuses on the wrong risks. As I will discuss below, the risks of pernicious competition caused by procedural harmonization are tolerable. The greater risk associated with procedural harmonization is that it will preclude competition and innovation that might lead to greater efficiency.

Thus, the first element of "universal proceduralism" is to identify the minimum set of procedures that will allow reorganization to happen on an entity-wide level without disturbing the relative priority of local entitlements or disturbing local governance rights. This approach is not de-

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losers of the courts. The case placers wanted more money for themselves and freedom from the restrictions of bankruptcy law and procedure.").

69. *Id.* at 255.

70. See Model Law, *supra* note 12, art. 17(2)(a); see also 11 U.S.C. § 1517(b)(1).

71. LOPUCKI, *supra* note 25, at 216 ("[F]orum-shopping multinationals . . . will choose among courts that are plausibly their home country courts. The chosen courts will, of course, be competitive ones. Those courts will hold quick hearings, declare themselves to be the home country courts, open the proceedings, and declare those proceedings to be main.").

signed to stop forum shopping, but to limit its pernicious effects and encourage it where beneficial. Parties should shop for “good” judges, and favor “well run” courts. They should not shop for biased judges who will favor the party making the forum choice, or for biased local law. In this regard, it seems to me that the Model Law strikes an appropriate balance. It formulates a set of rules that fall within the second category. They facilitate the administration of a case between and among courts, and little else.

The Model Law’s major provisions can be set forth quite succinctly: (1) it provides procedures for a representative of a foreign proceeding to obtain recognition and open a case domestically;<sup>72</sup> (2) it puts in place an automatic stay;<sup>73</sup> (3) it describes the relief available to a foreign representative in such a way that administering the case will not interfere with cases pending in other countries;<sup>74</sup> (4) it defines which proceeding is the “main” proceeding;<sup>75</sup> (5) it creates mechanisms to permit communication among courts with cases pending involving the debtor;<sup>76</sup> (6) it creates principles for coordinating pending proceedings;<sup>77</sup> and (7) it creates a rule to prevent claimants from double dipping where there are multiple cases pending.<sup>78</sup>

With these exceptions, the Model law leaves most of a country’s bankruptcy rules untouched. It does not establish priorities. It does not confer avoidance powers. It does not establish governance rules, rules for administering a case, or rules for confirming a plan of reorganization. All of these other crucial aspects of bankruptcy law are left to local law (including choice of law).

### *B. Harmonized Choice of Law*

The second principle of “universal proceduralism” is harmonization of choice of law principles. Lynn’s critique ignores choice of law entirely. Lynn assumes that with choice of forum goes choice of law.<sup>79</sup> The forum jurisdiction, he asserts, will generally apply its own law to the bank-

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72. See Model Law, *supra* note 12, art. 9; see also 11 U.S.C. § 1515.

73. See Model Law, *supra* note 12, art. 20(1); see also 11 U.S.C. §§ 1520–1521.

74. See Model Law, *supra* note 12, art. 19(4); see also 11 U.S.C. § 1519(c).

75. See Model Law, *supra* note 12, art. 2(b); see also 11 U.S.C. § 1502(4).

76. See Model Law, *supra* note 12, art. 25(2); see also 11 U.S.C. § 1525(b).

77. See Model Law, *supra* note 12, art. 29; see also 11 U.S.C. § 1529.

78. See Model Law, *supra* note 12, art. 23; see also 11 U.S.C. § 1530.

79. LOPUCKI, *supra* note 25, at 232 (arguing that if court competition prevails, “multinational companies [will be] free to choose the courts in which they will reorganize or liquidate and the law that will govern the rights of their creditors and other stakeholders”).

ruptcy cases that are filed there.<sup>80</sup> This assumption is not logically compelled. Choice of forum and choice of law are two distinct inquiries. Courts can and do apply the law of other jurisdictions to disputes that come before them.<sup>81</sup> They also can, and do, apply the law of other countries.<sup>82</sup>

Indeed, while the Model Law does not attempt to do this, the risk of pernicious forum shopping could be considerably reduced through the harmonization of choice of law principles. Where choice of law principles are harmonized, choice of forum does not alter the substantive law that applies to a case. This is not a novel approach. Under Article 9 of the Uniform Commercial Code, one public filing will perfect a security interest in all fifty states, because all fifty states have adopted a uniform choice of law rule.<sup>83</sup> Even without formal harmonization, there exists broad commonality about certain choice of law principles. Property rights are generally determined by the law of the jurisdiction where the property or the debtor is located.<sup>84</sup> Contracts are governed by the law of the jurisdiction with the most significant interest in the transaction—the situs of the contract.<sup>85</sup> There are certainly variations in approach for intangible property and for contracts that have no obvious location, but for many disputes the answers are predictable. For example, an employment contract between an American company and a French employee working in France will likely be governed by French labor law. To the extent that choice of law principles can be harmonized, choice of forum will diminish in importance.

The harder question is how such a multi-law case should be administered. U.S. bankruptcy law provides a model, and the Model Law does not preclude it. In a case involving a corporate group, multiple cases could be administratively consolidated in one court yet decided according to the bankruptcy law of multiple jurisdictions. While such a regime sounds facially implausible, and working out the details will require

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80. *Id.* at 231.

81. *See, e.g.*, 16 AM. JUR. 2D *Conflict of Laws* § 5 (1964).

82. *See id.* §§ 9–11.

83. *See* U.C.C. § 9-301 (1998).

84. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 223(1) (1971) (“Whether a conveyance transfers an interest in land and the nature of the interest transferred are determined by the law that would be applied by the courts of the situs.”). Under Article 9 of the Uniform Commercial Code, certain property rights are governed by the law of the jurisdiction where the debtor is located. *See* U.C.C. § 9-301 (1998).

85. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 188(1) (1971) (“The rights and duties of the parties with respect to an issue in contract are determined by the local law of the state which, with respect to that issue, has the most significant relationship to the transaction and the parties . . .”).

more space than is available here, it is still preferable to, or at least no more complicated than, the “cooperative territorial” approach advocated by LoPucki. Indeed, to a certain extent, this approach has already been used in at least one bankruptcy case.<sup>86</sup>

An example might help here. If one imagines the case of a debtor with three subsidiaries in three different countries, there are three possibilities available to the main court for administering the proceeding. Once it has opened ancillaries in the countries where assets or subsidiaries are located, it could: (1) administer the assets of the subsidiary through the ancillary proceedings with the cooperation of those courts in a proceeding not unlike the “cooperative territoriality” described by LoPucki;<sup>87</sup> (2) it could centrally administer all of the assets, but handle the claims of the subsidiary’s creditors under the law of the subsidiary’s jurisdiction, much as a court does in the United States when a case is administratively (but not substantively) consolidated; or (3) the case might be substantively consolidated. Universal proceduralism would follow the second approach. Universalism would favor the third.

Universal proceduralist principles can also be applied to the case of a single corporate debtor with assets and operations spread across the globe. Assets might be centrally administered in the main case, but the location of the assets, local law governing those assets, and the law governing the claimants against those assets might be respected rather than collapsed.

Substantive consolidation is the result that LoPucki assumes will always occur, because it is easier to administer, and because he assumes that the home country court is unconstrained by an appellate court or federal law.<sup>88</sup> Here he misapprehends the dynamics of the international bankruptcy system. The decision to consolidate is not unconstrained. Unlike a U.S. case where the orders of one bankruptcy court are self-executing and enforceable throughout the United States. (but subject to appellate review),<sup>89</sup> the judge in a main case must still obtain the cooperation of foreign courts.

While the Model Law will make cooperation among courts administratively easier to obtain, cooperation is not a given. Local courts that perceive that their citizens are being harmed may resist cooperation, and

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86. The *Collins & Aikman Group* case, described by Gabriel Moss in his contribution to this symposium, appears to have followed this approach. See Gabriel Moss, *Group Insolvency – Choice of Forum and Law: The European Experience Under the Influence of English Pragmatism*, 32 BROOK. J. INT'L L. 1005 (2007).

87. See LoPucki, *Cooperation*, *supra* note 6, at 750.

88. LOPUCKI, *supra* note 25, at 231.

89. See 28 U.S.C. 1334(e) (2005).

Article 21 of the Model Law, along with section 1522 of Chapter 15, allow them to resist actions taken by the court in the main case that violate local law. The need for cooperation and the threat of non-cooperation place significant constraints on the ability of debtors to use the main case to ignore creditor expectations through forum choice.

### *C. Constrained Venue Choice*

The third principle of universal proceduralism is constrained venue choice. LoPucki heaps particular scorn on the peculiarity in U.S. law that combines state of incorporation as a basis for venue and the so-called “venue hook.”<sup>90</sup> This pair of rules allows all members of a corporate group to file wherever an affiliate has a case pending. Thus virtually any corporate group can file in Delaware, and reorganize all affiliates in that court, regardless of where the business’s operations, assets, and executives are actually located. LoPucki’s extension of this critique to the UNCITRAL Model Law and the E.U. Reg. turns on his view that the “center of main interest” approach used in those statutes is the functional equivalent of U.S. law and will give forum shopping free reign.

LoPucki is correct that the COMI standard is a standard rather than a rule, but he is wrong to equate it with the U.S. rule (which is clear but offers little constraint). While it is true that multiple jurisdictions may lay claim to status as the COMI for a multinational enterprise, the standard is not completely manipulable. It is unlikely that more than two or three jurisdictions will be in a position to claim that they are a debtor’s COMI. Management, significant assets, or business operations must be present for a jurisdiction to qualify as the COMI.

Most importantly, however, LoPucki again ignores the necessarily multi-jurisdictional nature of the cases governed by the Model Law. Under U.S. law, bankruptcy courts have jurisdiction over property “wherever located and by whomever held”,<sup>91</sup> and can gain personal jurisdiction through nationwide service of process.<sup>92</sup> A bankruptcy court in New York can enforce its judgment against assets in Montana without involving the Montana courts (though it might choose to). While the bank-

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90. See LOPUCKI, *supra* note 25, at 252 (“[N]ew rules should eliminate the venue hook—the ability of a parent company to file in the court where the bankruptcy of a subsidiary is pending. Members of a corporate group should be allowed to reorganize together only at the location of the parent company or the group.”).

91. 11 U.S.C. § 541(a); see also *H.K. & Shanghai Banking Corp., Ltd. v. Simon (In re Simon)*, 153 F.3d 991, 996 (9th. Cir. 1998) (holding that the jurisdictional reach of §541(a) extends outside the territorial jurisdiction of the United States), *cert. denied*, 525 U.S. 1141 (1999).

92. See Fed. R. Bankr. P. 7004(d).

ruptcy estate may have extraterritorial reach, U.S. courts, as a practical matter, only have jurisdiction over parties and assets in the United States. This gives U.S. courts expanded reach with regard to many creditors who do business in the United States. However, this power is not global. Courts must generally enforce their orders in foreign jurisdictions by opening a proceeding in that jurisdiction and seeking to have their orders recognized.

While the Model Law makes recognition of the foreign proceeding automatic, and grants a stay of proceedings upon recognition,<sup>93</sup> there are many situations in which the Model Law permits the local court to determine whether the relief requested should be granted.<sup>94</sup> Even where the Model Law does not permit it, such discretion exists as a practical matter. The proceeding contemplated by the Model Law is not self-executing. The court handling the main proceeding must still obtain the cooperation of the foreign court.<sup>95</sup> While the Model Law instructs a court in a non-main proceeding to defer to the main proceeding,<sup>96</sup> there is no logical reason why the main/non-main characterization of a case cannot and therefore will not be contested, where an implausible choice has been made. While the debtor may have a number of plausible choices as to which jurisdiction is main and which is non-main, concern about defending that choice will limit the debtor's discretion and the forum court's power.

#### *D. Comity*

While principles of comity and the instruction to cooperate contained in the Model Law encourage courts to defer to each other, comity is a double-edged sword. Comity principles also allow a court to conclude that an act of a foreign court is not entitled to respect or cooperation. Even where such behavior is discouraged by statute, foreign courts have the power to say "no." Whenever deciding whether it is the main proceeding, a court must consider whether it is the right court to administer the debtor's case. Whenever seeking cooperation, courts must be careful to articulate the reasons why their orders are entitled to respect.

##### 1. The Limits of Cooperation

Courts faced with these decisions are always cognizant of the risk of a "war of courts." They ignore this concern at their peril. One excellent

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93. See *supra* notes 71–72 and accompanying text.

94. See Model Law, *supra* note 12, art. 19; see also 11 U.S.C. § 1521.

95. See Model Law, *supra* note 12, art. 10; see also 11 U.S.C. § 1519.

96. See Model Law, *supra* note 12, art. 28; see also 11 U.S.C. § 1529.

example arises out of the *Yukos* bankruptcy.<sup>97</sup> There a Russian oil company with virtually all of its assets and operations in Russia created a subsidiary in Texas for the sole purpose of opening a case there. The Texas bankruptcy court opened the case, and the debtor immediately sought to enjoin the sale by Yukos of all of its assets in Russia.<sup>98</sup> Though the forum shop was blatant, the U.S. court issued the injunction anyway.<sup>99</sup> The U.S. court ignored the fact that, to enforce its order, it would have to obtain the cooperation of the Russian courts.<sup>100</sup> The sale in Russia went ahead as planned.<sup>101</sup> The only effect of the Texas court's order was that certain bidders, who had assets in the United States, did not bid in Russia because they did not wish to disregard the U.S. order (likely reducing the price obtained at auction).<sup>102</sup>

Even in a regime such as that envisioned by the Model Law, comity remains important as a structural principle. The possibility of a war of courts continues to limit the power of the main proceeding. Cooperation must be earned. In the "universal" world that Jay envisions, the goal will be a one-court proceeding with automatic recognition and virtually man-

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97. *In re Yukos Oil Co.*, 320 B.R. 130 (Bankr. S.D. Tex. 2004) (order granting initial injunction against auction), *and dismissed*, two months later, 321 B.R. 396 (Bankr. S.D. Tex. 2005) (dismissing Yukos Oil's Chapter 11 petition for "cause" under 11 U.S.C. §1112(b) on the basis that Yukos' ability to successfully effectuate its reorganization plan was severely hindered by the Russian government's apparent unwillingness to cooperate with Yukos, and moreover, Yukos' motives in filing were questionable in light of Yukos' transfer of funds to a U.S. bank account less than one week prior to filing its bankruptcy petition).

98. *Id.* at 132.

99. *Id.* The court perfunctorily concluded "that Debtor maintains significant assets in the Southern District of Texas, and that Debtor has standing to be a debtor under Chapter 11 of the Bankruptcy Code." *Id.*; *see also* Gregory L. White, Russel Gold & Thaddeus Herrick, *Yukos Seeks Refuge in a U.S. Court*, WALL ST. J., Dec. 12, 2004, at A3.

100. *See* Gregory L. White & Guy Chazan, *Mystery Russian Company Wins Bid on Yukos Unit—Offer of \$9.37 Billion Seals Fate of Beleaguered Firm, But Many Questions Linger*, WALL. ST. J., Dec. 20, 2004, at A1.

101. *See* Erin E. Arvedlund & Simon Romero, *Kremlin Reasserts Hold on Russia's Oil & Gas*, N.Y. TIMES, Dec. 17, 2004, at A1.

102. *Id.*; *see also* Guy Chazan, *Intrigue Deepens Over Yukos Buyer—Gazprom Sells Unit Snared In U.S. Court, While Bidder is Tied to Siberia's Surgut*, WALL ST. J., Dec. 22, 2004, at A2. More recently, the Russian debtor sought recognition in an ancillary case under Chapter 15. *See* Chapter 15 Petition for Recognition of Foreign Proceeding filed by Yukos Oil Co. (In re: Petition of Eduard K. Rebgun, as Receiver of Yukos Oil Co.), No. 06-B-10775 (Bankr. S.D.N.Y. Apr. 13, 2006), *available at* [http://www.chapter15.com/bin/chapter15\\_view\\_company?cid=1145244846](http://www.chapter15.com/bin/chapter15_view_company?cid=1145244846). Under the current regime, and under the Model Law regime, courts will still have the resources to fight back.

datory cooperation.<sup>103</sup> In the world that I envision, cooperation will be a strong presumption, but can be withheld. As such, it is necessary to seek to articulate the principles that might disentitle an order of a main proceeding to cooperation.

## 2. Comity Principles that Permit Non-cooperation

If the goal of an international insolvency law that facilitates efficient cross-border reorganizations is to be realized, the circumstances under which a court should decline to cooperate with a foreign main proceeding must necessarily be limited and carefully defined. There are three appropriate bases under which a court might decline to cooperate with a main proceeding without compromising the goal of efficient case administration: agency, illegality, and violation of creditors' expectations. These principles fit comfortably within general principles of comity, but they are worth articulating and defining with some particularity in the bankruptcy context.

### *a. Agency*

Agency problems create a very limited basis for objecting when a court concludes that the main proceeding is administering the estate in a way that advantages one stakeholder class but harms the estate as a whole. It is important to recognize that this principle does not turn on the distributional scheme of the particular country, but on whether assets are being wasted for the benefit of a particular stakeholder. Needless to say, principles of deference should apply, and it is not sufficient that one court concludes that the other court is not maximizing value. Rather the conclusion must be that the other court is destroying value at the behest of, and for the benefit, of one class of stakeholders.

### *b. Illegality*

A second limited basis for non-cooperation arises when a court can be shown not to be following the choice of law or substantive law principles that its own choice of law or substantive law principles would require. In other words, the court declining to cooperate would have to show that the court with which it was declining to cooperate was acting illegally.

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103. See Westbrook, *Global Solution*, *supra* note 6, at 2299 (“[T]he proper long-term, theoretical solution to the problem of multinational insolvency is universalism, whether or not such a solution is achievable in the foreseeable future.”).

*c. Creditor Expectations*

Finally, protection of creditor expectations provides a limited basis for non-cooperation if the act of the main proceeding would defeat the legitimate expectations of domestic creditors. This is not unlike the standard in former section 304 of the U.S. Bankruptcy Code.<sup>104</sup> These legitimate expectations should be judged against the background of the fact that creditors knew they were doing business with a foreign entity. In most instances, choice of law principles applied in the main proceeding should provide sufficient protection to the legitimate expectations of these creditors. Defeated creditor expectations, therefore, should only rarely provide a basis for non-cooperation.

None of these bases for non-cooperation are anything new. Most of them would have operated as bases for non-cooperation under former sections 304 and 305 of the U.S. Bankruptcy Code. The key point here is that these limited bases for non-cooperation should be sufficient to limit the extent of pernicious forum shopping under the COMI standard of the Model Law without foreclosing the legitimate reasons for choosing one court over another, and without stifling the development of local law.

*E. Conclusion*

In practice, there may be relatively little difference between what I describe as universal proceduralism and what Jay describes as modified universalism. The difference lies in aspiration, rather than practical administration. Modified universalism starts small, but retains larger aspirations. It is these larger aspirations that worry me, and they worry me for some of the same reasons that they worry Lynn. There are benefits to harmonization, but it has a dark side too. It can facilitate pernicious jurisdictional competition. It can stifle beneficial jurisdictional competition as well, and because it is limited to areas where there is consensus, it may be substantively watered down. On balance I think the benefit of harmonizing key aspects of bankruptcy procedure outweighs the costs, but I would keep the scope narrow in order to leave room for local legislation.

## III. UNIVERSAL PROCEDURALISM BUT DOMESTIC TRADITIONALISM

While I have spent most of my effort in this Article arguing against the limited aspirations of LoPucki's cooperative territoriality, I think that his work demonstrates important limits on the universalist vision of one case

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104. See 11 U.S.C. § 304, *repealed by* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, 119 Stat. 146.

and one law. Lynn's view is that neither one case nor one law are achievable goals without giving rise to the unacceptable cost of facilitating a race to the bottom, and perhaps eliminating beneficial legal diversity.<sup>105</sup> In my view, the goal of one case is achievable, but the goal of one law is neither achievable nor desirable.

Under any scenario that I can envision, applying "one law" to a transnational case will either create excessive incentives for forum shopping, or require excessive levels of harmonization. My concern lies in the limits of harmonization. To the extent that harmonization is sought on distributive questions, the likely motivation for the harmonization effort will be to benefit a concentrated interest group at the expense of the public at large. To the extent that harmonization is not achieved, then these same distributive questions will create tremendous pressures on participants in the bankruptcy system to engage in forum shopping. In my view, the best we can hope for is a bankruptcy regime which administers a case in a common coordinated proceeding, but which is transparent as to the major distributive questions regarding property distribution and governance. This may require one court to apply many different laws to different pieces of property and to the different legal entities involved in the case.

The question that Jay might raise is whether such an arrangement is workable enough to allow reorganizations to occur. I believe it will still be a significant improvement over current law. Bankruptcy courts are familiar with cases that are administratively but not substantively consolidated. As such, they are familiar with the need to administer a number of entities in one case, sometimes with multiple plans. Universal proceduralism means that in some of these cases, the court may have to actually administer some of the cases under different bankruptcy laws. In doing so, they may need to seek the assistance of the ancillary courts in other jurisdictions, but the goal should be to gain the collective benefits of coordination without disturbing the expectations of national creditors.

The principles I have articulated here are quite similar to those articulated by Baird and Jackson in their work on the so-called "creditors' bargain" heuristic.<sup>106</sup> In their view, the goal of bankruptcy law should be limited to the steps necessary to correct the collective action problem

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105. Lynn M. LoPucki, *Global and Out of Control?*, 79 AM. BANKR. L.J. 79, 102 (2005) ("Harmonization is a euphemism for forcing commercially less important countries to adopt the remedies and priorities of the commercially more important countries.").

106. See Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97 (1984).

created by the race of diligence.<sup>107</sup> Non-bankruptcy entitlements should not be disturbed beyond the minimum necessary to capture the so-called reorganization dividend or going concern value.<sup>108</sup> In other scholarship, I have argued that this approach understates the aspirations of domestic bankruptcy law.<sup>109</sup> Baird and Jackson's argument turns on a combination of contractarian theory, concerns about judicial competence, and concerns about forum shopping. Ronald Mann has pointed out that the "contractarian" argument does not work to the extent that it applies to arguments about how to divide up reorganization surplus.<sup>110</sup> I have argued that judicial competence does not generate an argument for proceduralism either.<sup>111</sup> Finally, the only argument that remains is Baird and Jackson's concern about forum shopping into bankruptcy. That argument too disappears domestically when one realizes that bankruptcy specific priorities condition the negotiations that occur in the shadow of bankruptcy. For these reasons, I am not convinced by the "proceduralist" argument in connection with domestic bankruptcy.

In international bankruptcy, however, the proceduralist's forum shopping argument has bite. To the extent that individual countries make bankruptcy specific choices about legal entitlements, they raise the stakes of true jurisdictional forum shopping and increase the likelihood of a race to the bottom. Thus, to the extent that countries need to be free to experiment with their local bankruptcy policies and to regulate the behavior of local entities inside or outside of bankruptcy, the law of transnational insolvencies should not seek to influence or limit those options.

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107. *Id.* at 100 ("[B]ankruptcy law at its core should be designed to keep individual actions against assets, taken to preserve the position of one investor or another, from interfering with the use of those assets favored by the investors as a group.").

108. Baird and Jackson argue as follows:

The relevant bankruptcy goal . . . is not that a firm stay in business, but rather that its assets are deployed in a way that, consistent with applicable nonbankruptcy restrictions, advances the interests of those who have rights in them. When there is no going-concern surplus, a reorganization would seem inappropriate because the firm's assets are worth more (and hence the owners recover more of what they advanced the debtor) if the assets are sold and used by third-party purchasers than they are if kept together. Conversely, when a firm's assets *are* worth more as a going concern, the owners, as a group, are probably better off if the assets are kept together, even though the firm may have defaulted on some of its obligations or may be insolvent.

*Id.* at 118–19.

109. See Janger, *supra* note 18, at 566–83.

110. See Ronald J. Mann, *Bankruptcy and the Entitlements of the Government: Whose Money is it Anyway?*, 70 N.Y.U. L. REV. 993 (1995).

111. See Janger, *supra* note 18, at 593–98.

## IV. UNIVERSAL PROCEDURALISM IN PRACTICE—SOME CONCLUDING THOUGHTS ON CHAPTER 15

The UNCITRAL Model Law on Cross-Border Insolvency is now the law in the United States and nine other countries, including the United Kingdom, Japan, and Mexico.<sup>112</sup> In my view, it provides a legal framework that can foster a universal proceduralist regime. Indeed, the pragmatic genius of the Model Law is that it provides a framework for cooperation that can accommodate case structures of almost any type. It clearly favors, however, a regime where cases are opened in the various jurisdictions where an entity has assets, executive offices, operations, or subsidiaries, and that those cases will “defer” to the main proceeding opened in the entity’s COMI.

As implemented in the United States, Chapter 15 gives a foreign representative access to U.S. courts to open either an ancillary case or a full blown case under another chapter of Title 11. Recognition of the proceeding is automatic,<sup>113</sup> and a stay goes into effect with regards to the debtors assets in the United States.<sup>114</sup> Other relief is available under U.S. law to the extent the foreign representative requests it, including the power to operate the business. It creates mechanisms that allow courts to communicate and coordinate the proceedings pending in various courts.

To the extent that it addresses the concerns I have raised above, the Model Law satisfies the requirements of universal proceduralism. It harmonizes only the minimal procedures necessary to administer a cross border case. It defines the “main case” as the case opened in the jurisdiction that is the debtor’s center of main interest. As I have discussed above, this is a term that is open to significant interpretation, as the recent *Eurofoods* decision<sup>115</sup> under the E.U. Reg. demonstrates, but it provides sufficient constraint on forum shopping to be preferable to the ad hoc mechanisms available under current law. It also contains limits on comity that should prevent a main proceeding from competing in ways that violate the principles of agency, legality, or creditor expectations described above. In particular sections 1507 and 1522 allow the court to deny relief requested by the foreign representative if it is not in the inter-

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112. Bob Wessels, *Will UNCITRAL Bring Changes to Insolvency Proceedings Outside the USA and Great Britain? It Certainly Will!*, 3 INT’L CORP. RESCUE 200, 201 (2006) (“Several countries have indeed enacted legislation that—to a varying extent—incorporates the Model Law into domestic law, these countries are Eritrea, Japan, Poland, South Africa, Spain, Mexico and within Yugoslavia, Montenegro, USA and (as of 4 April 2006) Great Britain.”).

113. See Model Law, *supra* note 12, art. 9; see also 11 U.S.C. § 1515.

114. See Model Law, *supra* note 12, art. 20; see also 11 U.S.C. §§ 1520–1521.

115. Case C-341/04, Eurofood IFSC Ltd., 2006 E.C.R. I-3813.

est of creditors or affected parties.<sup>116</sup> These provisions are broad enough to allow the court to consider the principles articulated above.

The element missing from the Model Law, and which remains to be accomplished if a system of universal proceduralism is to be realized, is a harmonized set of choice of law principles. This, it seems to me, is the next and most important step in realizing a regime of universal proceduralism.

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116. See Model Law, *supra* note 12, arts. 7, 22; see also 11 U.S.C. §§ 1507, 1522.

# INCREMENTALISMS IN GLOBAL LAWMAKING

*Susan Block-Lieb*\* & *Terence C. Halliday*\*\*

## I. INTRODUCTION

Academics have noted that global law may develop only slowly—two steps forward, three steps back, three steps forward, two steps back. Some are frustrated with the interminable pace and the fragmentation caused (they claim) by incrementalism in international law.<sup>1</sup> To others, the gradual accretion of international law constitutes strength. For example, Oona Hathaway<sup>2</sup> describes the benefits of incremental international law-making in this way:

Rather than confront states immediately with a legal regime that couples challenging goals with strong sanctions for failure to meet them, states can be gradually led toward stronger legal rules. This can be ac-

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Both authors have been involved in UNCITRAL proceedings since 1999: Block-Lieb as a delegate from the American Bar Association and Halliday as a social scientific observer. Our findings are based on a combination of research methods, including participation in all formal Working Group and Commission sessions and informal expert meetings, statistical analysis of speech turns by all delegates, content analysis of all recommendations, and interviews of key delegates and UNCITRAL staffers during all phases of the proceedings.

1. See, e.g., Johathan I. Charney, *Technology and International Negotiations*, 76 AM. J. INT'L L. 78, 79–80 (1982) (“While traditionally the international law relevant to new technological developments has slowly evolved out of the customs and practices of nations before being codified in international agreements, . . . the current international situation has been characterized as ‘functional eclecticism’ or ‘incrementalism,’ which means that a relatively disorganized international community reacts in an ad hoc manner to direct needs and demands.”); Sara Dillon, *Looking for the Progressive Empire: Where is the European Union’s Foreign Policy?*, 19 CONN. J. INT’L L. 275, 278 (2004) (arguing that “decades-old European Community ‘method’—rational planning, bureaucratic solutions, suppression of political passion and a steady incrementalism—is incapable of catching popular fire in a way that would allow the EU to mount a true global challenge to the U.S.”).

2. Oona A. Hathaway, *Between Power and Principle: An Integrated Theory of International Law*, 72 U. CHI. L. REV. 469, 531 (2005) (constructing an integrated theory of international law, and observing that one method for mediating “conflict between commitment and compliance” with international law involves moving “states incrementally down the path toward stronger international rules with true enforcement provisions”).

completed by starting with relatively weak international rules backed by little or no sanctions that all states feel comfortable joining, but then gradually pushing states to accept successively stronger and more challenging requirements.<sup>3</sup>

The benefits of incrementalism are, thus, only revealed over time. These benefits are also prominent when assessing how to tackle hard cases for global reform. Incremental development of global law is more often championed where law reformers possess limited authority<sup>4</sup> and where the subject is either controversial<sup>5</sup> or technical<sup>6</sup> (or both).

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3. *Id.*

4. Amichai Cohen similarly describes bureaucracies and administrative agencies as legitimizing international law, albeit only incrementally. Amichai Cohen, *Bureaucratic Internalization: Domestic Governmental Agencies and the Legitimization of International Law*, 36 GEO. J. INT'L L. 1079, 1107–08 (2005). Cohen describes agencies' slow progress in implementing international norms to domestic policy in this way:

Revolution via bureaucracy will never be considered legitimate. In cases of persistent domestic opposition to the implementation of international law, agencies can only take small steps, constantly seeking to change public perceptions and ideas. Hence, when an agency uses its legitimacy to promote a specific policy, it usually does so through an incremental process of policy changes.

*Id.*; see also Sabino Cassese, *Administrative Law Without the State? The Challenge of Global Regulation*, 37 N.Y.U. J. INT'L L. & POL. 663 (2005); James Salzman, *Decentralized Administrative Law in the Organization for Economic Cooperation and Development*, 68 L. & CONTEMP. PROBS. 189 (2005) (making a similar observation in the context of describing the Organization for Economic Cooperation and Development (OECD)).

5. For a defense of the incrementalism with which international environmental law often proceeds, see, for example, Philippa England, *Book Reviews*, 54 INT'L & COMP. L.Q. 1037, 1038 (2005) (reviewing Francis Botchway, *International Encyclopaedia of Laws, Supplement 46*, in INTERNATIONAL ENCYCLOPAEDIA OF LAWS: ENVIRONMENTAL LAW) (“More sophisticated legal techniques are not necessarily the solution—realistic, feasible solutions driven by the political will of leaders, the general population and supported by the international community may offer a more incremental but ultimately more effective method of dealing with environmental issues.”). See also Melissa E. Crow, *Smokescreens and State Responsibility: Using Human Rights Strategies to Promote Global Tobacco Control*, 29 YALE J. INT'L L. 209 (2004) (describing recommendations for incremental development of international standards on tobacco regulation).

6. See, e.g., Arthur J. Cockfield, *Tax Integration Under NAFTA: Resolving the Conflict Between Economic and Sovereignty Interests*, 34 STAN. J. INT'L L. 39, 58 (1998) (defending “gradualism” on the topic of integration of tax laws of NAFTA member states); Carl Felsenfeld & Genci Bilali, *The Role of the Bank for International Settlements in Shaping the World Financial System*, 25 U. PA. J. INT'L ECON. L. 945, 1044 (2004) (noting that the international financial system has evolved (and should evolve) “incrementally, changing marginally in response to pressures from markets and governments, not discontinuously in response to radical visions”); Janet Koven Levit, *The Dynamics of*

Not surprisingly, then, incrementalists have found much to like about global insolvency law reform. John Pottow describes the “genius” of the Model Law on Cross-Border Insolvency promulgated by the United Nations Commission on International Trade Law (UNCITRAL) as a combination of its “modesty of scope” and “procedural focus”—attributes that together lead him to describe the Model Law as the product of “procedural incrementalism.”<sup>7</sup> Pottow’s work is important because, more than simply noting that the Model Law on Cross-Border Insolvency constitutes incremental reform and lauding the benefits of its incrementalism, it also attempts to explain *how* international law develops incrementally.<sup>8</sup> By focusing his theory of procedural incrementalism on a single

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*International Trade Finance Regulation: The Arrangement on Officially Supported Export Credits*, 45 HARV. INT’L L.J. 65, 69 (2004) (pointing to the Arrangement on Officially Supported Export Credits as a case study and concluding: “In its pragmatism, the elasticity of its soft form, consensus-backed incrementalism, and dialogue-enhancing procedures [sic], the Arrangement is an international regulatory framework that effectively beckons compliance, thereby deserving attention and emulation.”).

7. John A. E. Pottow, *Procedural Incrementalism: A Model for International Bankruptcy*, 45 VA. J. INT’L L. 935, 939 (2005). Pottow describes UNCITRAL’s incrementalism in the Model Law on Cross-Border Insolvency as follows:

By adopting an incrementalist and procedurally animated approach (what I call “procedural incrementalism” as a shorthand), the Model Law created an opportunity to bridge the theoretical gap between universalists and territorialists. This was accomplished obliquely: on the surface, the Model Law bridged it by appearing to be a hybrid of universalism *and* territorialism, with something seemingly for everyone. Beneath the surface, however, the Model Law actually advanced universalism, and in a way that caused minimal affront to territorialist jurisdictions. The Model Law’s design thus allowed hesitant states to “acclimate” to a regime of universalism. This is the genius of the Model Law and makes it unprecedented in its effectiveness as a mechanism of international reform.

*Id.*

8. Pottow is not the first scholar to note that “soft law” assists in promoting the incremental development of global law. *See, e.g.*, Kenneth W. Abbott & Duncan Snidal, *Hard and Soft Law in International Governance*, 54 INT’L ORG. 421, 446 (2000) (“Because even soft legal agreements commit states to characteristic forms of discourse and procedure, soft law provides a way of achieving compromise over time.”); David M. Trubek et al., “*Soft Law, “Hard Law,” and European Integration: Toward a Theory of Hybridity*,” 11-12 (Univ. of Wis. Legal Stud. Res. Paper Series, Paper No. 1002, 2005), available at <http://SSRN.com/abstract=855447> (constructing a list of explanations as to “why soft law might be preferable to hard law in some circumstances,” and listing “incrementalism” as “one such benefit” in that “[s]oft law can also represent a first step on the path to legally binding agreements or hard law”); *see also* Wolfgang H. Reinicke & Jan Martin Witte, *Interdependence, Globalization, and Sovereignty: The Role of Non-Binding International Legal Accords*, in COMMITMENT AND COMPLIANCE: THE ROLE OF

episode of global lawmaking, however, Pottow may place undue emphasis on the “procedural focus” of incremental global lawmaking, and may not fully appreciate its dynamic benefits.

More than simply appraise the case for incrementalism, we also explain how incrementalism works, offering a dynamic model of incrementalism with potentially broad application. Focusing on how UNCITRAL has engaged in global lawmaking over its roughly forty-year tenure, we find that incrementalism takes at least three forms.<sup>9</sup> *Vertical* incrementalism occurs when international organizations dig more deeply in a particular area over progressive rounds.<sup>10</sup> *Horizontal* incrementalism can be observed when international organizations expand the substantive boundaries of the range of topics they seek to embrace in successive rounds. *Pyramidal* incrementalism occurs when an international organization deliberately drafts its norms by standing on the shoulders of prior efforts of other international organizations.

This careful examination of methodologies permits us to observe important connections between UNCITRAL’s incremental progress in law

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NON-BINDING NORMS IN THE INTERNATIONAL LEGAL SYSTEM 75, 76 (Dinah Shelton ed., 2000) (explaining that non-binding international legal agreements “are not necessarily an alternative to international hard law or inter-state cooperation, but they can and often do represent the first important element in an evolutionary process that shapes legal relationships among and between multiple actors, facilitating and ultimately enhancing the effectiveness and efficiency of transnational policy-making”).

9. This dynamic model of incremental global lawmaking is not meant to assert that soft law should only serve “as a way station to harder legalization,” nor that “legal agreements have an inevitable life cycle from softer toward harder legalization.” Abbott & Snidal, *supra* note 8, at 423, 447 (“Hard law is probably more likely to evolve from soft law than from (utopian) plans to create hard law full-blown. But this does not imply that all soft legalization is a way station to hard(er) legalization, or that hard legalization is the optimal form.”). Like Abbott and Snidal, we see important normative value in soft law, but leave explication of the circumstances in which soft law should be preferred to hard law for another time. Here, we argue that international and global law often develops incrementally, that the incremental development of law may in some instances be assisted by first adopting soft laws that, over time, become harder, that the incremental development of global law may, in other instances, take a horizontal or pyramidal path rather than a vertical one, and, finally, that incremental global lawmaking can bolster the legitimacy of the lawmaker.

10. Although we are the first to call this sort of progress “vertical incrementalism,” we are not the first to note that the incremental development of international law may, and indeed perhaps should, take a path in which agreements slowly harden over time. *See, e.g.*, Hathaway, *supra* note 2, at 531 (“The creation of weak international rules may frequently serve to offset pressure for stronger rules that would be more effective. Hence this incrementalist strategy must be embarked upon with caution. In fact, if incrementalism is to be successful, it may be necessary to require participants in the regime to make successive steps toward stronger and more enforceable rules.”).

reform and the legitimacy<sup>11</sup> with which the international community views its law reform efforts.<sup>12</sup> Political science scholarship indicates that the legitimacy of international organizations comes from three sources: representativeness; procedural fairness; and effectiveness. We argue that incrementalism facilitates legitimacy because it assists an international organization in promoting (a perception of) its effectiveness to the international community. If the organization meets the standards for success that it sets itself, it is more likely to be considered effective. Setting and meeting achievable goals are more important, then, than setting and meeting grandiose goals. On this ground, success in taking a series of small steps is preferable to having made an unsuccessful attempt at achieving grand plans. Over time the repeated meeting of incremental improvements sets up expectations that its success will occur as a matter of course. Since that success involves the perceived rightness of its actions and products, audiences will be more inclined to take-for-granted the naturalness of obedience, compliance, or conformity to the norms promulgated by the organization.

Insolvency law highlights the benefits of UNCITRAL's incrementalism (and the relationship between its incrementalism and its legitimacy) precisely because international agreement on the substance of insolvency law was believed by many to present insoluble difficulties. Experts were (and some remain) skeptical of the likelihood of global reform of insolvency laws, both because insolvency law is thought to be more deeply embedded in national traditions and legal cultures than other areas where

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11. Legal sociologist Mark Suchman defines legitimacy as "a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions." Mark C. Suchman, *Managing Legitimacy: Strategic and Institutional Approaches*, 20 ACAD. OF MGMT. REV. 571, 574 (1995). By this he means that an actor, such as a nation-state, corporation, or NGO, believes in the "rightness" of a rule or the authority of an institution. If a rule is legitimate, it should be obeyed. If an institution has authority, it should be acknowledged. In either case, an external standard becomes internalized by an actor. It is critical to recognize that legitimacy is a *subjective* state, that is, it depends on a perception by others. See also JÜRGEN HABERMAS, COMMUNICATION AND THE EVOLUTION OF SOCIETY ch. 5 (Thomas McCarthy trans.) (1979); IAN HURD, LEGITIMACY AND POWER IN INTERNATIONAL RELATIONS (forthcoming 2007); Tom R. Tyler, *A Psychological Perspective on the Legitimacy of Institutions and Authorities*, in THE PSYCHOLOGY OF LEGITIMACY: EMERGING PERSPECTIVES ON IDEOLOGY, JUSTICE, AND INTERGROUP RELATIONS 416 (John T. Jost & Brenda Major eds., 2001). We know an institution is legitimate by the assessments and behaviors of its audiences or constituencies; legitimacy should not be equated with coercion or self-interest.

12. For further discussion of the legitimacy of UNCITRAL, see Susan Block-Lieb & Terence Halliday, *Legitimation and Global Lawmaking*, (Fordham L. Legal Studies Res. Paper No. 952492, 2006), available at <http://ssrn.com/abstract=952492>.

successful conventions and model laws have been developed, such as sales and arbitration, and because there is wide substantive and institutional divergence of insolvency regimes across the world's nations. Moreover, insolvency law puts on the table fundamental policy disputes over the relative market power of parties often in conflict—owners and managers, managers and workers, secured creditors and unsecured creditors, shareholders and stakeholders. Differences in insolvency regimes reflect differences in the principal ways that states and markets are regulated. Insolvency law is thought to be a highly complex area where the authority of technical specialists might be expected to dominate.<sup>13</sup>

This Article provides a glimpse at the incremental path UNCITRAL has followed and offers preliminary comments on the methodology and benefits of incrementalism. Part II of this Article looks historically at the international instruments promulgated by UNCITRAL since its inception, and notes its incremental progress within various areas of trade law. Part III examines in greater detail the efforts of a single working group within UNCITRAL: the Working Group on Insolvency Law. Part IV comments on the connections between legitimacy and incremental global law reform.

## II. UNCITRAL'S INCREMENTALISMS

The United Nation's General Assembly adopted a resolution to establish its Commission on International Trade Law in 1966.<sup>14</sup> In justifying the creation of UNCITRAL, the General Assembly "[r]eaffirm[ed] its conviction that divergencies arising from the laws of different States in matters relating to international trade constitute one of the obstacles to the development of world trade."<sup>15</sup> Because other international organizations had been established earlier with the same ends in mind and law reform had only slowly lumbered forward, the Resolution justified the need for yet another international organization devoted to "the progressive harmonization and unification" of trade law on the grounds that "[broader] participation in this field on the part of many developing countries" would "be desirable" and that the U.N. was uniquely positioned both to provide a more representative forum for law reform and to "co-ordinate[], systematize[] and accelerate[]" the process of "harmonization and unification of the law of international trade."<sup>16</sup>

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13. BRUCE G. CARRUTHERS & TERENCE C. HALLIDAY, *RESCUING BUSINESS: THE MAKING OF CORPORATE BANKRUPTCY LAW IN ENGLAND AND THE UNITED STATES* 1-11 (1998).

14. G.A. Res. 2205(XXI), U.N. Doc. A/RES/2205 (Dec. 17, 1966).

15. *Id.*

16. Here are the relevant four paragraphs from G.A. Res. 2205(XXI):

This charter, on its face, encourages UNCITRAL to proceed incrementally by providing that UNCITRAL “shall further the progressive harmonization and unification of the law of international trade,” not simply by adopting conventions, but through eight different permitted means. The Resolution grants UNCITRAL broad leeway in the form of the international instrument through which it chooses to accomplish law reform, indicating that it should “prepar[e] and promot[e] the adoption of new international conventions, model law[,] and uniform laws,” as well as “promot[e] the codification and wider acceptance of international trade terms, provisions, customs[,] and practices . . . .” Incrementalism is invited, if not virtually assured, by the range of international instruments and other technologies of law reform permitted by the Resolution.

The Resolution also envisions UNCITRAL as a coordinator of global law reform as much (and arguably even more than) as a source of global law. Seven of the eight proscribed means for furthering the “progressive harmonization and unification of the law of international trade” that appear in the Resolution involve the coordination of other organizations.<sup>17</sup> Paragraph eight provides that UNCITRAL may proceed by:

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*Having noted with appreciation* the efforts made by intergovernmental and non-governmental organizations towards the progressive harmonization and unification of the law of international trade by promoting the adoption of international conventions, uniform laws, standard contract provisions, general conditions of sale, standard trade terms and other measures,

*Noting at the same time* that progress in this area has not been commensurate with the importance and urgency of the problem, owing to a number of factors, in particular insufficient co-ordination and co-operation between the organizations concerned, their limited membership or authority and the small degree of participation in this field on the part of many developing countries,

*Considering* it desirable that the process of harmonization and unification of the law of international trade should be substantially co-ordinated, systematized and accelerated and that a broader participation should be secured in furthering progress in this area,

*Convinced* that it would therefore be desirable for the United Nations to play a more active role towards reducing or removing legal obstacles to the flow of international trade . . . .

*Id.*

17. José Angelo Estrella Faria, Secretary to UNCITRAL’s Working Group in Electronic Commerce, explains the number and range of law reform bodies in existence at the time of UNCITRAL’s creation in this way:

Obviously, UNCITRAL was not the first international organization to act in the field of harmonization of commercial and private law. Both the Hague Conference on Private International Law (“Hague Conference”) and the International

- (a) Co-ordinating the work of organizations active in this field and encouraging co-operation among them;
- (b) Promoting wider participation in existing international conventions and wider acceptance of existing model and uniform laws;
- (c) Preparing or promoting the adoption of new international conventions, model laws and uniform laws and promoting the codification and wider acceptance of international trade terms, provisions, customs and practices, in collaboration, where appropriate, with the organizations operating in the field;
- (d) Promoting ways and means of ensuring a uniform interpretation and application of international conventions and uniform laws in the field of the law of international trade;

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Institute for the Unification of Private Law (“UNIDROIT”) had made remarkable contributions to legal harmonization long before the United Nations was established in 1945.

Following the establishment of the United Nations, a second group of international organizations involved in the development of rules of international commercial law emerged. Before the creation of UNCITRAL, this group included other organs of the United Nations, such as the United Nations Conference on Trade and Development (“UNCTAD”), the U.N. Economic Commissions for Africa (“ECA”), Asia and the Pacific (“ESCAP”), Europe (“ECE”), and Latin America and the Caribbean (“ECLAC”). On a worldwide scale, there were also specialized agencies of the United Nations, such as the International Bank for Reconstruction and Development (“World Bank”), the United Bureaux for Protection of Intellectual Property (“BIRPI”), which later became the World Intellectual Property Organization (“WIPO”), the Intergovernmental Maritime Consultative Organization (“IMCO”), which later became the International Maritime Organization (“IMO”), and the International Civil Aviation Organization (“ICAO”).

A third group of international organizations, separate from those established by the United Nations, also aided in the development of international commercial law. This group included regional organizations and intergovernmental groupings, such as the European Economic Community (“EEC”), the Council of Mutual Economic Assistance, the Council of Europe, the various inter-American (such as the Organization of the American States) and Latin-American organizations (such as the Latin-American Association of free trade (“ALALC”)), and the Organization of African Unity (“OAU”).

Finally, non-governmental organizations, such as the International Chamber of Commerce (“ICC”) and the International Maritime Committee (“CMI”), had for several decades worked towards trade law harmonization.

José Angelo Estrella Faria, *The Relationship Between Formulating Agencies in International Legal Harmonization: Competition, Cooperation, or Peaceful Coexistence? A Few Remarks on the Experience of UNCITRAL*, 51 LOY. L. REV. 253, 255–56 (2005).

- (e) Collecting and disseminating information on national legislation, and modern legal developments, including case law, in the field of the law of international trade;
- (f) Establishing and maintaining a close collaboration with the United Nations Conference on Trade and Development;
- (g) Maintaining liaison with other United Nations organs and specialized agencies concerned with international trade;
- (h) Taking any other action it may deem useful to fulfil [sic] its functions.<sup>18</sup>

Subsequent paragraphs broaden the scope of coordination UNCITRAL is directed to fulfill, by permitting it also to “consult with or request the services of any international or national organization, scientific institution and individual expert,”<sup>19</sup> as well as to “establish appropriate working relationships with intergovernmental organizations and international non-governmental organizations concerned with the progressive harmonization and unification of the law of international trade.”<sup>20</sup> These paragraphs of the Resolution direct UNCITRAL to progress pyramidally—to make incremental progress on the “progressive harmonization and unification of the law of international trade” by coordinating with and, if possible, standing on the shoulders of earlier efforts of other organizations (international and national, governmental, intergovernmental and non-governmental, within the United Nations and outside it).

UNCITRAL is probably best known for its drafting of the Convention on Contracts for the International Sales of Goods (CISG),<sup>21</sup> which has been adopted in more than fifty countries including the United States.<sup>22</sup>

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18. G.A. Res. 2205(XXI), *supra* note 14, ¶ 8.

19. *Id.* ¶ 11.

20. *Id.* ¶ 12.

21. United Nations Convention on Contracts for the International Sale of Goods (1980), available at <http://www.uncitral.org/pdf/english/texts/sales/cisg/CISG.pdf> [hereinafter CISG].

22. For a list of the roughly seventy nations that have adopted the CISG in one form or another, see UNCITRAL: United Nations Commission on International Trade Law, [http://www.uncitral.org/uncitral/en/uncitral\\_texts/sale\\_goods/1980CISG\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/sale_goods/1980CISG_status.html) (last visited Mar. 21, 2007). Neither Japan nor the United Kingdom has adopted the CISG. *See id.*

**Table 1. UNCITRAL Work Products and Legal Technologies: 1974–2005**

<b>Year</b>	<b>UNCITRAL Work Product</b>	<b>Legal Technology</b>
1974	Convention on the Limitation Period in the International Sale of Goods	convention
1976	Arbitration Rules	rules
1978	Convention on the Carriage of Goods by Sea (the "Hamburg Rules")	convention
1980	Conciliation Rules	rules
1980	Convention on Contracts for the International Sale of Goods	convention
1982	Recommendations to assist arbitral institutions and other interested bodies with regard to arbitrations under the UNCITRAL Arbitration Rules	recommendations
1982	Unit of Account Provision and Provisions for the Adjustment of the Limit of Liability in International Transport and Liability Conventions	model legislative provisions
1983	Uniform Rules on Contract Clauses for an Agreed Sum Due Upon Failure of Performance	rules
1985	Model Law on International Commercial Arbitration	model law
1985	Recommendation on the Legal Value of Computer Records	recommendation
1987	Legal Guide on Drawing Up International Contracts for the Construction of Industrial Works	legal guide
1988	Convention on International Bills of Exchange and International Promissory Notes	convention
1991	Convention on the Liability of Operators of Transport Terminals in International Trade	convention
1992	Legal Guide on International Countertrade Transactions	legal guide
1992	Model Law on International Credit Transfers	model law
1993	Model Law on Procurement of Goods and Construction with Guide to Enactment	model law + guide to enactment
1994	Model Law on Procurement of Goods, Construction and Services, with Guide to Enactment	model law + guide to enactment
1995	Convention on Independent Guarantees and Stand-by Letters of Credit	convention
1996	Notes on Organizing Arbitral Proceedings	notes
1996	Model Law on Electronic Commerce with Guide to Enactment	model law + guide to enactment
1997	Model Law on Cross-Border Insolvency with Guide to Enactment	model law + guide to enactment

2000	Legislative Guide on Privately Financed Infrastructure Projects	legislative guide
2001	Model Law on Electronic Signatures with Guide to Enactment	model law + guide to enactment
2001	Convention on the Assignment of Receivables in International Trade	convention
2002	Model Law on International Commercial Conciliation with Guide to Enactment and Use	model law + guide to enactment and use
2003	Model Legislative Provisions on Privately Financed Infrastructure Projects	model legislative provisions
2005	Convention on the Use of Electronic Communications in International Contracts	convention
2005	Legislative Guide on Insolvency Law	legislative guide

Over the past forty years, UNCITRAL has produced conventions, model laws, legislative guides, and other international instruments on many areas of procedural and substantive law, including international arbitration,<sup>23</sup> e-commerce,<sup>24</sup> international payments,<sup>25</sup> procurement, and

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23. See, e.g., UNCITRAL, UNCITRAL Arbitration Rules (1976), available at <http://www.uncitral.org/pdf/english/texts/arbitration/arb-rules/arb-rules.pdf>; UNCITRAL, UNCITRAL Conciliation Rules (1980), available at <http://www.uncitral.org/pdf/english/texts/arbitration/conc-rules/conc-rules-e.pdf>; *Recommendations to Assist Arbitral Institutions and Other Interested Bodies with Regard to Arbitrations Under the UNCITRAL Arbitration Rules Adopted at the Fifteenth Session of the Commission*, [1982] 8 Y.B. UNCITRAL 420, available at <http://www.uncitral.org/pdf/english/texts/arbitration/arb-recommendation/arb-recommendation-e.pdf>; UNCITRAL, UNCITRAL Model Law on International Commercial Arbitration (1985), available at [http://www.uncitral.org/pdf/english/texts/arbitration/ml-arb/06-54671\\_Ebook.pdf](http://www.uncitral.org/pdf/english/texts/arbitration/ml-arb/06-54671_Ebook.pdf); UNCITRAL, UNCITRAL Notes on Organizing Arbitral Proceedings (1996), available at <http://www.uncitral.org/pdf/english/texts/arbitration/arb-notes/arb-notes-e.pdf>; UNCITRAL, UNCITRAL Model Law on International Commercial Conciliation with Guide to Enactment and Use (2002), available at <http://www.uncitral.org/pdf/english/texts/arbitration/ml-conc/ml-conc-e.pdf>.

24. UNCITRAL, UNCITRAL Recommendation on the Legal Value of Computer Records (1985), available at <http://www.uncitral.org/pdf/english/texts/electcom/computerrecords-e.pdf>; UNCITRAL, UNCITRAL Model Law on Electronic Commerce with Guide to Enactment (1996), available at [http://www.uncitral.org/pdf/english/texts/electcom/05-89450\\_Ebook.pdf](http://www.uncitral.org/pdf/english/texts/electcom/05-89450_Ebook.pdf); UNCITRAL, UNCITRAL Model Law on Electronic Signatures with Guide to Enactment (2001), available at <http://www.uncitral.org/pdf/english/texts/electcom/ml-elecsig-e.pdf>; UNCITRAL, United Nations Convention on the Use of Electronic Communications in International Contracts (2005), available at [http://www.uncitral.org/pdf/english/texts/electcom/06-57452\\_Ebook.pdf](http://www.uncitral.org/pdf/english/texts/electcom/06-57452_Ebook.pdf).

25. United Nations, United Nations Convention on International Bills of Exchange and International Promissory Notes (Dec. 9, 1988), available at [http://www.uncitral.org/pdf/english/texts/payments/billsnotes/X\\_12\\_e.pdf](http://www.uncitral.org/pdf/english/texts/payments/billsnotes/X_12_e.pdf) [hereinafter Convention on International Bills of Exchange and International Promissory Notes]; UNCITRAL, UNCITRAL Model Law on International Credit Transfers (1992), available at <http://www.uncitral.org/pdf/english/texts/payments/transfers/ml-credittrans.pdf>; UNCITRAL, United Nations Convention on Independent Guarantees and Stand-By Letters of Credit (1995), available at <http://www.uncitral.org/pdf/english/texts/payments/guarantees/guarantees.pdf> [hereinafter Convention on Independent Guarantees and Stand-By Letters of Credit]; United Nations, United Nations Convention on the Assignment of Receivables in International Trade (2001), available at <http://www.uncitral.org/pdf/english/texts/payments/receivables/ctc-assignment-convention-e.pdf> [hereinafter Convention on the Assignment of Receivables in International Trade].

infrastructure development,<sup>26</sup> international transport of goods,<sup>27</sup> and insolvency.<sup>28</sup> There are currently six active UNCITRAL working groups, whose topics range from insolvency<sup>29</sup> and secured transactions<sup>30</sup> to electronic commerce, procurement, transport law, and international arbitration and conciliation.<sup>31</sup>

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26. UNCITRAL, *Legal Guide on Drawing Up International Contracts for the Construction of Industrial Works* (1987), *available at* <http://www.uncitral.org/pdf/english/texts/procurem/construction/lgconstr-e.pdf>; UNCITRAL, *UNCITRAL Model Law on Procurement of Goods and Construction* (1993), *available at* <http://www.uncitral.org/pdf/english/texts/procurem/proc93/proc93.pdf>; UNCITRAL, *UNCITRAL Model Law on Procurement of Goods, Construction and Services, with Guide to Enactment* (1994), *available at* <http://www.uncitral.org/pdf/english/texts/procurem/ml-procurement/ml-procure.pdf>; UNCITRAL, *UNCITRAL Legislative Guide on Privately Financed Infrastructure Projects* (2000), *available at* <http://www.uncitral.org/pdf/english/texts/procurem/pfip/guide/pfip-e.pdf>; UNCITRAL, *UNCITRAL Model Legislative Provisions on Privately Financed Infrastructure Projects* (2003), *available at* <http://www.uncitral.org/pdf/English/texts/procurem/pfip/model/annex1-e.pdf>.

27. *United Nations Convention on the Carriage of Goods by Sea* (1978) (the “Hamburg Rules”), *available at* [http://www.uncitral.org/pdf/English/texts/transport/hamburg/XI\\_d\\_e.pdf](http://www.uncitral.org/pdf/English/texts/transport/hamburg/XI_d_e.pdf); *Unit of Account Provision and Provisions for the Adjustment of the Limit of Liability in International Transport and Liability Conventions* (1982); *United Nations Convention on the Liability of Operators of Transport Terminals in International Trade* (1991), *available at* [http://www.uncitral.org/pdf/English/texts/transport/ott/X\\_13\\_e.pdf](http://www.uncitral.org/pdf/English/texts/transport/ott/X_13_e.pdf).

28. *UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment* (1997), *available at* <http://www.uncitral.org/pdf/English/texts/insolv/insolvency-e.pdf>; *UNCITRAL Legislative Guide on Insolvency Law* (2004), *available at* [http://www.uncitral.org/pdf/english/texts/insolven/05-80722\\_Ebook.pdf](http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf) [hereinafter *Legislative Guide*].

29. For a list and description of the ongoing work of the Insolvency Working Group, see [http://www.uncitral.org/uncitral/en/commission/working\\_groups/5Insolvency.html](http://www.uncitral.org/uncitral/en/commission/working_groups/5Insolvency.html).

30. The Working Group on Secured Transactions Law began its work on the Secured Transactions Guide in 2000 and projects the guide’s completion in late 2007. For a list and description of their ongoing work, see [http://www.uncitral.org/uncitral/en/commission/working\\_groups/6Security\\_Interests.html](http://www.uncitral.org/uncitral/en/commission/working_groups/6Security_Interests.html).

31. For a description of Working Groups I, II, III and IV and their ongoing projects and draft work product, see UNCITRAL, *Working Groups*, [http://www.uncitral.org/uncitral/en/commission/working\\_groups.html](http://www.uncitral.org/uncitral/en/commission/working_groups.html) (last visited May 6, 2007).

Table 1 (above) lists UNCITRAL's work product over time. It also lists the legal technologies UNCITRAL employed for these projects. Table 1 demonstrates that UNCITRAL has historically relied on model laws and conventions to communicate to domestic legislatures. Over time, it has adopted two sets of rules, seven conventions, two recommendations, two sets of model legal provisions, eight model laws (four of which it combined with guides to enactment), one legal guide and one set of notes. Of the twenty-five international instruments produced by UNCITRAL since its inception, fifteen constitute model laws, model legal provisions, or conventions. In a companion article,<sup>32</sup> we note that when it has spoken to domestic legislatures (and there are several legal technologies directly solely to private parties that we exclude from our count), UNCITRAL has overwhelmingly chosen to speak through conventions (of which it has produced seven), model laws (of which there are eight) and model legal provisions (of which there are two sets). The only exceptions to this general observation include one recommendation (on the Legal Value of Computer Records) and two legislative guides (one on Privately Financed Infrastructure Projects and another on Insolvency Law).

In large part, UNCITRAL's success in promulgating conventions, model laws, and model legal provisions has been the result of its incrementalism. Table 2 (below) reconfigures this list of work product by subject, rather than chronologically. It demonstrates that UNCITRAL has returned multiple times to each subject area of trade law. In revisiting a topic, UNCITRAL often becomes increasingly specific in its focus. Work that starts as rules or a recommendation may end with UNCITRAL promulgating a model law or convention on the topic. On these topics, UNCITRAL's incrementalism occurs vertically. But not all of UNCITRAL's incrementalism is the result of digging more deeply on a single topic and in the end adopting a convention or model law. UNCITRAL has, on occasion, begun its work on a topic by promulgating a convention or model law. Its success in adopting a convention or model law on a topic has not meant that work ceases on a subject, however. Instead, Table 2 also demonstrates incrementalism that moves sideways by expanding on the issue covered in the earlier convention or model law to consider a related topic in the same subject area. Thus, even where UNCITRAL leads with a convention or model law, it may move horizontally to cover more ground and add breadth. In some instances, finally, UNCITRAL's work follows on the heels of the earlier work of other in-

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32. Susan Block-Lieb & Terence Halliday, *Harmonization and Modernization in UNCITRAL's Legislative Guide on Insolvency Law*, TEX. INT'L L. J. (forthcoming 2007).

ternational organizations. With this sort of pyramidal progress, UNCITRAL is more likely to promulgate a convention or model law, rather than some softer international instrument. In the sections that follow, we relate each of these forms of incremental progress to specific UNCITRAL work.

**Table 2. UNCITRAL Work Products and Legal Technologies, Sorted by Subject**

Subject	Year	UNCITRAL Work Product	Legal Technology
Arbitration and dispute resolution	1976	Arbitration Rules	rules
Arbitration and dispute resolution	1980	Conciliation Rules	rules
Arbitration and dispute resolution	1982	Recommendations to assist arbitral institutions and other interested bodies with regard to arbitrations under the UNCITRAL Arbitration Rules	recommendations
Arbitration and dispute resolution	1985	Model Law on International Commercial Arbitration	model law
Arbitration and dispute resolution	1996	Notes on Organizing Arbitral Proceedings	notes
Arbitration and dispute resolution	2002	Model Law on International Commercial Conciliation with Guide to Enactment and Use	model law + guide to enactment and use
Sales	1974	Convention on the Limitation Period in the International Sale of Goods	convention
Sales	1980	Convention on Contracts for the International Sale of Goods	convention
Sales	1983	Uniform Rules on Contract Clauses for an Agreed Sum Due Upon Failure of Performance	rules
Sales	1992	Legal Guide on International Countertrade Transactions	legal guide
Transportation	1978	Convention on the Carriage of Goods by Sea (the "Hamburg Rules")	convention
Transportation	1991	Convention on the Liability of Operators of Transport Terminals in International Trade	convention
Electronic records and electronic commerce	1985	Recommendation on the Legal Value of Computer Records	recommendation
Electronic records and electronic commerce	1996	Model Law on Electronic Commerce with Guide to Enactment	model law + guide to enactment

Electronic records and electronic commerce	2001	Model Law on Electronic Signatures with Guide to Enactment	model law + guide to enactment
Electronic records and electronic commerce	2005	Convention on the Use of Electronic Communications in International Contracts	convention
Procurement and project finance	1987	Legal Guide on Drawing Up International Contracts for the Construction of Industrial Works	legal guide
Procurement and project finance	1993	Model Law on Procurement of Goods and Construction with Guide to Enactment	model law + guide to enactment
Procurement and project finance	1994	Model Law on Procurement of Goods, Construction and Services, with Guide to Enactment	model law + guide to enactment
Procurement and project finance	2000	Legislative Guide on Privately Financed Infrastructure Projects	legislative guide
Procurement and project finance	2003	Model Legislative Provisions on Privately Financed Infrastructure Projects	model legislative provisions
Payments	1988	Convention on International Bills of Exchange and International Promissory Notes	convention
Payments	1992	Model Law on International Credit Transfers	model law
Payments	1995	Convention on Independent Guarantees and Stand-by Letters of Credit	convention
Payments	2001	Convention on the Assignment of Receivables in International Trade	convention
Insolvency	1997	Model Law on Cross-Border Insolvency with Guide to Enactment	model law + guide to enactment
Insolvency	2005	Legislative Guide on Insolvency Law	legislative guide

*A. Vertical Incrementalism*

UNCITRAL's vertical incrementalism is most starkly evidenced with the progression of legal technologies produced by UNCITRAL on electronic commerce. With e-commerce, UNCITRAL ultimately succeeded in promulgating two model laws and a convention, but only after first producing a less binding and less specific international instrument. UNCITRAL's work in this area started quite modestly with its production of the Recommendation on the Legal Value of Computer Records in 1985.<sup>33</sup> With this Recommendation, UNCITRAL walked very gingerly into the topic of automatic data processing, computer records, electronic communications and electronic data interchange. Comprising no more than two pages in length, the Recommendation amounts to little more than a "Recommendation" to "Governments" that they review their "legal rules affecting the use of computer records as evidence in litigation in order to eliminate unnecessary obstacles to their admission," as well as any "legal requirements" that "trade related documents" or "documents for submission to governments" be "in writing" or signed.<sup>34</sup> The preamble paragraphs of the Recommendation make clear that, although the commercial practices associated with electronic communications were rapidly changing, domestic commercial laws had not.<sup>35</sup> Although there were no existing domestic laws on the books, there was a sense that the technology was poised to mushroom in importance and a fear that inter-

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33. UNCITRAL, *Recommendation on the Legal Value of Computer Records (1985)*, U.N. Doc. A/CN.9/265, available at <http://www.uncitral.org/pdf/english/texts/electcom/computerrecords-e.pdf> [hereinafter Recommendation]. The Commission prepared the Recommendation after considering several reports it had received on the topic. The first, a report from the Secretary-General of the U.N. entitled "Legal Aspects of Automatic Data Processing," (A/CN.9/254), "identified several legal issues relating to the legal value of computer records, the requirement of a 'writing,' authentication, general conditions, liability and bills of lading." See UNCITRAL, UNCITRAL MODEL LAW ON ELECTRONIC COMMERCE WITH GUIDE TO ENACTMENT 1996, WITH ADDITIONAL ARTICLE 5 *BIS* AS ADOPTED IN 1998, at 64, ¶ 125, U.N. Sales No. E.99V.4 (1999), available at [http://www.uncitral.org/pdf/English/texts/electcom/05-89450\\_Ebook.pdf](http://www.uncitral.org/pdf/English/texts/electcom/05-89450_Ebook.pdf). The Commission also considered a report of the Working Party on Facilitation of International Trade Procedures (WP.4), which had been jointly sponsored by the Economic Commission for Europe and the United Nations Conference on Trade and Development, *id.*, and a report by the UNCITRAL Secretariat entitled "Legal Value of Computer Records" (A/CN.9/265).

34. Recommendation, *supra* note 33, at 2.

35. See *id.* at 1-2.

national trade would be held back if commercial law was not brought up to speed with these commercial practices.<sup>36</sup>

Eleven years passed before UNCITRAL next spoke on the topic of the computerization of commercial practices,<sup>37</sup> but since then UNCITRAL has promulgated two model laws and one convention on the topic.<sup>38</sup> Importantly, these model laws and convention build on the earlier Recommendation and on each other. The UNCITRAL Model Law on Electronic Commerce explains its history and background as “prepared in response to a major change in the means by which communications are made between parties using computerized or other modern techniques in doing business.”<sup>39</sup> Although it notes the Commission’s adoption of the Recommendation as instrumental in its production of the Model Law on Electronic Commerce,<sup>40</sup> the Guide to Enactment of the Model Law on Electronic Commerce also explains the need both for the Model Law and for the accompanying Guide to Enactment in terms of a need for a more

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36. In a companion Article we argue that this Recommendation takes on special significance in describing the history of UNCITRAL because “[t]he case for ‘in with the new’ modernization was, thus, first made with this Recommendation.” Block-Lieb & Halliday, *Harmonization and Modernization*, *supra* note 32.

37. It may be unfair to say that UNCITRAL waited eleven years to speak on the topic of electronic communications. Its LEGAL GUIDE ON ELECTRONIC FUNDS TRANSFERS (1987), and UNCITRAL Model Law on International Credit Transfers, *supra* note 25, focused on the needs of electronic commerce. *See* Model Law on Electronic Signatures with Guide to Enactment (2001), *supra* note 24, at 9. Moreover, UNCITRAL was involved in the preparation of several reports on the topic. *See* The Secretary-General, *Report of the Secretary-General on Legal Implication of Automatic Data Processing*, U.N. Doc. A/CN.9/279 (1986); The Secretary-General, *Report of the Secretary-General on Legal Implications of Automatic Data Processing*, U.N. Doc. A/CN.9/292 (1987); The Secretary-General, *Report of the Secretary-General on Electronic Data Interchange: Preliminary Study of Legal Issues Related to the Formation of Contracts by Electronic Means*, U.N. Doc. A/CN.9/333 (1990). For a discussion of these and other efforts to push for global law reform on this topic, see Amelia H. Boss, *The International Commercial Use of Electronic Data Interchange and Electronic Communications Technologies*, 46 BUS. L. 1787, 1789–90 (1991).

38. In 1996, UNCITRAL adopted a Model Law on Electronic Commerce with Guide to Enactment, *see supra* note 24; in 2001, it promulgated the Model Law on Electronic Signatures with Guide to Enactment, *see supra* note 24. Most recently, in 2005, the U.N. adopted its Convention on the Use of Electronic Communications in International Contracts. *See supra* note 24.

39. Model Law on Electronic Commerce with Guide to Enactment, *supra* note 24, at 64.

40. *Id.* at 65 (In historical section, referring to the earlier Recommendation as “express[ing] some of the principles on which the Model Law is based.”).

precise statement of desirable legislative reforms than had been presented in the Recommendation.<sup>41</sup>

[T]here was a general feeling that, in spite of the efforts made through the 1985 UNCITRAL Recommendation, little progress had been made to achieve the removal of the mandatory requirements in national legislation regarding the use of paper and handwritten signatures. It has been suggested by the Norwegian Committee on Trade Procedures (NORPRO) in a letter to the Secretariat that 'one reason for this could be that the 1985 UNCITRAL Recommendation advises on the need for legal update, but does not give any indication of how it could be done.' In this vein, the Commission considered what follow-up action to the 1985 UNCITRAL Recommendation could usefully be taken so as to enhance the needed modernization of legislation. The decision by UNCITRAL to formulate model legislation on legal issues of electronic data interchange and related means of communication may be regarded as a consequence of the process that led to the adoption by the Commission of the 1985 UNCITRAL Recommendation.<sup>42</sup>

The Model Law on Electronic Commerce, adopted by the Commission in 1996, was quickly complemented by an additional article 5 bis adopted by the Commission at its thirty-first session in 1998.<sup>43</sup>

Five years after adoption of the Model Law on Electronic Commerce, UNCITRAL promulgated its Model Law on Electronic Signatures with Guide to Enactment.<sup>44</sup> In this Guide to Enactment, UNCITRAL explains that the Model Law on Electronic Signatures represents a "modest by significant addition to the UNCITRAL Model Law on Electronic Commerce" in that it "offers practical standards against which the technical reliability of electronic signatures may be measured."<sup>45</sup> It is careful to

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41. *Id.*

42. *Id.* at 66–67.

43. See UNCITRAL, *Report of the United Nations Commission on International Trade Law on the Work of its Twenty-Ninth Session, 28 May–14 June 1996*, at 48–49, ¶ 209, U.N. Doc. A/51/17 (1996). Current publications of the Model Law on Electronic Commerce all include article 5 bis, with a footnote indicating the chronology of its production.

44. See Model Law on Electronic Signatures with Guide to Enactment, *supra* note 24.

45. Model Law on Electronic Signatures with Guide to Enactment, *supra* note 24, at 8 (noting that Model Law on Electronic Signatures building "on the fundamental principles underlying article 7 of the UNCITRAL Model Law on Electronic Commerce," and that the Model Law on Electronic Signatures "adds substantially to the UNCITRAL Model Law on Electronic Commerce."); see also UNCITRAL, *Report of the United Nations Committee on International Trade Law on the Work of its Thirty-Fourth Session*, U.N. Doc. A/56/588 (Nov. 27, 2001) ("Desiring to build on the fundamental principles underlying article 7 of the Model Law on Electronic Commerce with respect to the fulfillment of the signature function in any electronic environment, with a view to promoting reli-

explain the relationship between the Model Law on Electronic Signatures and the Model Law on Electronic Commerce, by describing the former as “fully consistent” with the latter<sup>46</sup> in that the Model Law on Electronic Signatures “builds on the flexible criterion” expressed in the earlier model law.<sup>47</sup> Importantly, the Guide to Enactment states that the Model Law on Electronic Signatures was drafted with cognizance of the developing technology and should not “be interpreted as discouraging the use of any method of electronic signature, whether already existing or to be implemented in the future.”<sup>48</sup>

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ance on electronic signatures for producing legal effect where such electronic signatures are functionally equivalent to handwritten signatures . . .”).

46. Model Law on Electronic Signatures with Guide to Enactment, *supra* note 24, at 32; *see also id.* at 18 (“It should be noted that some countries consider that the legal issues related to the use of electronic signatures have already been solved by the UNCITRAL Model Law on Electronic Commerce and do not plan to adopt further rules on electronic signatures until market practices in that new area are better established. However, States enacting the new Model Laws alongside the UNCITRAL Model Law on Electronic Commerce may expect additional benefits.”).

47. *Id.* at 36 (“Building on the flexible criterion expressed in article 7, paragraph 1(b), of the UNCITRAL Model Law on Electronic Commerce, articles 6 and 7 of the new Model Law establish a mechanism through which electronic signatures that meet objective criteria of technical reliability can be made to benefit from early determination as to their legal effectiveness.”); *see also id.* at 34 (“As a supplement to the UNCITRAL Model Law on Electronic Commerce, the new Model Law is intended to provide essential principles for facilitating the use of electronic signatures.”).

48. *Id.* at 21. The Guide to Enactment expressly recognizes that States may “need to preserve flexibility” in the face of rapid technological development, and contends that legislation implementing the Model Law on Electronic Signatures would not preclude this needed flexibility. *Id.* at 34.

As a supplement to the UNCITRAL Model Law on Electronic Commerce, the new Model law is intended to provide essential principles for facilitating the use of electronic signatures. However, as a ‘framework,’ the Model Law itself does not set forth all the rules and regulations that may be necessary (in addition to contractual arrangements between users) to implement those techniques in an enacting State. Moreover, as indicated in this Guide, the Model Law is not intended to cover every aspect of the use of electronic signatures. Accordingly, an enacting State may wish to issue regulations to fill in the procedural details for procedures authorized by the Model Law and to take account of the specific, possibly changing, circumstances at play in the enacting State, without compromising the objective of the Model Law. It is recommended that, should it decide to issue such regulation, an enacting State should give particular attention to the need to preserve flexibility in the operation of electronic signature systems by their users. *See id.*

The Guide’s reference to the flexibility of the Model Law on Electronic Signatures may be intended as a response to criticisms that the Model Law is “based on an outmoded idea of how digital signatures are likely to be used in Internet commerce” and compounds “this shortcoming by mandating risk allocation rules that are counter-intuitive and unproductive.” Jane K. Winn, *Electronic Commerce Law: 2001 Developments*, 57 BUS. L. 541, 550 (2002) (“The E-Signatures Model Law was supported by most partici-

Later, in 2005, UNCITRAL adopted, and the United Nations ratified, a Convention on the Use of Electronic Communications in International Contracts.<sup>49</sup> Like the Model Law on Electronic Signatures, the scope of the Convention on the Use of Electronic Communications in International Contracts is narrower, but digs more deeply than the broad scope of the Model Law on Electronic Commerce. A comparison of the provisions of the Convention to the provision of the Model Law on Electronic Commerce finds more than several defined terms and articles that closely resemble each other.<sup>50</sup> Commentators describe the Convention as “[b]uilding on the earlier Model Law.”<sup>51</sup> Some have even argued that

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pants in the UNCITRAL drafting process but was vociferously objected to by some members of the U.S. delegation.”). Winn argues that the Model Law ossifies this disconnect between technology and law, rather than providing needed flexibility as the Guide suggests:

In addition, the E-Signatures Model Law was promulgated by UNCITRAL after developed countries had already passed laws dealing with the same subject matter in quite different ways than the Model Law. Because it is unlikely any developed countries are going to repeal their current laws in order to enact legislation based on the Model Law, the Model Law is unlikely to achieve its objective of harmonizing law in this area. What it is likely to do, however, is encourage developing countries to pass laws that are out of step with actual commercial practice in Internet commerce, further disadvantaging their local businesses that try to compete in the global information economy.

*Id.* It is interesting to note that few countries have enacted legislation to implement the Model Law on Electronic Signatures to date, none of them developed nations.

49. Convention on the Use of Electronic Communications in International Contracts, *supra* note 24.

50. For provisions that are virtually identical except for the use of similarly defined but distinctly named terms, compare Convention on the Use of Electronic Communications in International Contracts, Art. 8 (Legal recognition of electronic communications), *supra* note 24, with Model Law on Electronic Commerce, Art. 5 (Legal recognition of data messages), *supra* note 24. There are, however, several provisions in the Convention that are found in neither the Model Law on Electronic Commerce nor the Model Law on Electronic Signatures.

51. José Angelo Estrella Faria, *The United Nations Convention of the Use of Electronic Communications in International Contracts—An Introductory Note*, 55 INT'L & COMPAR. L. Q. 689, 689 (2006) (“Calls for another round of legislation, an international convention or electronic commerce, to achieve further harmonization of national laws began even before the drafting of the UNCITRAL Model Law on Electronic Signatures have been completed. Underlying those proposals was the recognition that despite the wide acceptance of the UNCITRAL Model Law on Electronic Commerce, only a binding instrument could effectively remove obstacles to electronic commerce that might derive, for example, from form requirements contained in other international conventions.”); Peter Winship & Louise Ellen Teitz, *Developments in Private International Law: Facilitating Cross-Border Transactions and Dispute Resolution*, 40 INT'L LAW. 505, 511

adoption of the Model Law paved the way for the Convention: “The rules of the MLEC were done as a model law at the time it was adopted because people were tentative about its solutions. Now they have proved valid and workable and deserve more legal force behind them.”<sup>52</sup> In this view, the Model Law created a trial run that permitted UNCITRAL to take the next step.<sup>53</sup>

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(2006) (noting that the United Nations Convention on the Use of Electronic Communications in International Contracts “builds upon the UNCITRAL Model Law on Electronic Commerce”). *But see* Charles H. Martin, *The UNCITRAL Electronic Contracts Convention: Will It Be Used or Avoided?*, 17 PACE INT’L L. REV. 261, 265 (2005) (“Although many CUECIC substantive legal rules are based on the MLEC, the procedural framework of CUECIC closely resembles the structure of the CISG, particularly regarding scope of application, statutory interpretation principles, and declarations by ratifying countries of variations from default legal rules. This procedural framework will affect the degree of acceptance and utilization of CUECIC by major trading nations like the United States.”).

52. John D. Gregory, *The Proposed UNCITRAL Convention on Electronic Contracts*, 59 BUS. L. 313, 317 (2004).

53. This story suggests an explanation for the fact that there have been no meetings of the Working Group on Electronic Commerce scheduled since 2004, when it promulgated the Convention on the Use of Electronic Communication in International Contracts—and that story would describe this radio silence as the culmination of a Working Group that had dug as deeply as technological marketplace developments required.

But that reading of events would be misleading in that pieces of other working groups’ ongoing projects involve consideration of the impact of electronic communications on their earlier work product. As noted earlier, there are six Working Groups, five of which met during 2006 and plan to meet again in 2007. All of the Working Groups, other than Working Group VI (secured transactions), are revisiting or revising existing international instruments to account for practical experience and technical developments since adoption. Three of the five active working groups, Working Groups I, II and III, are engaged in revisions to an earlier UNCITRAL model law or convention. Working Group I (procurement and project finance) continues to meet to discuss possible revisions to the UNCITRAL Model Law on Procurement of Goods, Construction and Services, *supra* note 26, including revisions to address electronic communications in public procurement. Christopher Yukins et al., *International Procurement*, 40 INT’L L. 337, 338–44 (2006); Don Wallace, Jr., *UNCITRAL: Reform of the Model Procurement Law*, 35 PUB. CONT. L.J. 485, 486 (2006) (noting that the “main justification” for current effort to reform UNCITRAL’s Model Procurement Law is “the need to bring the Model Law into the electronic age”). Working Group II (international arbitration and conciliation) is actively considering revisions to the UNCITRAL Arbitration Rules, with an emphasis placed on considering the implications of electronic communications for possible revisions to the Arbitration Rules. UNCITRAL, *Report of the Working Group on Arbitration and Conciliation on the Work of its Forty-Fifth Session*, at 3, ¶ 6, U.N. Doc. A/CN.9/614 (Oct. 5, 2006). Working Group III (transport law) is engaged in a project to draft a convention on the carriage of goods, a small piece of which involves considering the impact of electronic bills of lading and other electronic communications in international transport. Of those actively meeting, only Working Groups V (insolvency) and VI (secured transactions) are not working on revisions to a model law or convention. The Secured Transac-

*B. Vertical + Horizontal Incrementalism*

A similar progression of deepening law reform appears when we closely examine UNCITRAL's work on the topics of arbitration and conciliation, although here UNCITRAL moved both vertically (in proceeding from rules to model law to convention) and horizontally (in shifting from arbitration to conciliation and back again).

UNCITRAL's work in this area began in 1976 with its promulgation of the Arbitration Rules<sup>54</sup> and in 1980 with the Conciliation Rules.<sup>55</sup> The Arbitration and Conciliation Rules are directed to private parties including international arbitrators, rather than domestic legislatures; similarly, UNCITRAL's Recommendations to Assist Arbitral Institutions and Other Interested Bodies with Regard to Arbitrations Under the UNCITRAL Arbitration Rules<sup>56</sup> and Notes on Organizing Arbitral Pro-

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tion Working Group has been working steadily since 2000 on its Legislative Guide on Secured Transactions Law, with its work projected to be completed by some time in 2007. UNCITRAL, *Draft Legislative Guide on Secured Transactions*, at 1–6, ¶¶ 1, 23, U.N. Doc. A/CN.9/WG.VI/WP.31 (Nov. 16, 2006). Following ratification of its Legislative Guide on Insolvency Law by the Commission and the U.N. General Assembly, UNCITRAL recently directed the Insolvency Working Group to consider three additional topics: the treatment of corporate groups, particularly in cross-border insolvency proceedings; the financing of cross-border insolvency proceedings; and court-to-court communication and the use of protocols in cross-border insolvency proceedings. UNCITRAL, *Annotated Provisional Agenda for the Thirty-First Session of Working Group V (Insolvency Law)*, at 1–2, ¶¶ 2–4, U.N. Doc. A/CN.9/WG.V/WP.73 (Sept. 22, 2006) [hereinafter *Annotated Provisional Agenda*]. Because the newly reconstituted Insolvency Working Group has met only once, it is unclear whether the Group conceives of its mandate as one to draft a convention, model law, legislative guide or other document (or to revise either the Model Law on Cross-Border Insolvencies or the Legislative Guide on Insolvency Law, or both).

54. UNCITRAL Arbitration Rules, *supra* note 23.

55. UNCITRAL Conciliation Rules, *supra* note 23. The Arbitration Rules were adopted following “extensive consultation with arbitral institutions and centres of international arbitration” and extensive deliberations of the proposed text.” *Id.* at 371 (citations omitted). Although the Rules were intended primarily as default rules to guide private parties’ “ad hoc” arbitrations,” they have also applied in arbitrations administered by “agencies such as the International Chamber of Commerce (ICC) and the American Arbitration Association (AAA) . . . [where] the parties generally have stipulated in the contract that the UNCITRAL Rules are to substitute for the institution’s rules, such as ICC’s Rules of Conciliation and Arbitration or AAA’s Commercial Arbitration Rules.” John D. Franchini, Note, *International Arbitration Under the UNCITRAL Arbitration Rules: A Contractual Provision for Improvement*, 62 FORDHAM L. REV. 2223, 2226–27 (1994).

56. UNCITRAL, *Recommendations to Assist Arbitral Institutions and Other Interested Bodies With Regard to Arbitrations Under the UNCITRAL Arbitration Rules Adopted at the Fifteenth Session of the Commission*, *supra* note 23. The Recommendations were drafted in recognition that “a substantial number of arbitral institutions have,

ceedings are addressed to arbitral institutions and, ultimately, arbitration parties but not legislatures or lawmakers.<sup>57</sup> In 1985, UNCITRAL subsequently shifted its focus toward domestic legislatures when it produced the Model Law on International Commercial Arbitration.<sup>58</sup> The Model Law on International Commercial Arbitration, “with its eight chapters and thirty-six articles, is a comprehensive work governing the arbitration agreement, the composition and jurisdiction of the arbitral tribunal, the conduct of the arbitral proceedings, and the making of and recourse against the award.”<sup>59</sup> It borrows numerous provisions regarding the arbitration procedure from UNCITRAL’s Arbitration Rules, but also includes “an enforcement mechanism almost identical to that of the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958”<sup>60</sup>—commonly referred to as the New York Convention.<sup>61</sup> More than simply combining provisions from UNCITRAL’s

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in a variety of ways, accepted or adopted these Rules.” *Id.* at 420, ¶¶ 2–5 (noting that arbitral institutions “have drawn on [the Rules] in preparing their own institutional arbitration rules” or have adopted “the UNCITRAL Arbitration Rules as such, maintaining their name” and indicating “that disputes referred to the institution shall be settled in accordance with the UNCITRAL Arbitration Rules, subject to any modifications set forth in those statutes or administrative rules,” or have indicated in their rules the acceptability of “the use of the UNCITRAL Arbitration Rules if parties so wished”).

57. In 1996, UNCITRAL adopted its Notes on Organizing Arbitral Proceedings, *supra* note 23. The Notes state that their purpose “is to assist arbitration practitioners by listing and briefly describing questions on which appropriately timed decisions on organizing arbitral proceedings may be useful” and “may be used whether or not the arbitration is administered by an arbitral institution.” *Id.* ¶ 1. Because the Notes are not binding “on the arbitrators or the parties,” they indicate that an “arbitral tribunal remains free to use the Notes as it sees fit and is not required to give reasons for disregarding them.” *Id.* ¶ 2.

58. UNCITRAL Model Law on International Commercial Arbitration, *supra* note 23. The Model Law on International Commercial Arbitration has received wide international approval.

59. Kenneth T. Ungar, Note, *The Enforcement of Arbitral Awards Under UNCITRAL’s Model Law on International Commercial Arbitration*, 25 COLUM. J. TRANSNAT’L L. 717, 719 (1987).

60. *Id.* The United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, frequently referred to as the New York Convention, was promulgated by the United Nations Conference on International Commercial Arbitration in 1958, eight years before the U.N. General Assembly established UNCITRAL. Often “considered the most successful private international law treaty of the twentieth century,” more than 130 nations have acceded to its terms. Leonardo D. Graffi, *Securing Harmonized Effects of Arbitration Agreements Under the New York Convention*, 28 Hous. J. INT’L L. 663, 667 (2006).

61. In its Web site description of the New York Convention, UNCITRAL claims ownership of the task of promoting the Convention as a “part of the Commission’s programme of work” on arbitration. UNCITRAL, *1985—Convention on the Recognition and*

Arbitration Rules with the New York Convention provisions on the recognition and enforcement of an arbitral award, the Model Law eliminated the “distinction between ‘foreign’ and ‘domestic’ awards present in the New York Convention.”<sup>62</sup> The Model Law and New York Convention also differ in scope, as the former applies only to international *commercial* arbitration, while the latter applies to *any* foreign arbitration. Some suggest that UNCITRAL’s primary agenda in promulgating the Model Law may have been political, and not simply the reformatting of existing material for enactment as a statute.<sup>63</sup> In a 1972 report to UNCITRAL, Special Rapporteur Ion Nestor argued that less developed and developing nations had avoided acceding to the New York Convention due to “the mutual distrust between both private and governmental undertakings belonging to countries with differing forms of economic organization or differing levels of development.”<sup>64</sup> A model law was

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*Enforcement of Foreign Arbitral Awards—the “New York” Convention*, available at [http://www.uncitral.org/uncitral/en/uncitral\\_texts/arbitration/NYConvention.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention.html) (last visited May 6, 2007).

Although the Convention, adopted by diplomatic conference on 10 June 1958, was prepared by the United Nations prior to the establishment of UNCITRAL, promotion of the Convention is an integral part of the Commission’s programme of work. The Convention is widely recognized as a foundation instrument of international arbitration and requires courts of contracting States to give effect to an agreement to arbitrate when seized of an action in a matter covered by an arbitration agreement and also to recognize and enforce awards made in other States, subject to specific limited exceptions. The Convention entered into force on 7 June 1959.

*Id.*

62. Ungar, *supra* note 59, at 721 (“By reducing the relevance of the place of arbitration, the Model Law insures that all awards rendered in international commercial arbitrations will be enforced uniformly.”).

63. *See id.* at 753 (“UNCITRAL has recognized that political and constitutional impediments to accession [to the New York Convention] exist for many U.N. member states, especially Latin American and African states . . . . The Model Law framework, by using the viable law of the Convention and making it more palatable to non-Convention states, may succeed in promoting unification and thereby improving the effectiveness of commercial dispute settlement and facilitating international commerce.”). We discuss the connection between UNCITRAL’s legitimacy and its incrementalism *infra* Part IV.

64. Special Rapporteur, *Problems Concerning the Application and Interpretation of Existing Multilateral Conventions on International Commercial Arbitration and Related Matters*, at 233, ¶ 144, U.N. Doc. A/CN.9/64 (Mar. 1, 1972) (prepared by Ion Nestor); *see also* The Secretary-General, *Report of the Secretary-General on Study on the Application and Interpretation of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards*, U.N. Doc. A/CN.9/168 (Apr. 20, 1979); The Secretariat, *Further Work in Respect of International Commercial Arbitration*, U.N. Doc. A/CN.9/169 (May 11, 1979); Ungar, *supra* note 59, at 734, n.92 (“It is not oversimplifying the issue to state

viewed as preferable to a convention in that developing nations might enact legislation implementing a model law that accommodated local constitutional, social, or cultural concerns, whereas a convention offered no such flexibility.<sup>65</sup> This political insight seems to have been correct. The Model Law on International Commercial Arbitration has been well received by the international community, including the community of less developed and developing nations that had eschewed the New York Convention. More than fifty countries have enacted legislation implementing the provisions of the Model Law, including several regions within the People's Republic of China and six states within the United States.<sup>66</sup> Moreover, promulgation of the Model Law appears to have jump-started interest in acceding to the New York Convention, as in 2006 and 2007, countries as diverse as the Marshall Islands, the United Arab Emirates, Gabon, and the Bahamas became parties to its terms.<sup>67</sup> To date, more than 140 nations are bound to the New York Convention, with most of these accessions or ratifications occurring after UNCITRAL had promulgated the Model Law in 1985.<sup>68</sup>

UNCITRAL's work on dispute resolution follows a similar pattern, but for different reasons. Building on its Rules on Conciliation, in 2002, UNCITRAL promulgated a Model Law on International Commercial Conciliation with Guide to Enactment and Use.<sup>69</sup> Because a conciliation proceeding, often called a mediation or dispute resolution procedure, is, by definition, not binding on the parties, UNCITRAL's decision to formalize its Rules on Conciliation is not easily justified. The Guide to Enactment to the Model Law on International Commercial Conciliation explains the need for legislation on the topic of conciliation in terms of the

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that the distrust is between developed countries, most of which [have long been] parties to the New York Convention, and the developing states of Latin America, Asia, and Africa, most of which are not.”)

65. Ungar, *supra* note 59, at 735–38.

66. For a list of enacting nations, see UNCITRAL, 1985—UNCITRAL Model Law on International Commercial Arbitration, *available at* [http://www.uncitral.org/uncitral/en/uncitral\\_texts/arbitration/1985Model\\_arbitration\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/1985Model_arbitration_status.html) (last visited May 6, 2007).

67. For announcement of these events, see UNCITRAL, Welcome to the UNCITRAL Web Site, *available at* <http://www.uncitral.org/uncitral/en/index.html> (last visited May 6, 2007).

68. For a list of nations to have signed, ratified, acceded or succeeded to the New York Convention, see UNCITRAL, 1958—Convention on the Recognition and Enforcement of Foreign Arbitral Awards, *available at* [http://www.uncitral.org/uncitral/en/uncitral\\_texts/arbitration/NYConvention\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention_status.html) (last visited May 6, 2007).

69. UNCITRAL, Model Law on International Commercial Conciliation with Guide to Enactment and Use, *supra* note 23.

need for bright-line rules regarding the inadmissibility in any subsequent judicial proceeding of admissions and arguments made in the context of a conciliation proceeding. In the absence of a statutory rule of inadmissibility, parties' agreements to keep the record in a conciliation confidential may not be enforceable, with this lack of enforceability undermining the salutary effects of truthfulness in the context of a non-binding dispute resolution mechanism. The Model Law on International Commercial Conciliation digs more deeply than the Conciliation Rules on which it was based in that it combines evidentiary rules and rules of confidentiality with proscriptions as to the contours of an approved conciliation proceeding.<sup>70</sup>

Viewing UNCITRAL's work on arbitration and conciliation chronologically, then, we find a quick horizontal move from arbitration to conciliation, followed by a return to arbitration. In returning to the topic of arbitration, UNCITRAL digs in more deeply, shifting from Rules, Recommendations, and Notes directed solely to private parties, to a Model Law on International Commercial Arbitration, and concluding with the Convention on International Commercial Arbitration. Once its work on arbitration culminated in a convention, UNCITRAL shifted sideways again, returning to the topic of conciliation. On the topic of conciliation, UNCITRAL dug in more deeply, moving from its Conciliation Rules to its Model Law on International Commercial Conciliation.

With its work on procurement and project finance, UNCITRAL also follows an incremental progression involving both vertical and horizontal moves. In 1987, UNCITRAL produced its Legal Guide on Drawing Up International Contracts for the Construction of Industrial Works.<sup>71</sup> This Guide, like the Arbitration Rules and Conciliation Rules, was not directed to domestic legislatures, but rather to the private and public parties that negotiate, draft, and execute contracts for the construction of industrial works. But as with its experience in arbitration and dispute resolution, UNCITRAL shifted from private to public audiences with its next international instrument on procurement. In 1993, UNCITRAL promul-

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70. It may be worth noting that only four countries have enacted legislation implementing the Model Law on International Commercial Conciliation (Canada, Croatia, Hungary, and Nicaragua); similarly, uniform legislation influenced by the Model Law has been promulgated in the United States of America (Uniform Mediation Act), but has been enacted by only six states (Illinois, Iowa, Nebraska, New Jersey, Ohio, and Washington) on the grounds that non-uniform state law is more protective of the confidentiality of the parties participating in a dispute resolution procedure than the Uniform Mediation Act.

71. UNCITRAL, Legal Guide on Drawing Up International Contracts for the Construction of Industrial Works, *supra* note 26.

gated its Model Law on Procurement of Goods and Construction and Guide to Enactment,<sup>72</sup> and in 1994 its Model Law on Procurement of Goods, Construction and Services with a Guide to Enactment.<sup>73</sup> The Guide to Enactment for the Model Law on Procurement of Goods, Construction and Services explains the quick succession of the two model laws as resulting from the decision of the Working Group to carve out issues surrounding the procurement of services from its deliberations on the procurement of goods and construction on the grounds that the issues confronting service contracts differed significantly from those governing goods and construction.<sup>74</sup> Upon completion of its work on the Model Law on Procurement of Goods and Construction, the Working Group returned to the topic of procurement and took up the issue of procurement of services. Rather than replicate its work on overlapping issues in a separate model law covering only the procurement of services, the Working Group, in short order, promulgated its Model Law on Procurement of Goods, Construction and Services, requiring only one session to complete the supplemented model law.<sup>75</sup> The Guide to Enactment to the

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72. UNCITRAL, Model Law on Procurement of Goods and Construction, *supra* note 26.

73. UNCITRAL, Model Law on Procurement of Goods, Construction and Services, with Guide to Enactment, *supra* note 26.

74. *Id.* at Introduction, ¶ 2 (“On the understanding that certain aspects of the procurement of services were governed by different considerations from those that governed the procurement of goods or construction, a decision had been made to limit the work at the initial stage to the formulation of model legislative provisions on the procurement of goods and construction. At the twenty-sixth session, having completed work on model statutory provisions on procurement of goods and construction, . . . the Commission discussed additions and changes to the Model Law on Procurement of Goods and Construction that would need to be made so as to encompass procurement of services and adopted the UNCITRAL Model Law on Procurement of Goods, Construction and Services . . . without thereby superseding the earlier text, whose scope is limited to goods and construction.”).

75. The Guide to Enactment of the Model Law on Procurement of Goods, Construction and Services explains the relationship between the provisions of the Model Law on goods and construction on one hand and the provisions pertaining to services as follows:

To take account of certain differences between the procurement of goods and construction and the procurement of services, the Model Law sets forth in chapter IV a set of procedures especially designed for the procurement of services. The main differences . . . arise from the fact that, unlike the procurement of goods and construction, procurement of services typically involves the supply of an intangible object whose quality and exact content may be difficult to quantify. The precise quality of the services provided may be largely dependent on the skill and expertise of the suppliers or contractors. Thus, unlike procurement of goods and construction where the price is the predominant criterion in the evaluation process, the price of services is often not considered as important

Model Law on Procurement of Goods, Construction and Services explains that the later Model Law was meant to supplement but not supersede the earlier text.

By 2000, UNCITRAL further broadened the scope of its work in this area by shifting horizontally from procurement to project finance. It did not commence its work on project finance with a model law or model legal provisions. Instead, in 2000, UNCITRAL produced the Legislative Guide on Privately Financed Infrastructure Projects.<sup>76</sup> The Forward to the Legislative Guide states that:

[t]he legislative recommendations are intended to assist in the establishment of a legislative framework favourable to privately financed infrastructure projects. The legislative recommendations are followed by notes that offer an analytical introduction with references to financial, regulatory, legal, policy and other issues raised in the subject area.<sup>77</sup>

The Legislative Guide was followed in 2003 by UNCITRAL's Model Legislative Provisions on Privately Financed Infrastructure Projects.<sup>78</sup> The Model Legislative Provisions are intended to build on the Legislative Guide, and, in fact, the Commission "requested the Secretariat to consolidate in due course the text of the Model Legislative Provisions and the Legislative Guide into one single publication and, in doing so, to retain the legislative recommendations contained in the Legislative Guide as a basis of the development of the Model Legislative Provisions."<sup>79</sup> Moreover, the Model Legislative Provisions on "selection of the concessionaire" refer to the Commission's earlier work on procurement, noting that

[t]he selection procedures reflected in this chapter are based largely on the features of the principal method for the procurement of services under the UNCITRAL Model Law on Procurement of Goods, Construction and Services . . . . The model provisions on the selection of the concessionaire are not intended to replace or reproduce the entire rules of the enacting State on government procurement, but rather to assist

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a criterion in the evaluation and selection process as the quality and competence of the suppliers or contractors.

*Id.* at ¶ 11.

76. UNCITRAL, Legislative Guide on Privately Financed Infrastructure Projects, *supra* note 26.

77. *Id.* at xi.

78. UNCITRAL, Model Legislative Provisions on Privately Financed Infrastructure Projects, *supra* note 26.

79. *Id.* at iii (citing Official Records of the General Assembly, Fifty-eighth Session, Supplement No. 17, U.N. Doc. A/58/17, ¶¶ 12–171).

domestic legislators in developing special rules for the selection of the concessionaire.”<sup>80</sup>

UNCITRAL’s work on procurement and project finance differs from its projects on arbitration and conciliation in that it dug more deeply on procurement before beginning its work on project finance. There are also important similarities with UNCITRAL’s work on arbitration and conciliation. In both arbitration and conciliation and procurement and project finance, UNCITRAL dug more deeply by building on work initially directed only to private parties (a Legal Guide on Procurement and a Legislative Guide on Privately Financed Infrastructure Projects) with the promulgation of legal technologies directed to a public audience—i.e., national legislatures (the Model Law on the Procurement of Goods and Construction, the Model Law on the Procurement of Goods, Construction and Services, and the Model Legal Provisions on Privately Financed Infrastructure Projects).

### *C. Horizontal Incrementalism*

On three occasions, UNCITRAL began its work in an area of trade law by promulgating a convention—sales, transport, and payments. What incrementalism can follow in the wake of a convention? On the subject of international sales, UNCITRAL adopted two conventions (the Convention on the Limitation Period in the International Sales of Goods<sup>81</sup> and the CISG<sup>82</sup>), followed by a legal guide (the Legal Guide on International Countertrade Transactions)<sup>83</sup> and a set of uniform rules (the Uniform Rules on Contract Clauses for an Agreed Sum Due Upon Failure of Performance).<sup>84</sup> On the topic of international transportation, UNCITRAL has adopted two conventions, but no other international instruments. In 1978, in one of UNCITRAL’s first instruments, it produced the Conven-

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80. UNCITRAL, Model Legislative Provisions on Privately Financed Infrastructure Projects, *supra* note 26, at 7 n.7.

81. UNCITRAL, United Nations Convention on the Limitation Period in the International Sale of Goods, *available at* <http://www.uncitral.org/pdf/english/texts/sales/limit/limit-conv.pdf> (last visited May 6, 2007).

82. CISG, *supra* note 21.

83. UNCITRAL, Legal Guide on International Countertrade Transactions, *available at* <http://www.uncitral.org/pdf/english/texts/sales/countertrade/countertrade-e.pdf> (last visited May 6, 2007).

84. UNCITRAL, Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance, U.N. Doc. A/CN.9/243, annex I, *available at* <http://www.uncitral.org/pdf/english/texts/sales/contract/vol14-p272-273-e.pdf> (last visited May 6, 2007).

tion on the Carriage of Goods by Sea.<sup>85</sup> With the exception of the Unit of Account Provision and Provisions for the Limit of Liability in International Transport and Liability Conventions,<sup>86</sup> UNCITRAL produced nothing further on the topic of international transportation until 1991 when it promulgated the Convention on the Liability of Operators of Transport Terminals in International Trade.<sup>87</sup> Similarly, on the topic of international payments, UNCITRAL's first effort involved the production in 1988 of a Convention on International Bills of Exchange and International Promissory Notes.<sup>88</sup> This convention was followed four years

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85. UNCITRAL, Final Act of the United Nations Conference on the Carriage of Goods by Sea (Nov. 10, 1988), *available at* [http://www.uncitral.org/pdf/english/texts/transport/hamburg/XI\\_d\\_3\\_e.pdf](http://www.uncitral.org/pdf/english/texts/transport/hamburg/XI_d_3_e.pdf). UNCITRAL's Web site indicates that thirty-two nations are party to the Hamburg Rules, and that fifty altogether have signed it. *See* UNCITRAL, 1978—United Nations Convention on the Carriage of Goods by Sea—the “Hamburg Rules,” [http://www.uncitral.org/uncitral/en/uncitral\\_texts/transport\\_goods/Hamburg\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/transport_goods/Hamburg_status.html) (last visited May 6, 2007).

86. For a description of this project, but no hyperlink to text, see UNCITRAL, 1982—Unit of Account Provision and Provisions for the Adjustment of the Limit of Liability in International Transport and Liability Conventions [http://www.uncitral.org/uncitral/en/uncitral\\_texts/transport\\_goods/1982Unit\\_provisions.html](http://www.uncitral.org/uncitral/en/uncitral_texts/transport_goods/1982Unit_provisions.html) (explaining that “the Unit of Account provision designates the Special Drawing Right as the unit of account in limitations of liability provisions. The two alternative sample provisions for adjusting the limits of liability are for use in the preparation of future international conventions containing limitation of liability provisions or in the revision of existing conventions.”). UNCITRAL built on these provisions when it subsequently promulgated the Convention on the Liability of Operators of Transport Terminals in International Trade in 1991.

87. United Nations Convention on the Liability of Operators of Transport Terminals in International Trade, (May 30, 1991), *available at* [http://www.uncitral.org/pdf/english/texts/transport/ott/X\\_13\\_e.pdf](http://www.uncitral.org/pdf/english/texts/transport/ott/X_13_e.pdf). UNCITRAL's Web site indicates that four nations have either ratified or acceded to the terms of this convention, and that another five nations have signed it. Five actions are needed for entry into force. *See* UNCITRAL, 1991—United Nations Convention on the Liability of Operators of Transport Terminals in International Trade, *available at* [http://www.uncitral.org/uncitral/en/uncitral\\_texts/transport\\_goods/1991Convention\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/transport_goods/1991Convention_status.html) (last visited Mar. 25, 2007).

88. *See* UNCITRAL, Convention on International Bills of Exchange and International Promissory Notes, *supra* note 25. On its Web site, UNCITRAL indicates that this convention has not come into force, as the participation of ten nations is required and only eight have acceded to its terms. *See* UNCITRAL, 1988—United Nations Convention on International Bills of Exchange and International Promissory Notes, [http://www.uncitral.org/uncitral/en/uncitral\\_texts/payments/1988Convention\\_bills\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/payments/1988Convention_bills_status.html) (last visited Apr. 18, 2007). We also note that UNCITRAL has long endorsed the Uniform Customs and Practices for Documentary Credits, promulgated by the International Chamber of Commerce beginning in 1962 and revised in 1974, 1983, and 1993. For a list of these UNCITRAL endorsed ICC texts, as well as hyperlinks to the UNCITRAL endorsements and the text of the ICC product, see UNCITRAL, Texts of Other Organisations Endorsed by UNCITRAL, [http://www.uncitral.org/uncitral/en/other\\_organizations\\_texts.html](http://www.uncitral.org/uncitral/en/other_organizations_texts.html) (last visited Mar. 25, 2007).

later by the Model Law on International Credit Transfers,<sup>89</sup> and thereafter by two additional conventions on topics on the law of international payments: the Convention on Independent Guarantees and Stand-by Letters of Credit in 1995<sup>90</sup> and the Convention on the Assignment of Receivables in International Trade in 2001.<sup>91</sup>

With each of these topics—sales, transport, and payments—UNCITRAL's incremental progress moved horizontally across the subjects. For example, on the topic of sales, UNCITRAL adopted, in relatively quick succession, two conventions: the Convention on the Limitation Period in the International Sale of Goods and the CISG.<sup>92</sup> The Convention of Limitations Periods covered a much narrower topic than the CISG. With payments, UNCITRAL began by promulgating a convention on International Bills of Exchange and International Promissory Notes, then moved to related but not overlapping topics with later model law and conventions—international credit transfers, independent guarantees and stand-by letters of credit, and the assignment of receivables. Similarly, on the topic of international transportation, UNCITRAL first produced the Convention on the Carriage of Goods by Sea (the “Hamburg Rules”), and later promulgated the Convention on the Liability of Operators of Transport Terminals in International Trade. The latter convention

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89. UNCITRAL, Model Law on International Credit Transfers, *supra* note 25. In its Web site, UNCITRAL indicates that no country has adopted legislation to implement this model law but that “directive of the European Parliament and of the Council of the European Union based on the principles of the UNCITRAL Model Law on International Credit Transfers was issued on 27 January 1997.” See UNCITRAL, 1992—Model Law on International Credit Transfers, *available at* [http://www.uncitral.org/uncitral/en/uncitral\\_texts/payments/1992Model\\_credit\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/payments/1992Model_credit_status.html) (last visited Mar. 25, 2007).

90. UNCITRAL, Convention on Independent Guarantees and Stand-By Letters of Credit, *supra* note 25. UNCITRAL's Web site indicates that this convention came into force in 2000; eight participating nations were required and nine have acceded to its terms. See UNCITRAL, Status 1995—United Nations Convention on Independent Guarantees and Stand-by Letters of Credit, [http://www.uncitral.org/uncitral/en/uncitral\\_texts/payments/1995Convention\\_guarantees\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/payments/1995Convention_guarantees_status.html) (last visited Mar. 25, 2007). In 1998, UNCITRAL endorsed the ICC's International Stand-by Practices, ISP98. For the text of ISP98 and the UNCITRAL endorsement of its terms, see UNCITRAL, Texts of Other Organisations Endorsed by UNCITRAL, [http://www.uncitral.org/uncitral/en/other\\_organizations\\_texts.html](http://www.uncitral.org/uncitral/en/other_organizations_texts.html) (last visited Mar. 25, 2007).

91. Convention on the Assignment of Receivables in International Trade, *supra* note 25. While four nations have signed the convention, only one, Liberia, has ratified it. Thus, because five nations are required to be bound by its terms for the convention to enter into force, it is not yet so effective. However, the Convention was first promulgated in 2001. See UNCITRAL, 2001—United Nations Convention on the Assignment of Receivables in International Trade, [http://www.uncitral.org/uncitral/en/uncitral\\_texts/payments/2001Convention\\_receivables\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/payments/2001Convention_receivables_status.html) (last visited Mar. 25, 2007).

92. See CISG, *supra* note 21.

covered issues of liability that had not been addressed in the earlier convention; moreover, the latter convention covered the liability of all transport terminals, and was not limited to the liability of terminals located at ports. Currently, Working Group III (transportation) has been involved in an immense effort to complete its Draft Convention on the Carriage of Goods [Wholly or Partly] [By Sea].<sup>93</sup> Working Group III has met twice a year for two-week-long working group sessions—roughly twice as long as other working groups generally meet. The explanation for these long sessions involves the breadth of the Draft Convention. Although the title of the Draft Convention appears to overlap the earlier Hamburg Rules on the carriage of goods by sea, the brackets in the title of the Draft Convention are meant to convey open issues that earlier divided the working group on the breadth of this endeavor. Many of the provisions of the Draft Convention cover the carriage of goods, not just by sea, but also by other means, such as air, rail, and ground transport, reflecting current interlocking practices in the market for carriage. The Working Group has agreed provisionally on the treatment of electronic bills of lading and other electronic documents used in the carriage of goods, and on the location of any arbitration of a dispute under a carriage contract containing an arbitration agreement, but has encountered difficulties reaching consensus on the liability rules that should be applied to the different transporters and the extent to which contractual waivers and other contractual opt-out provisions should be considered binding. If the Working Group succeeds in completing the Draft Convention along the lines suggested, the Draft Convention on the Carriage of Goods [Wholly or Partly] [By Sea] will constitute a huge horizontal move from the scope of the two earlier UNCITRAL conventions on international transport.

#### *D. Pyramidal Incrementalism*

Neither Table 1 nor Table 2 is constructed to reveal UNCITRAL's pyramidal incrementalism. Nonetheless, consistent with its mandate to coordinate legal activities among international organizations working in the field of international trade law,<sup>94</sup> UNCITRAL works with other international actors and on others' work product. It has endorsed the texts of other international organizations;<sup>95</sup> it also partners loosely from time to

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93. For a compilation of the Working Group's agenda and reports of its drafting sessions, see UNCITRAL, Working Group III, [http://www.uncitral.org/uncitral/en/commission/working\\_groups/3Transport.html](http://www.uncitral.org/uncitral/en/commission/working_groups/3Transport.html) (last visited Mar. 25, 2007).

94. See G.A. Res. 2205(XXI), *supra* note 14, ¶¶ 8, 11–12.

95. For a list of the texts of other organizations endorsed by UNCITRAL, see UNCITRAL, Texts of Other Organisations Endorsed by UNCITRAL,

time with entities, such as UNDROIT, the Hague Convention, the World Bank, and the International Monetary Fund, for the drafting and implementation of core areas of commercial law in transitional and developing countries.<sup>96</sup>

Moreover, UNCITRAL often refers to and builds upon the work of other international organizations. For example, before commencing work on the international sales of goods, the Commission directed the Working Group to consider (and the Working Group considered at length) the texts of earlier conventions: the 1964 Hague Convention relating to a Uniform Law on the International Sale of Goods (to which the Uniform Law on the International Sale of Goods is annexed), the 1964 Hague Convention relating to a Uniform Law on the Formation of Contracts for the International Sale of Goods (to which the Uniform Law on the Formation of Contracts for the International Sale of Goods is annexed), and the 1955 Hague Convention on the Law Applicable to International Sales of Goods.<sup>97</sup> One commentator contends that the CISG “would not have been successfully completed had the ground not been leveled by the extensive work done by UNIDROIT in the preparation of the Hague Uni-

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[http://www.uncitral.org/uncitral/en/other\\_organizations\\_texts.html](http://www.uncitral.org/uncitral/en/other_organizations_texts.html) (last visited Mar. 25, 2007).

96. For a description of UNCITRAL’s coordination with other international organizations, see UNCITRAL, *Coordination of Work on International Trade Law*, <http://www.uncitral.org/uncitral/en/tac/coordination.html> (last visited Mar. 25, 2007). See also Faria, *supra* note 17, at 271 (“A recent example is the cooperation between the Hague Conference and UNCITRAL in the formulation of the choice-of-law rules contained in chapter 5 of the United Nations Convention on the Assignment of Receivables in International Trade (2001).”).

97. For the Report of the Working Group on the International Sale of Goods, see *Report of the Working Group on the International Sale of Goods, First Sess., 5–16 January 1970*, U.N. Doc. A/CN.9/35 (1970) (discussing these three Hague Conventions). See also The Secretary-General, *Report of the Secretary-General on the Analysis of Replies and Comments by Governments on the Hague Conventions of 1964*, U.N. Doc. A/CN.9/31 (1970). The Working Group on Time-Limits and Limitations (which ultimately produced the UNCITRAL Convention on the Limitation Period in the International Sale of Goods, also studied the 1955 and 1964 Hague Conventions. See *Report of the Working Group on Time-Limits and Limitations (Prescriptions), First Session, 18–22 August 1969*, U.N. Doc. A/CN.9/30 (1970). For text of the 1964 and 1955 Hague Conventions, see *Convention Relating to a Uniform Law on the International Sale of Goods, July 1, 1964*, available at <http://www.cisg.law.pace.edu/cisg/text/antecedents.html> (last visited Mar. 19, 2007); *Convention Relating to a Uniform Law on the Formation of Contracts for the International Sale of Goods, July 1, 1964*, available at <http://www.cisg.law.pace.edu/cisg/text/ulf.html> (last visited Mar. 19, 2007); and *Convention on the Law Applicable to International Sales of Goods, Sept. 1, 1964*, available at [http://www.hcch.net/index\\_en.php?act=conventions.text&cid=31](http://www.hcch.net/index_en.php?act=conventions.text&cid=31) (last visited Mar. 19, 2007).

form Laws.”<sup>98</sup> In establishing a Working Group on international transport law, the Commission “[r]equest[ed] the Secretary General to prepare a study in depth giving *inter alia* a survey of work in the field of international legislation on shipping done or planned in the organs of the United Nations, or in intergovernmental or non-governmental organizations, and to submit it to the Commission at its third session.”<sup>99</sup> Similarly, its Convention on International Commercial Arbitration builds upon not only UNCITRAL’s Rules on Arbitration, but also an earlier U.N. international instrument on arbitration, the New York Convention.<sup>100</sup>

### III. INCREMENTALISMS IN UNCITRAL’S INSOLVENCY WORKING GROUP

In 1997, UNCITRAL produced the Model Law on Cross-Border Insolvency with Guide to Enactment, and in 2004 its Legislative Guide on Insolvency Law. Unlike the incrementally more specific work product promulgated on electronic commerce, procurement, and arbitration and dispute resolution, the Legislative Guide is “less specific” and “less binding” than the Model Law on Cross-Border Insolvency. Still, we view UNCITRAL’s work on the topic of insolvency law as having proceeded incrementally over the past ten years—vertically, horizontally, and pyramidally. We look at each brand of incrementalism at work in UNCITRAL’s Working Group on Insolvency Law and note that vertical

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98. Faria, *supra* note 17, at 270.

99. UNCITRAL, *Report of the United Nations Commission on International Trade Law on the Work of its Second Session*, at 110, ¶ 133(2), U.N. Doc. A/7618 (1970); see also The Secretary-General, *Report of the Secretary-General on A Survey of the Work in the Field of International Legislation on Shipping Undertaken by Various International Organizations and Co-ordination of Future Work in this Field*, at 233, ¶ 2, U.N. Doc. A/CN.9/41 (1970), available at <http://daccessdds.un.org/UNDOC/GEN/NL7/001/04/PDF/NL700104.pdf?OpenElement>. Faria comments on the pyramidal incrementalism of UNCITRAL’s Working Group on Transport in these terms:

The United Nations Conference on Trade and Development (“UNCTAD”) provides another example. In the early 1970s, UNCTAD was involved in preparing a convention on maritime transport, but later transferred the project to UNCITRAL, which concluded it with the adoption in 1978 of the United Nations Convention on the Carriage of Goods by Sea (“Hamburg Rules”), which entered into force on November 1, 1992. Similarly, UNIDROIT, after having carried out a substantial part of the preliminary work on a convention concerning the liability of operators or transport terminals in international trade, handed over the project in 1984 to UNCITRAL, which carried it until its adoption in a diplomatic conference in 1991.

Faria, *supra* note 17, at 270–71.

100. See *supra* text accompanying notes 55–71.

incrementalism has been relied on less than horizontal and pyramidal measures of incremental progress.

#### *A. Pyramidal Incrementalism*

With both the Model Law on Cross-Border Insolvency and the Legislative Guide on Insolvency Law, UNCITRAL's Insolvency Working Group did not start from a clean slate.

##### 1. Model Law

For more than thirty years, the European Union struggled to reach agreement on the terms of a convention on which judgments entered in insolvency cases would be recognized by member States.<sup>101</sup> The need for a convention among European member states to coordinate the conduct of their insolvency proceedings was foreseen by the (first) Treaty of Rome,<sup>102</sup> establishing the European Economic Community, but the Brussels Convention on the enforcement and recognition of judgments within Europe “specifically excluded insolvency proceedings from its scope.”<sup>103</sup> In fits and starts, experts drawn from member states drafted a Preliminary Draft Convention and a Draft Convention on the topic,<sup>104</sup> but these efforts “collapsed because the draft's adoption of universalism could not garner support from territorialist states.”<sup>105</sup> Work on an intra-European convention on insolvency law recommenced in 1989, and again in 1995 following ratification of the Treaty of Maastricht and the European

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101. See, e.g., GABRIEL MOSS ET AL., THE EC REGULATION ON INSOLVENCY PROCEEDINGS: A COMMENTARY AND ANNOTATED GUIDE 2 (2002) (“Over the period from 1960 to 1996 the Insolvency Convention project featured on the agenda of the institutions of the European Community/European Union, particularly the Commission and the Council.”).

102. Treaty Establishing the European Economic Community art. 220(4), March 25, 1957, 298 U.N.T.S. 11 (committing Member States to negotiate a series of conventions, including a convention to secure “the simplification of formalities governing the reciprocal recognition and enforcement of judgments of courts or tribunals and of arbitration awards”). Art. 220(4) of the (first) Treaty of Rome led to the Brussels Convention on Sept. 27, 1968.

103. Pottow, *supra* note 7, at 957; see Convention on Jurisdiction and the Enforcement of Judgments in Civil and Commercial Matters art. 1(2), Sept. 27, 1968, 29 I.L.M. 1417–18; see also, e.g., André J. Berends, *UNCITRAL Model Law on Cross-Border Insolvency: A Comprehensive Overview*, 6 TUL. J. INT'L & COMP. L. 309, 316–17 (1998).

104. *Preliminary Draft of a Convention on Bankruptcy, Winding-Up, Arrangements, Compositions and Similar Proceedings*, COM (1973) 3.327/1/XIV/70-F (initially dated Feb. 16, 1970 and subsequently revised June 4, 1973), available at [http://aei.pitt.edu/5612/01/002316\\_1.pdf](http://aei.pitt.edu/5612/01/002316_1.pdf); see also *Draft of a Convention on Bankruptcy, Winding-Up, Arrangements, Compositions and Similar Proceedings*, COM (1980) III/D/72/80.

105. Pottow, *supra* note 7, at 957.

Community's transformation into the European Union. Although twelve member states went so far as to initial a draft Insolvency Convention in early 1996, by mid-year, this draft Insolvency Convention languished for want of the signature of the United Kingdom within the requisite deadline due to political reasons having nothing to do with insolvency law.<sup>106</sup> Prospects for European agreement on the recognition of cross-border insolvency proceedings looked bleak, but market interests pressed for a solution to the problem of cross-border cases.<sup>107</sup> Not until 1999 was the then-defunct E.U. Insolvency Convention revived in the form of a Regulation on Insolvency Proceedings,<sup>108</sup> in which "the substantive provisions of the Convention's text were incorporated with only a handful of alterations, other than essential drafting adjustments."<sup>109</sup> The E.U. Regulation was adopted in May 29, 2000,<sup>110</sup> and came into immediate effect.

At a Congress on International Trade Law held in May 1992 in New York, UNCITRAL first considered taking on the topic of insolvency law.<sup>111</sup> A joint UNCITRAL-INSOL Colloquium on Cross-Border Insol-

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106. See MOSS ET AL., *supra* note 101, at 5, n.13 (describing the United Kingdom's failure to sign the convention in this way: "Although the pretext for non-signature by the United Kingdom in May 1996 was the disagreement between the UK and its EC partners over the agricultural crisis caused by the BSE epidemic, it subsequently transpired that the UK Government had concluded that the Convention's failure to make clear and unambiguous provision for its application to the colony of Gibraltar was an insurmountable obstacle to UK acceptance of the text.").

107. While there had been a number of cross-border insolvency cases that had preceded it, the dual insolvency proceedings involving Maxwell Communications Corp., filed both in the United States and in the United Kingdom in late 1991, highlighted the need for transnational law on the coordination of such cases. See *In re Maxwell Commc'n Corp.*, 93 F.3d 1036 (2d Cir. 1996); see also Jay Lawrence Westbrook, *Creating International Insolvency Law*, 70 AM. BANKR. L. J. 563 (1996); Jay Lawrence Westbrook, *The Lessons of Maxwell Communications*, 64 FORDHAM L. REV. 2531 (1996); Caryn M. Chittenden, Comment, *After the Fall of Maxwell Communications: Is the Time Right for a Multinational Insolvency Treaty?*, 28 WAKE FOREST L. REV. 161 (1993).

108. See MOSS ET AL., *supra* note 101, at 4, n.8 (explaining that "Community Conventions . . . are negotiated by all existing members of the Community (now the EU) as at the time of their adoption, and require the ratification of all members in order to enter into force."). By contrast, "[a] Regulation is a creature of the EC Treaty. As such, . . . Regulations shall: (1) have 'general application'; (2) be 'binding in their entirety'; and (3) be 'directly applicable in all Member States.'" *Id.* at 17.

109. *Id.* at 5.

110. Council Regulation (EC) No. 1346/2000 of 29 May 2000 on Insolvency Proceedings, 160 OFFICIAL J. OF THE EUR. COMMUNITIES 1 (2000) [hereinafter E.U. Regulation].

111. *Cross-Border Insolvency: Note by the Secretariat*, at 248, ¶1, U.N. Doc. A/CN.9/378/Add.4 (1993), available at <http://www.uncitral.org/pdf/english/yearbooks/yb-1993-e/vol24-p248-253-e.pdf> [hereinafter *Cross-Border Insolvency*]. The Note indi-

veny followed in mid-1994,<sup>112</sup> and by the summer of 1995, the Commission authorized “the development of a legal instrument relating to cross-border insolvency.”<sup>113</sup> Thus, the Working Group on Insolvency Law began its work on the Model Law on Cross Border Insolvency in 1995 at a time when the European Union looked poised to adopt its Convention on Insolvency. Although within the year the E.U. Convention on Insolvency had failed to gather the requisite support, UNCITRAL continued to work on its draft Model Law, and it concluded this work in May 1997. By December 1997, the U.N. General Assembly had formally recognized UNCITRAL’s Model Law and recommended that member states enact legislation implementing it. All this occurred before the European Union had returned to the topic of cross-border insolvency in the form of the E.U. Regulation on Cross-Border Insolvency.

While it may technically be inaccurate to say that UNCITRAL’s work on the Model Law on Cross Border Insolvency builds on the E.U. Regulation on the same topic, work on the E.U. Convention on Insolvency clearly influenced the Model Law, and the E.U. Regulation is nearly identical to the earlier Convention on Insolvency.<sup>114</sup> Reports to the Commission and to the Working Group detail earlier “initiatives towards regulation of cross-border insolvencies,” and include discussion of the E.U. Convention on Insolvency.<sup>115</sup> Some country delegates to UNCITRAL’s Working Group had been involved in negotiating and drafting the E.U. Convention and the later E.U. Regulation.

Nor surprisingly, the Model Law contains clear references to important legal concepts embedded in the E.U. Regulation on Cross-Border Insolvency (but first found in the earlier E.U. Insolvency Convention). Specifically and most important to the question of cross-border insolvency proceedings, both the Model Law and the E.U. Regulation govern the circumstances under which a “foreign” proceeding—an insolvency proceeding pending in a jurisdiction outside the jurisdiction of the enacting State—and a “foreign representative”—an insolvency representative ap-

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cates that, at the Congress, “proposals were made that the Commission consider undertaking work on international aspects of bankruptcy.” *Id.*

112. The Secretariat, *Report on UNCITRAL-INSOL Colloquium on Cross-Border Insolvency*, U.N. Doc. A/CN.9/398 (May 19, 1994).

113. UNCITRAL, *Possible Issues Relating to Judicial Cooperation and Access and Recognition in Cases of Cross-Border Insolvency*, at 3, 18th Sess., U.N. Doc. A/CN.9/WG.V/WP.42 (Sept. 26, 1995), available at <http://www.uncitral.org/pdf/english/travaux/insolvency/acn9-wg5-wp42-e.pdf>.

114. It would also be fair to say that UNCITRAL’s rapid progress on its Model Law on Cross-Border Insolvency spurred the European Union to complete its work on the E.U. Regulation.

115. *Cross-Border Insolvency*, *supra* note 111, at 251–53, ¶¶ 33–48.

pointed to administer an insolvency proceeding pending in a foreign jurisdiction—should be recognized by and in courts of the enacting state. Both distinguish between two levels of recognition and accord greater deference to a “foreign main proceeding” than a “foreign nonmain proceeding.” Both define a “foreign main proceeding” as an insolvency proceeding pending in the jurisdiction in which the debtor’s “centre of main interests” is located, and a “foreign nonmain proceeding” as an insolvency proceeding pending in the jurisdiction in which an “establishment” of the debtor is located. The definition of an “establishment” in UNCITRAL’s Model Law is virtually identical to that found in the E.U. Regulation, and while the Model Law does not directly define a debtor’s “centre of main interests,” both presume that a debtor’s COMI exists in its “place of registration.” One further similarity between the two is noteworthy: neither the E.U. Regulation nor the UNCITRAL Model Law on Cross-Border Insolvency purport to harmonize substantive insolvency law. Both documents are focused, by and large, to questions of procedure: setting the process for the recognition of foreign proceedings and foreign representatives; and encouraging and facilitating the cooperation of the insolvency representatives and courts in which cross-border proceedings are pending. Both also cover creditors’ rights to information about cross-border proceedings and the procedures applicable to the filings of claims in such proceedings, including the language in which notice and filings should be made. Both contain a stay of pending actions, although the scope of the stay provided under the E.U. Regulation is considerably narrower than that envisioned by the Model Law.

Despite this influence, the Model Law differs from the E.U. Regulation on Cross-Border Insolvency in important ways.<sup>116</sup> Most notably, the Model Law embraces a more universal treatment of cross-border insolvency proceedings (although this universalism is tempered with a heavy dose of pragmatism), while the E.U. Regulation adopts a more territorial view of cross-border coordination of insolvency proceedings.<sup>117</sup> Surprisingly, given its universalist leanings, the Model Law does not contain rules of private international law (that is, conflict of law rules), although

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116. There are numerous differences between the E.U. Regulation and UNCITRAL’s Model Law on Cross Border Insolvency, far too many for us to detail in this context. For a more detailed discussion of these differences, see, for example, Ramy El-Boraei, *Forum of Competent Jurisdiction: Lessons from the European Union Insolvency Regulation*, 39 INT’L LAW. 781 (2005).

117. *Id.* at 782–84.

the E.U. Regulation includes more than ten such provisions.<sup>118</sup> The Model Law's failure to adopt conflict of law rules was not the result of indifference to the issue or for lack of effort.<sup>119</sup>

We also note here the efforts of two private organizations to build on UNCITRAL's Model Law. First, in 1996, the International Bar Association, through its Committee J on insolvency law, promulgated the Cross-Border Insolvency Concordat,<sup>120</sup> which it describes as "the precursor of modern cross-border court-to-court protocols."<sup>121</sup> The Concordat is intended as a "framework for harmonizing cross-border insolvency proceedings."<sup>122</sup> Addressing issues of coordination, cooperation, and applicable law, the Concordat offers not "a rigid set of rules" for adoption by national legislatures, but rather a flexible set of alternatives that "could be implemented by court orders or formal agreements between official representatives or informal arrangements, depending upon the rules and practices of the particular fora involved."<sup>123</sup> The American Law Institute (ALI) has also worked in this area. Its Transnational Insolvency Project on Co-Operation Among NAFTA Countries commenced in the mid-1990s and continued through 2003. With the NAFTA project, the ALI published a three-volume comparative law study of the insolvency laws

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118. See E.U. Regulation, *supra* note 110. While the E.U. Regulation contains a number of rules governing the applicable law in cross-border insolvency cases, these rules of private international law are more procedural than substantive.

119. *Cross-Border Insolvency*, *supra* note 111, contains eleven paragraphs (out of a total of fifty-four paragraphs) on conflicts of laws. See *id.* at 250, ¶¶ 22–24 (conflicting laws regarding priority in distribution); *id.* at 250–51, ¶¶ 25–26 (questions regarding recognition of cross-border composition); *id.* at 251, ¶¶ 27–30 (recognition and treatment of security interests in cross-border insolvency proceedings); *id.* at 251, ¶¶ 31–32 (applicable avoidance law). *Possible Issues Relating to Judicial Cooperation and Access and Recognition in Cases of Cross-Border Insolvency*, *supra* note 113, at 13–14, ¶¶ 48–53 (discussing possible effects of recognition of foreign insolvency proceedings in terms of which countries' insolvency law should apply).

120. For a copy of the International Bar Association's Cross-Border Insolvency Concordat, see INTERNATIONAL BAR ASSOCIATION, SECTION ON BUSINESS LAW, COMMITTEE J—INSOLVENCY AND CREDITORS' RIGHTS CROSS-BORDER INSOLVENCY CONCORDAT (1996), available at <http://www.iiiglobal.org/international/projects/concordat.pdf> [hereinafter CONCORDAT].

121. See INTERNATIONAL BAR ASSOCIATION, Section on Insolvency, Restructuring and Creditor's Rights Projects, [http://www.ibanet.org/legalpractice/Insolvency\\_Projects.cfm](http://www.ibanet.org/legalpractice/Insolvency_Projects.cfm) (last visited Mar. 22, 2007) [hereinafter IBA Insolvency Projects].

122. See CONCORDAT, *supra* note 120.

123. *Id.* For a more detailed discussion of the Concordat, see David H. Culmer, *The Cross-Border Insolvency Concordat and Customary International Law: Is It Ripe Yet?*, 14 CONN. J. INT'L L. 563 (1999); Anne Nielsen, Mike Sigal & Karen Wagner, *The Cross-Border Insolvency Concordat: Principles to Facilitate the Resolution of International Insolvencies*, 70 AM. BANKR. L.J. 533 (1996).

of Canada, Mexico, and the United States,<sup>124</sup> as well as the ALI Principles of Co-operation in NAFTA Cross-Border Insolvency Cases, containing numerous recommendations directed to practitioners, courts, and legislatures.<sup>125</sup> Also as a part of its Transnational Insolvency Project, the ALI, together with the International Insolvency Institute, began work on Principles of Cooperation in 2005.<sup>126</sup> The Principles of Cooperation intend to “extend and disseminate” the ALI’s earlier NAFTA work to “jurisdictions across the world, subject to appropriate local modifications, and to obtain the endorsement of influential domestic associations, courts, and other groups in those jurisdictions.”<sup>127</sup>

## 2. Legislative Guide

In considering the feasibility of “possible future work” on cross-border insolvency, the Commission flirted with the possibility of harmonizing divergent insolvency laws more generally since, after all, what better way to coordinate cross-border cases.<sup>128</sup> But the question of harmonizing

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124. AMERICAN LAW INSTITUTE, *Transnational Insolvency: International Statement of United States Bankruptcy Law* (2003); AMERICAN LAW INSTITUTE, *Transnational Insolvency: International Statement of Canadian Bankruptcy Law* (2003); AMERICAN LAW INSTITUTE, *Transnational Insolvency: International Statement of Mexican Bankruptcy Law* (2003); see also Jay Lawrence Westbrook & Jacob S. Ziegel, *The American Law Institute NAFTA Insolvency Project*, 23 BROOK. J. INT'L L. 7 (1998) (providing an overview of the NAFTA project).

125. AMERICAN LAW INSTITUTE, *Transnational Insolvency: Cooperation Among the NAFTA Countries, Principles of Co-operation in NAFTA Cross-Border Insolvency Cases* (2003). For a copy of the principles, but not the related commentary, see INTERNATIONAL INSOLVENCY INSTITUTE, International Organizations and Projects, available at <http://www.iiiglobal.org/organizations/index.html> (last visited May 17, 2007).

126. See American Law Institute, *Transnational Insolvency: Principles of Cooperation*, available at [http://www.ali.org/index.cfm?fuseaction=projects.proj\\_ip&projectid=18](http://www.ali.org/index.cfm?fuseaction=projects.proj_ip&projectid=18) (last visited Mar. 28, 2007).

127. *Id.*

128. *Cross-Border Insolvency*, *supra* note 111, at 253, ¶¶50–51.

It has been stated by commentators and associations of practitioners that it would desirable to harmonize ground rules in some of the areas of insolvency law, which would allow international insolvencies, including compositions, to be resolved in a more predictable fashion and without undesirable conflicts between the jurisdictions interested in the insolvency. . . . However, . . . it has also been pointed out in international discussions that it may be unrealistic to suppose that any principle of universality of insolvency proceedings could be attained at the global, or even at regional, level in the foreseeable future.

*Id.* The Report of the Secretariat on UNCITRAL-INSOL Colloquium on Cross-Border Insolvency, A/CN.9/398, puts the possibility of harmonizing divergent insolvency laws most directly:

the substance of insolvency laws, rather than simply providing a means for the cross-border recognition and coordination of such cases, was dropped as quixotic at the time UNCITRAL began its work on the Model Law. A little more than a year after UNCITRAL promulgated the Model Law on Cross-Border Insolvency, however, Australia proposed and the Commission agreed to reconstitute the Working Group on Insolvency Law with the aim to tackle just such a project. What had transpired in the interim to convince UNCITRAL that the time was ripe for such an ambitious project, given the breadth of this project and earlier determinations of its infeasibility?

Systemic financial crises in Southeast Asia and South America during the mid-1990s caused the financial leaders of the developed nations to press for reform of domestic corporate, financial, and commercial laws on a global scale.<sup>129</sup> As a result, the Financial Stability Forum was created and various international organizations initiated various reform efforts associated with raising the level of the “global financial architecture.”<sup>130</sup> In this spirit, the legal staffs of the International Monetary Fund

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A third possibility that might in due time be considered for work by the Commission is the formulation of a set of model legislative provisions on insolvency. While it was not the conclusion of the Colloquium, and it is not here proposed to draft a comprehensive insolvency code with a view to achieving substantive unification of law, work in this area of law may eventually be important not only for Governments concerned with modernization of law, but also for the commercial community and for legal practitioners. . . [S]uch a project could be designed in a manner that would take into account the different policy options that a State would wish to consider in drafting its insolvency law, and would present model provisions for implementing those various policy options.

*Id.* ¶ 19.

129. For the press release of the G-7 calling for the strengthening of the international financial architectures, see Press Release, G7 Statement (June 18, 1999), *available at* [http://www.g8.utoronto.ca/summit/1999koln/g7statement\\_june18.htm](http://www.g8.utoronto.ca/summit/1999koln/g7statement_june18.htm). For a list of these ongoing projects, see Ongoing and Recent Work Relevant to Sound Financial Systems, Note by the Financial Stability Forum Secretariat (Mar. 21, 2006), *available at* <http://www.fsforum.org/Publications/OngoingnoteMay06.pdf>. For a review of the success of the standards and codes initiative, see Benu Schneider, *Do Standards and Codes Prevent Financial Crises? Some Proposals on Modifying the Standards-Based Approach*, UNCTAD DISCUSSION PAPERS NO. 177 (Apr. 2005), *available at* [http://www.unctad.org/en/docs/osgdp20051\\_en.pdf](http://www.unctad.org/en/docs/osgdp20051_en.pdf).

130. The Financial Stability Forum “brings together senior representatives of national financial authorities (e.g. central banks, supervisory authorities and treasury departments), international financial institutions, international regulatory and supervisory groupings, committees of central bank experts and the European Central Bank.” See Fi-

(IMF),<sup>131</sup> the Asian Development Bank (ADB),<sup>132</sup> and the World Bank<sup>133</sup> each published reports on best practices in the area of domestic insolvency law.<sup>134</sup>

Thus, in 1999 when Australia formally proposed that UNCITRAL reconstitute its Working Group on Insolvency Law in order to consider preparing a legislative guide for domestic legislatures to consider when reforming their insolvency laws, UNCITRAL did not start its work on the Legislative Guide on Insolvency Law on a clean slate. It began its work on the Legislative Guide in the midst of a burgeoning international law reform effort both on the topic of insolvency law and corporate and financial laws more generally. Some questioned whether UNCITRAL's involvement in drafting a legislative guide on the topic would be useful in that earlier reform efforts seemed to have completed the task. What value could UNCITRAL bring to the task? What added ground could it cover given the grave dissensus separating existing insolvency laws around the globe, including those of the developed nations? A comparison of the World Bank Principles, or the IMF's report on Effective and Efficient Insolvency Laws, demonstrates a strong correlation among the principles adopted in the reports issued by the IMF, ADB, and World Bank.<sup>135</sup>

Although the Legislative Guide on Insolvency Law builds on these reports, it also extends well beyond the work of these international financial organizations. Part One of the Legislative Guide adopts eight "key objectives" of any "modern" insolvency law, which strongly resemble

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nancial Stability Forum, Who We Are, available at [http://www.fsforum.org/about/who\\_we\\_are.html](http://www.fsforum.org/about/who_we_are.html) (last visited Mar. 28, 2007).

131. INT'L MONETARY FUND [IMF], LEGAL DEP'T, *Orderly and Effective Insolvency Procedures*, available at <http://www.imf.org/external/pubs/ft/orderly/> (last visited Mar. 28, 2007).

132. INT'L INSOLVENCY INST. [III], *Law and Policy Reform at the Asian Development Bank* (Apr. 2000), available at [http://www.iiiglobal.org/organizations/docs/113\\_Aasian\\_Development\\_Bank\\_Insolvency\\_Law\\_Reforms.pdf](http://www.iiiglobal.org/organizations/docs/113_Aasian_Development_Bank_Insolvency_Law_Reforms.pdf).

133. THE WORLD BANK, *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems* (Apr. 2001), available at <http://worldbank.org/GILD/PrinciplesAndGuidelines/201627/Principles%20and%20Guidlines%20for%20Effective%20Insolvency%20and%20Creditor%20Rights%20Systems.pdf>.

134. The reports issued by the IMF, ADB, and World Bank were not the first efforts to identify common ground and possible "best practices" in national insolvency laws. In the mid-1980s, the International Bar Association drafted the Model International Insolvency Cooperation Act (MIICA), to which these reports all make reference. See IBA Insolvency Projects, *supra* note 121.

135. See Susan Block-Lieb, Comparison of World Bank, IMF and ADB Reports on Insolvency Reform, July 22, 2002, available at [http://law.fordham.edu/documents/fac-sb\\_matrix2002.pdf](http://law.fordham.edu/documents/fac-sb_matrix2002.pdf).

the recommendations made in these earlier reports.<sup>136</sup> But it would be a mistake to suggest that UNCITRAL had nothing to add on the topic of domestic insolvency law given the earlier reports on which these key objectives are so clearly based. The Legislative Guide, in Part Two, continues for another 200 pages to comment in detail on these eight broad policy norms and to provide nearly 200 legislative recommendations. The commentary and recommendations contained in the Legislative Guide on Insolvency Law are consistent with the best practices identified in the IMF and ADB Reports, and the Principles and Guidelines set forth in the World Bank report, but go well beyond the broad statements contained in these earlier reports. We talk about this horizontal move in the sections that follow.

### *B. Horizontal and Vertical Incrementalism*

UNCITRAL's Working Group on Insolvency Law was created in order to deliberate on the need for and contents of a Model Law on Cross-Border Insolvencies. It promulgated the Model Law in 1997, which has since been implemented by legislation enacted in ten nations: Eritrea, Japan, Mexico, Poland, Romania, Montenegro, Serbia, South Africa, the United States, and the United Kingdom (including Northern Ireland and the British Virgin Islands).<sup>137</sup> With less than two years of respite, the Working Group was reconstituted in 1999 to consider the desirability of drafting an international instrument addressed at attempting to raise the level of domestic insolvency law, with a particular interest in the insolvency laws of developing and underdeveloped nations.<sup>138</sup>

The move from the Model Law to the Legislative Guide represents a nearly perfectly horizontal move; although both address issues of insolvency law, there is little overlap between the two UNCITRAL documents. While the Model Law on Cross-Border Insolvency addresses questions of procedure, only occasionally does the Legislative Guide make procedural recommendations. Most of the recommendations in the Legislative Guide involve the substance of an insolvency law. While the Model Law on Cross-Border Insolvencies addresses the coordination and

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136. Legislative Guide, *supra* note 28, at 9–20. The Key Objectives themselves constitute Recommendation 7. *See id.* at 20.

137. For a discussion of the status of UNCITRAL's Model Law on Cross-Border Insolvency, see UNCITRAL, 1997—Model Law on Cross-Border Insolvency, *available at* [http://www.uncitral.org/uncitral/en/uncitral\\_texts/insolvency/1997Model\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model_status.html) (last visited Mar. 28, 2007).

138. UNCITRAL, *Possible Future Work on Insolvency Law*, U.N. Doc. A/CN.9/WG.V/WP.50 (Sept. 20, 1999), *available at* <http://daccessdds.un.org/doc/UNDOC/LTD/V99/880/13/PDF/V9988013.pdf?OpenElement>.

recognition of insolvency proceedings pending in multiple countries—and thus transnational law—the Legislative Guide focuses nearly exclusively on questions of domestic insolvency law.

There are two occasions on which the Legislation Guide turns to questions of international law. First, the Legislative Guide expressly recommends the enactment of legislation to implement the provisions of the Model Law on Cross-Border Insolvency. Recommendation 5 provides that an “insolvency law should include a modern, harmonized and fair framework to address effectively instances of cross-border insolvency.”<sup>139</sup> Recommendation 5 goes on to recommend “[e]nactment of the UNCITRAL Model Law on Cross-Border Insolvency.”<sup>140</sup> The Model Law is incorporated within the Legislative Guide as an Annex to the latter.<sup>141</sup> Second, although the drafters of the Model Law were unable to agree on any model law provisions regarding private international law or conflicts of law rules, the Legislative Guide contains four recommendations addressing applicable law in insolvency proceeding, including provisions on which insolvency law ought to govern.<sup>142</sup>

UNCITRAL’s work on the topic of insolvency law did not cease with its adoption of the Legislative Guide. Following a colloquium jointly sponsored by UNCITRAL and INSOL International and held in Vienna in 2005, UNCITRAL reconvened the Working Group on Insolvency Law to continue its work on court-to-court protocols, corporate groups, and cross-border post-commencement financing.<sup>143</sup> Unlike the shift from the Model Law to the Legislative Guide, this new work builds vertically on earlier efforts of the Working Group, both the Model Law and the Legislative Guide.

### 1. Court-to-Court Coordination

Although the Model Law on Cross-Border Insolvency directs courts with jurisdiction over cross-border proceedings to “cooperate to the maximum extent possible with foreign courts or foreign representatives,”<sup>144</sup> it gave courts little guidance on how this coordination should take place other than to provide that “[t]he court is entitled to communicate directly with, or to request information or assistance directly from,

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139. Legislative Guide, *supra* note 28, at 14.

140. *Id.*

141. *Id.* at annex, pt. 2, at 307–64.

142. *Id.*, Rec. 30–34, at 72–74. An initial draft of these Recommendations on Applicable Law was prepared by a group of experts that included representatives from the Hague Convention.

143. *Annotated Provisional Agenda*, *supra* note 53, at 2, ¶ 5.

144. UNCITRAL Model Law on Cross-Border Insolvency, *supra* note 28, art. 25(1).

foreign courts or foreign representatives”<sup>145</sup> and a list of forms of cooperation.<sup>146</sup> Nearly every year since 1999, UNCITRAL, in conjunction with INSOL International, has hosted a Multinational Judicial Colloquium in various locations around the globe.<sup>147</sup> Since being reconstituted, the Working Group has “facilitated informally” a compilation of “practical experience with respect to negotiating and using cross-border insolvency protocols” by consulting with judges and insolvency practitioners, and continuing and building on the multinational judicial colloquia.<sup>148</sup>

## 2. Corporate Groups

The Legislative Guide was not completely silent on the topic of corporate groups. It provided three pages of commentary on the difficulty of addressing the topic of corporate groups, either with multiple insolvency proceedings in a single jurisdiction or multiple proceedings pending before courts across the globe,<sup>149</sup> but it contained no recommendations on the topic. To fill this gap, the current Working Group on Insolvency Law was directed by the Commission to consider the topic of corporate groups,<sup>150</sup> and it has met twice to consider the topic.<sup>151</sup>

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145. *Id.* art. 25(2).

146. *Id.* art. 27. As noted earlier, others have sought to extend on UNCITRAL’s Model Law by promulgating additional recommendations for coordination in cross-border insolvency cases. See *supra* text accompanying notes 124–31 (discussing IBA Concordat on Cross-Border Insolvency and ALI Transnational Projects).

147. For information about these colloquia, see UNCITRAL, UNCITRAL Colloquia, available at <http://www.uncitral.org/uncitral/en/commission/colloquia.html> (last visited Mar. 28, 2007).

148. *Annotated Provisional Agenda*, *supra* note 53, at 3, ¶ 9(c).

149. Legislative Guide, *supra* note 28, at 249, pt. 2, § V (Management of proceedings); at 276–79, pt. C (Treatment of corporate groups in insolvency).

150. *Annotated Provisional Agenda*, *supra* note 53, at 3, ¶ 9(a).

After consideration, the Commission agreed that: (a) The treatment of corporate groups in insolvency was sufficiently developed for the topic to be referred to Working Group V (Insolvency Law) for consideration in 2006 and that the Working Group should be given the flexibility to make appropriate recommendations to the Commission regarding the scope of its future work and the form it should take, depending upon the substance of the proposed solutions to the problems the Working Group would identify under that topic.

*Id.*

151. For the documents recording that meeting, see UNCITRAL, Working Group V, 2001–2004: Insolvency Law, available at [http://www.uncitral.org/uncitral/en/commission/working\\_groups/5Insolvency.html](http://www.uncitral.org/uncitral/en/commission/working_groups/5Insolvency.html) (last visited Mar. 28, 2007).

### 3. Post-commencement Financing of Corporate Groups

The Legislative Guide contains five pages of commentary and five recommendations on the topic of the necessity and standards for providing access to fresh funds to an insolvency representative following the commencement of insolvency proceedings—a concept referred to in the Legislative Guide as post-commencement financing.<sup>152</sup> The current Working Group on Insolvency Law has been directed to consider the circumstances under which the provision of post-commencement financing could be facilitated through domestic legislation, both in the case of a corporate group with multiple proceedings pending in the enacting state and in the case of a corporate group with multiple proceedings pending in a number of different countries.<sup>153</sup> The provision of post-commencement financing to a corporate group, whether in a domestic or cross-border setting, was covered neither in the Model Law nor in the Legislative Guide, and constitutes a natural extension of other issues currently being considered by the Working Group—court-to-court coordination and corporate groups.<sup>154</sup>

#### IV. INCREMENTALISMS AND LEGITIMACY

An examination of both the source and consequences of incrementalism suggests interrelationships between this method of global lawmaking and the legitimacy of the international organization. Incrementalism is not merely a matter of adoption or enactment of strategies of nation-states, nor even the strategies of international organizations as they anticipate the steps that adopting states will be prepared to take. It is also a strategy adopted by international organizations to legitimate themselves and thereby, their products. Incrementalism in nation-states presumes that the global norms to be adopted have been developed by international organizations generally perceived to be legitimate and that the product of an international organization has been developed by means that are perceived as right and fair. Incrementalism applies not only to the international organization as a whole, as it seeks to ratchet up its cachet and

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152. Legislative Guide, *supra* note 28, at 75–82, pt. 2, § II (Treatment of assets on commencement of insolvency proceedings); *id.* at 113–19, pt. D (Post-commencement finance), including Recommendations 63–68.

153. *Annotated Provisional Agenda*, *supra* note 53, at 3, ¶ 9(b) (“Post-commencement financing should initially be considered as a component of work to be undertaken on insolvency of corporate groups, with the Working Group being given sufficient flexibility to consider any proposals for work on additional aspects of the topic.”).

154. *Id.* at 2–3, ¶ 8 (describing work on corporate groups and post-commencement financing for corporate groups, as building upon and complementary to the work already completed by the Commission in the Legislative Guide).

reputation as a rightful locus of global norm-making, but also to its products in a given area of global lawmaking. Thus, we find it not surprising that UNCITRAL's boldest projects—its efforts to develop international laws governing electronic communications and e-commerce, and to build and articulate a global consensus on, not simply the coordination of insolvency proceedings that transcend borders, but the substance of domestic insolvency laws—are its most recent efforts. UNCITRAL may not have been viewed capable or qualified to take on global law reform of this magnitude without first having succeeded in promulgating conventions on international sales, transport, payments, arbitration and dispute resolution, and procurement and project finance.

In either case, it can be expected that an international organization will pursue what Ian Hurd labels "legitimation strategies."<sup>155</sup> These strategies will seek to build legitimation on three foundations: representativeness, such that the crafters of new global norms are seen to be representative of the jurisdictions, or more properly, the kinds of jurisdictions, to which they are promulgated; procedural fairness, such that participants in global reform efforts have their voices heard by rules that enable the weak and the strong, peripheral and core players, to participate in ways that seem fair; and effectiveness, such that prior accomplishments of an international organization are parlayed into probable future successes. Each of these criteria affects incremental steps in global norm-making.

If early drafts of global norms have been formulated by a biased subset of powerful countries only, or by countries in the North only, or by the representatives of only one legal family, then an international organization might well pursue a legitimation strategy of broadening its representativeness in order to demonstrate to all potential adopters that nations like theirs did in fact have their voices heard in the norm-making process. Sometimes international organizations may overreach and have to start again with a more legitimate decision-making body. For instance, the U.N. Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958—commonly referred to as the New York Convention—may have overreached by generating a product that gave many nations too little opportunity to reflect their national differences. When UNCITRAL took over this earlier U.N. project, stepped back, and tried again with the Model Law on International Commercial Arbitration, it was much more successful, precisely because it allowed local flexibility in adoption and covered a narrower scope of arbitrations.<sup>156</sup> Similarly, if the rules of participation in the drafting chamber allow expert organiza-

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155. HURD, *supra* note 11.

156. *See supra* text accompanying notes 56–72.

tions to overwhelm the policy and political concerns of delegates, a product may emerge that takes much bigger steps than many nation-states can manage. Arguably most important of all, legitimacy rests in some measure on prior success. While this is true for an international organization as a whole, it is also true for its products in a particular legal arena. A sensible legitimation strategy would therefore proceed with first steps that permit both consensual products from a representative body and probable adoption by a large number of nations, including nations with strong symbolic auspices. The insolvency cycles exemplify this pattern: beginning with a Model Law on a narrow front and, following its success, proceeding with a Legislative Guide on a wider front, and thereafter pressing forward with even more challenging issues. Beginning with procedure and broadening to substance.

First, examination of multiple steps within a particular area of law reveals that incrementalism is not all of a piece. It involves not one but multiple strategies. Examining the entirety of its record of law reform, we find that UNCITRAL works both vertically within issues to sharpen the focus and horizontally to broaden the scope of the reach of its international instruments on a subject. We also find that occasionally UNCITRAL has worked pyramidally to build, not simply on its own work product, but on the shoulders of law reform efforts promulgated by other international organizations, such as the United Nations, UNIDROIT, the Hague Convention, the World Bank, and the International Monetary Fund. Second, there are multiple incrementalisms. We have identified three. *Vertical* incrementalism follows a logic of "intensification of action." More intensive development of a topic can take several forms: a move towards more binding international instruments (e.g., from a set of recommendations or principles to a convention), an increased precision in the detail covered over successive rounds of norm-making, or a shift from procedural to substantive topics. *Horizontal* incrementalism follows a logic of "extensification of action." Here, the breadth of a topic or domain is widened. *Pyramidal* incrementalism explicitly acknowledges that global norm-making frequently involves competition or cooperation among a variety of international organizations, each of which may have offered one or another proposal for global norms. When successive products explicitly or even implicitly build on prior products, often produced by different international organization, then the subsequent steps towards an integration of products in a global consensus take on a pyramidal form. Multiplicities of building blocks are successively forged into more coherent products. We have seen that UNCITRAL has performed this function in many areas of law, not the least insolvency.

These two theoretical steps—that incrementalism take multiple forms and that incrementalism can be explained in part as a legitimation strategy for international organizations—introduce many questions.

We identify three forms of incrementalism, but have only begun to examine the implications of each. Take pyramidal incrementalism. This is a profoundly political move because frequently it is intricately involved with delicate mutual adjustments among multiple international organizations in a legal field, sometimes including professional associations and other private legislatures. Occasionally, it occurs by aggregating discrete endeavors among organizations that might have had nothing to do with each other directly. That the UNCITRAL Working Group on Insolvency succeeded in bringing together the distinctive contributions of the European Union, Hague Conference, Asian Development Bank, and International Bar Association with its Legislative Guide on Insolvency Law presents a case in point. Pyramidal incrementalism may also occur either by conciliating among competing views or alternative formulations, or by transcending or compromising over competing forms of global norms, such as principles, standards, recommendations, and draft model laws. It could proceed via a hostile takeover, where an international organization seizes the initiative from smaller, weaker organizations and appropriates their produces for its own purpose, or via a friendly merger, where an international organization gains the support and cooperation of its predecessors because it has assets they do not have.<sup>157</sup> We know much too little about the political dynamics of this kind of incrementalism.

Furthermore, it is clear that the various forms of incrementalism may engage each other in complex ways, but we cannot yet explain why in very detailed terms. We hypothesize that there are sequences of incrementalisms that arise in differing circumstances. UNCITRAL's initiatives on insolvency suggest one sequence: beginning with a topic (in this instance, one focused on procedure) on which earlier transnational (regional) work had been nearly completed, moving horizontally to a broader range of related substantive issues again by means of a pyramidal building of international consensus, then following by further efforts to dig deeper in issues on which consensus was not reached in the first or second effort at global lawmaking. UNCITRAL's work on e-commerce present another sequence: beginning with a topic at the broadest levels of generality, and then returning to that topic again and again to dig more deeply, intensifying and hardening its efforts over time. A pyramidal in-

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157. See Terence Halliday, *Legitimacy, Technology, and Leverage: The Building Blocks of Insolvency Architecture in the Decade Past and the Decade Ahead*, 32 BROOK. J. INT'L L. 1081 (2007).

crementalism might never occur if a pioneering organization seizes the initiative on a topic and other international organizations subsequently defer to it as the appropriate forum for global norm-making. Moreover, a horizontal initiative may overreach and the next step may be to narrow its breadth and soften its aspirations for hard law. Or, alternatively, incremental reform efforts may proceed too slowly to engage the approval of the international community.<sup>158</sup> We leave for subsequent research the task of identifying these sequences and explaining the circumstances likely to produce one sequence rather than another.

We have proposed that one set of explanatory factors will be legitimating the challenges of an international organization. This raises a number of questions regarding the relationship between incrementalism and legitimacy that are stimulated by our data, but go beyond the bounds of this paper.

For example, do international organizations, such as UNCITRAL, adopt characteristic patterns of incrementalism? If an organization is well established and accorded high generalized legitimacy by its key audiences, will it require fewer incremental steps than an international organization that is less favorably received by the international community? Can it move more rapidly to expand its work horizontally? Will it be less (or more) reliant on a pyramidal strategy? If an international organization is weaker or suffers from legitimation deficits, is it likely to confine its aspirations? This might suggest that there is an international division of labor in a field of global lawmaking where some organizations are well positioned, in part due to their "stock" of legitimacy, to perform integrative, and coordinating and consensus-building functions. Resolution 2205 (XXI) claims such a mandate, but was the mandate developed through international consensus, or was it simply asserted by the U.N. on behalf of UNCITRAL with UNCITRAL left to build its role as a coordinative body?

In addition, do attributes of an area of law lead to differing strategies by international organization? An entirely new area, such as electronic commerce, might necessarily begin with a narrow focus that has an affinity with vertical and horizontal incrementalism. A long-established area of law such as bankruptcy, which has stimulated a variegated international field of international organizations, each offering its particular product, might necessarily require that subsequent entrants to the field either narrowly focus on missing elements or accept that a broadened

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158. See, e.g., Hathaway, *supra* note 2, at 531 ("The danger of this [sort of incrementalist] approach, however, is that it can stall at any point in the cycle.").

focus requires a pyramidal advance such as the Legislative Guide on Insolvency.

Does vertical incrementalism (e.g., in the direction of a harder global norm) or horizontal incrementalism (e.g., in reaching to hitherto undeveloped areas of law) require a re-examination of the legitimacy warrants of an international organization? This question in turn implies that incrementalisms of any kind may take the form of larger or smaller steps. Incrementalisms have formal properties pertaining to the size of the incremental step or the speed of movement from one stage to the next. UNCITRAL's Working Group on Insolvency Law took a quick and large step beyond the Model Law. How was this possible? In part because it had achieved quick success with the Model Law and that gave it a shot of legitimacy. In part because the procedural rules it adopted allowed experts and delegates to work effectively together. In even greater part, it can be argued that the quick expansive step towards the core topics of substantive and procedural bankruptcy law was made possible by the diverse efforts of other international organizations. UNCITRAL had a great deal to work with, including some sense of how much convergence might be possible, thanks to the initiatives of the IMF, World Bank, and Asian Development Bank. Pyramidal incrementalism, in other words, leveraged horizontal incrementalism.

#### IV. CONCLUSION

So the dance continues—up and across the dance floor, arm and arm with other international organizations in an elaborate roundelay, building on earlier performances. Consensus building—for that is what produces global law—takes time and political skill. Once we conceptualize incrementalism in these terms, a theoretical and empirical agenda opens up that includes but far exceeds insolvency lawmaking. By distinguishing among types and formal properties of incrementalism, and by linking them with the problem of legitimacy for international organizations, we offer a conceptual apparatus conducive to explaining why international organizations take the steps they do in crafting global law.

# CHOOSING THE LAW GOVERNING SECURITY INTERESTS IN INTERNATIONAL BANKRUPTCIES

*Steven L. Harris*\*

As one who approaches international bankruptcies<sup>1</sup> with security interests<sup>2</sup> in the foreground, I was immediately struck by The American Law Institute's acknowledgment that two of the bankruptcy choice-of-law issues confronting holders of security interests—which jurisdiction's avoidance law should apply and which jurisdiction's priority scheme should apply—are particularly difficult to resolve as a practical matter and that “[p]riority problems, including the choice of law to govern [security interests], are among the greatest obstacles to achievement of a unified approach to the general default of multinational companies.”<sup>3</sup> Mindful of the Institute's admonition that the solution to these

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\* Professor of Law, Chicago-Kent College of Law. The author thanks Elizabeth DeArmond, David Gerber, Charles Mooney, and Mark Rosen for their helpful comments. Citations to the official text of, and comments to, the Uniform Commercial Code (“U.C.C.”) are to the version that appears in Uniform Commercial Code 1 (2005 ed. West). Citations to “former” U.C.C. Article 1 are to the version of Article 1 found *id.* at 1879. Citations to “former” U.C.C. Article 9 are to the version of Article 9 found *id.* at 1775.

1. As has become customary in this context, I use “bankruptcy” to include proceedings for liquidation and reorganization and limit my discussion to corporate debtors.

2. I use the term according to its definition in the Bankruptcy Code, 11 U.S.C. § 101 (2005). “The term ‘security interest’ means lien created by agreement.” Bankruptcy Code § 101(51). “The term ‘lien’ means charge against or interest in property to secure payment of a debt or performance of an obligation.” *Id.* § 101(37). As used in the U.C.C., the term “security interest” includes many outright sales of accounts and other receivables. U.C.C. § 1-201(37)(b)(35) (definition of “security interest”); § 9-109(a)(3), (d) (applicability of Article 9). I deal here only with security interests that secure obligations; however, the analysis may be relevant to a discussion of other transfers of personal property, including transfers of ownership (whether governed by or excluded from Article 9).

3. AMERICAN LAW INSTITUTE, TRANSNATIONAL INSOLVENCY PROJECT: PRINCIPLES OF COOPERATION AMONG THE NAFTA COUNTRIES 18 (2003) [hereinafter “ALI PRINCIPLES”] (relying upon Ulrik Rammeskov Bang-Pedersen, *Asset Distribution In Transnational Insolvencies: Combining Predictability and Protection of Local Interests*, 73 AM. BANKR. L.J. 385 (1999) and Jay L. Westbrook, *Universal Priorities*, 33 TEXAS INT’L L.J. 27 (1998)). Of course, holders of security interests are concerned about which law will govern various other aspects of a bankruptcy. These include whether (to the extent the security interest enjoys priority) the secured party will be entitled to recover the collateral itself or just the value of the collateral. If just the value, under which standard of valuation? How long a delay before the secured party will receive a distribution? What happens during the delay (e.g., may the debtor use or sell the collateral)? How are costs and risks attendant to the delay (e.g., the opportunity cost to the secured party; the risk of a

problems probably must await “some level of institutional advance,”<sup>4</sup> I nevertheless have chosen to avail myself of the opportunity that this Symposium presents by pursuing some tentative, exploratory work on the subject.

#### I. THE NEED FOR PREDICTABILITY

These important choice-of-law issues are difficult in large part because they implicate an array of desiderata, no one of which can be satisfied in full without impairing the satisfaction of another (or so it seems). As have others, I take “predictability” to be a principal desideratum of the content of choice-of-law rules.<sup>5</sup> Financial institutions and others who extend secured credit (“secured parties”) desire certainty. By entering into a secured transaction with a debtor, secured parties have taken steps designed to increase the likelihood of being paid. A security interest is meant to afford reasonable assurance that, if the debtor defaults in payment or performance of the secured obligation, the secured party will have the legal right and practical ability to use the collateral as a source from which the secured obligation can be recovered. Anything that prospectively undermines the assurance reduces the value of the security interest. Whatever reduces the value of the security interest increases the cost of the credit transaction. And, as we all know, the debtor typically bears at least part of the increase.

The desire for certainty concerning the choice of law governing security interests in personal property fueled the tremendous and remarkably successful drive for a uniform effective date for revised Uniform Commercial Code Article 9.<sup>6</sup> Inasmuch as revised Article 9 strongly resembles its predecessor in most respects, one might have minimized the im-

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reduction in the nominal value of collateral through depreciation or loss) allocated between the secured party and other creditors? This article does not address these concerns.

4. ALI PRINCIPLES, *supra* note 3, at 18.

5. Both territorialists and universalists claim that their approach to international bankruptcies fosters predictability. Lynn M. LoPucki, *The Case for Cooperative Territoriality in International Bankruptcy*, 98 MICH. L. REV. 2216 (2000); Jay Lawrence Westbrook, *Locating the Eye of the Financial Storm*, 32 BROOK. J. INT'L L. 1019 (2007); Jay Lawrence Westbrook, *Choice of Avoidance Law in Global Insolvencies*, 17 BROOK. J. INT'L L. 499 (1991). By stating that predictability is a desideratum, I should not be understood to say that it is the *only* desideratum. Other concerns are discussed below.

6. See U.C.C. § 9-701 (providing for effective date of July 1, 2001). All fifty states and the District of Columbia enacted revised Article 9 prior to the uniform effective date, and on that date the revised Article took effect in all but four states. G. Ray Warner, *Non-uniform Effective Dates and the Transition to Revised Article 9*, AM. BANKR. INST., available at <http://68.72.75.1/abidata/online/journaltext/01jullien.html> (last visited Apr. 25, 2007).

portance of temporal uniformity. The official comments observe, however, that “[w]hile always important, uniformity is essential to the success of this Article.” As the primary example, the comments refer to the change wrought by revised Article 9 in the designation of the jurisdiction whose law governs perfection of a security interest. “[H]orrendous complications may arise” if “the status of a particular security interest as perfected or unperfected[] would depend on whether the matter was litigated in a State in which former Article 9 was in effect or a State in which [the revised] Article was in effect. . . . Any one State’s failure to adopt the uniform effective date will greatly increase the cost and uncertainty surrounding the transition.”<sup>7</sup>

The differences among the various legal regimes governing secured credit around the world are, to say the least, substantially greater than the differences between former and revised Article 9. The absence of uniformity among potentially governing laws may impose much more significant costs on a secured transaction that implicates more than one nation than on an otherwise identical transaction that implicates only U.S. jurisdictions. The differences among national regimes go far beyond questions of how to “perfect” a security interest. Rather, the very effectiveness of a secured transaction may depend on the jurisdiction whose law governs.<sup>8</sup>

As others have explained at length, merely adding the possibility of a collective proceeding reduces predictability and increases costs (unless the collective proceeding has absolutely no effect on the rights of the secured party with respect to the collateral).<sup>9</sup> These include the costs attendant to strategic behavior (e.g., depending on whether bankruptcy law treats a particular creditor’s claim more or less favorably than non-bankruptcy law, the creditor has an incentive to push the debtor into bankruptcy or keep the debtor out) and those attendant to planning for multiple outcomes.<sup>10</sup> If maximizing predictability and minimizing costs for secured parties were the only considerations, we might prefer a bankruptcy law that affords to the secured party the identical rights as otherwise applicable non-bankruptcy law affords and that leaves security interests completely unaffected. Of course, the same could be said for unsecured claims; making the rights of unsecured creditors turn on whether

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7. U.C.C. § 9-701, cmt.

8. To a very limited extent, this was the case with respect to the difference between former and revised Article 9. *See id.*

9. *See, e.g.,* THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 203–04 (1986). A collective proceeding addresses the claims of many, and sometimes all, creditors of a given debtor.

10. *Id.* at 196–97.

the debtor is the subject of a collective proceeding imposes costs. Presumably, a bankruptcy proceeding confers benefits that more than offset these costs. Otherwise, we would be content with non-bankruptcy law.

This analysis suggests that bankruptcy law should affect a secured party's non-bankruptcy rights only to the extent necessary to produce the benefits that a collective proceeding affords. A secured party's principal concern is recovering promptly the full amount of its claim. From this perspective, one might favor a bankruptcy law that gives a secured party a recovery whose value equals the recovery that, as a practical matter, would have been obtained in the absence of a bankruptcy. In the first instance, this means that a security interest should be eligible for priority with respect to the value of the collateral. That is, a bankruptcy law should recognize the distinction between secured and unsecured claims.<sup>11</sup> If applicable non-bankruptcy law treats a given claim as secured by particular assets, the claim should be eligible for the same treatment under bankruptcy law.<sup>12</sup>

## II. UNIFORM CHOICE-OF-LAW RULES: A SECOND-BEST SOLUTION

Where a secured transaction implicates more than one jurisdiction, which jurisdiction's non-bankruptcy law is applicable? The answer would make little difference if the substantive law governing creation of a security interest were uniform throughout the world and all the various bankruptcy laws gave effect to security interests: The same outcome would obtain regardless of which jurisdiction's substantive law a bankruptcy court were to apply.<sup>13</sup> The fact is, however, that secured-credit regimes are notoriously nonuniform, and there is little reason to believe that uniformity will be achieved in the near, or even the middle, term. Given this substantive nonuniformity, the best way to achieve predictability may well be to push for uniformity in the governing choice-of-law rule.<sup>14</sup>

With a single choice-of-law rule (or set of choice-of-law rules) that is applied universally, a secured party would know which jurisdiction's

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11. I use the terms "secured claim" and "unsecured claim" as they are used in Bankruptcy Code, 11 U.S.C. § 506(a)(1) (2005).

12. As I suggested, the fact that a security interest is being treated in a collective proceeding is likely to require that the treatment it receives will differ from the non-bankruptcy treatment. Differences in treatment arising from collectivist considerations, including the application of avoidance powers, are discussed below.

13. This is not to say that we would be living in a world of complete predictability. Uncertainty of meaning and application would attend even a uniform law.

14. Note, however, that the unpredictability that attends any judicial determination is exacerbated when the court applies the law of a foreign jurisdiction.

substantive secured-credit regime would apply to any given secured transaction. A uniform choice-of-law rule would be more costly than a uniform substantive law of secured transactions.<sup>15</sup> It would require secured parties whose transactions implicate many jurisdictions to familiarize themselves with a variety of secured-transactions laws. However, a uniform choice-of-law rule would be a marked improvement over the current situation, where a secured party in an international transaction must assess the likelihood of its security interest being challenged in courts of different nations and determine which substantive law each of those courts would be likely to apply.

### III. CHOOSING THE CHOICE-OF-LAW RULE

#### *A. The Lex Situs Approach*

What should be the content of a uniform choice-of-law rule? As a general matter, courts apply the law of the situs of property—the *lex situs*—to determine the existence and enforceability of claims to the property.<sup>16</sup> While some have criticized the results of indiscriminate application of the situs rule, even with respect to real property,<sup>17</sup> there would seem to be good reasons to apply the law of the situs to determine in the first instance whether a security interest will be recognized in a debtor's bankruptcy.

Suppose, for example, that a secured party (“*SP*”) claims a security interest in goods owned by a debtor (“*Debtor*”) and located in a particular nation (“*State A*”). The physical presence of the goods is the only (or at least the primary) connection between *State A* and the transaction parties, whose other contacts are all with another nation (“*State B*”). If *SP* wants to enforce its security interest against an unwilling *Debtor*, in all likelihood it will need to invoke the assistance of a sheriff or comparable public official from *State A*. It may be the case that a public official will assist *SP* in response to a judgment entered by *State B*. But *SP*'s safest and surest course is to seek a determination by a *State A* court that *SP* has a property claim that supports enforcement. To make this determination, the *State A* court normally will consult its own law. At least as to the effectiveness of the secured transaction between the immediate parties, the law of *State A* may well give effect to the parties' express choice

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15. The statement in the text assumes that the uniform substantive law does not itself impose large, unnecessary costs.

16. Restatement (Second) of Conflict of Laws § 222, cmt. b (1971).

17. See, e.g., RUSSELL J. WEINTRAUB, COMMENTARY ON THE CONFLICT OF LAWS (5th ed. 2006).

of law within fairly broad limits.<sup>18</sup> If State A law gives effect to party autonomy in this setting and the parties to the security agreement provide that their rights are governed by the law of State B, then a State A court is likely to look to the substantive law of State B to determine whether a security interest has been created. If not, then a State A court is likely to look to the substantive law of State A.

The determination whether *SP* has an in rem claim to the collateral may be relevant not only to the resolution of a “property” question, i.e., whether *SP* holds a security interest enforceable against the debtor,<sup>19</sup> but also to the resolution of a “priority” question: How is the value of the collateral to be allocated between *SP* and a competing creditor or purchaser of the collateral (“X”)? Just as recognition of *SP*’s security interest should depend on whether it would be recognized by the courts of State A, so should the recognition of other asserted in rem claims. That is to say, where property is located in State A, a third party may need to invoke the power of the courts of State A to realize the benefits of its property interest. For the same reason, the relative ranking of two in rem claims (e.g., whether X’s claim is superior or junior to *SP*’s), should be (and in many jurisdictions is) decided by the law of situs of the goods. There also is likely to be a cost savings if a court applies the law of State A to both the property and priority questions.

In some jurisdictions, the bankruptcy administrator (in the U.S., the trustee in bankruptcy) enjoys the rights and powers of an in rem creditor or purchaser.<sup>20</sup> In such cases I would determine those relative rights by reference to the same law as I would apply to determine the existence of a cognizable security interest—the law of the location of the collateral. So, in the example above, if the applicable bankruptcy law provides that collateral comes into the bankruptcy estate free of any security interest that would be subordinate to the rights of a judicial lien creditor, then the court would look to the substantive law of State A to determine whether *SP*’s security interest would be junior or senior to the rights of a creditor who acquires a judicial lien through the judicial process of State A.<sup>21</sup>

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18. See, e.g., U.C.C. § 1-301(c) (2001) (a transaction bearing a “reasonable relation” to that state will trigger application of that state’s act); former U.C.C. § 1-105(1) (2000).

19. Under Article 9, a security interest that has become enforceable against the debtor is said to have attached. See U.C.C. § 9-203(a) (2001) (“[a] security interest attaches when it becomes enforceable against the debtor with respect to the collateral”); *id.* 9-203(b) (explaining when a security interest becomes enforceable).

20. See, e.g., Bankruptcy Code, 11 U.S.C. § 544(a) (2005).

21. Even a state that permits the parties to establish property rights between themselves under the law of another state is most unlikely to permit the parties to impose the other state’s law on third parties. Compare U.C.C. § 1-301(c)(2) (2001) (affording parties broad autonomy to choose the governing law) with U.C.C. § 1-301(g) (2001) (providing

ALI Principles observes that “the traditional choice-of-law rules for secured transactions are coming under increasing pressure.”<sup>22</sup> It refers specifically to the fact that revised Article 9 “abandons for certain purposes the traditional *lex situs* rule in favor of a location rule that depends internationally on a post-hoc conclusion about the substance of the debtor’s security-interest law.”<sup>23</sup> The scope of this abandonment should not be overstated. Where the security interest is possessory (i.e., tangible collateral is in the possession of the secured party), the law of the jurisdiction in which the collateral is located governs the priority of competing claims to the collateral.<sup>24</sup> And even in the much more common case where the debtor remains in possession of tangible collateral, the *situs* rule applies: the priority of a security interest is governed by the law of the jurisdiction where the collateral is located.<sup>25</sup> Indeed, as regards tangible collateral, revised Article 9 departs from the *situs* rule only with respect to whether a nonpossessory security interest is perfected. As to such a security interest, perfection is governed by the law of the jurisdiction in which the debtor is located.<sup>26</sup> The “location of the debtor” choice-of-law rule tells the forum court that (1) the applicable priority rule is that of the law of the *situs* and (2) if the priority law of the *situs* turns on whether a security interest is perfected or unperfected, the court should determine whether the security interest enjoys perfected status by reference to the perfection requirements of the debtor’s location.

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that, to the extent the U.C.C. governs a transaction, the parties’ agreement is ineffective to the extent it is contrary to the Article 9 choice-of-law rules governing perfection and priority).

22. ALI PRINCIPLES, *supra* note 3, at 19.

23. *Id.* The rule in question is found in U.C.C. § 9-307(b) (2001). For a discussion of this choice-of-law rule and its potential for universal applicability, see Charles W. Mooney, Jr., *Extraterritorial Impact of Choice of Law Rules for Non-United States Debtors under Revised Uniform Commercial Code Article 9 and a New Proposal for International Harmonization*, in CROSS-BORDER SECURITY AND INSOLVENCY 187 (Michael Bridge & Robert Stevens eds. 2001).

24. *See* U.C.C. § 9-301(2) (2001). For these purposes, “tangible” collateral that is subject to “possession” includes not only goods but also money and intangibles that have been reified, such as instruments, tangible negotiable documents of title, and tangible chattel paper. *See* U.C.C. § 9-313(a) (2001); U.C.C. § 9-102(a) (2001) (defining “instrument,” “document,” “chattel paper,” and “tangible chattel paper”); U.C.C. 1-201(b)(16) (2001) (defining “tangible document of title”); U.C.C. § 7-104 (2001) (explaining when a document of title is negotiable).

25. U.C.C. § 9-301(3)(c) (2001).

26. U.C.C. § 9-301(1) (2001).

As a general matter, nonpossessory perfection will be accomplished by filing a financing statement in the public record.<sup>27</sup> From the perspective of predictability, assuming that the court applies the “uniform” choice-of-law rules in Article 9, a secured party has comfort that, if it takes the perfection steps specified by the local law of the debtor’s jurisdiction, it will enjoy perfected status for purposes of applying the priority rules of the situs. Put otherwise, from a planning perspective, as applied to security interests in goods, the effect of Article 9’s nontraditional choice-of-law rule (location of the debtor) ordinarily is to tell the secured party what to file and where to file it. The wrinkle for international transactions, under which the law governing perfection turns on a “post-hoc conclusion about the substance of the debtor’s security-interest law,”<sup>28</sup> reflects Article 9’s paramount concern for public notice in a world in which most non-U.S. jurisdictions do not have a public-notice system for secured transactions in personal property.<sup>29</sup> In short, nothing in the policy underlying revised Article 9’s choice-of-law provisions suggests that the validity and priority of a security interest in the debtor’s bankruptcy should be determined other than under the non-bankruptcy substantive law of the jurisdiction where the collateral is located (in the example, State A).<sup>30</sup> Indeed, this is the approach of the UNCITRAL Draft Legisla-

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27. See § U.C.C. 9-310(a) (2001) (stating the general rule that a financing statement must be filed to perfect all security interests and setting forth exceptions); U.C.C. § 9-307(b) (2001) and (c) (debtor is located in the District of Columbia if the ordinary rules for determining its location point to a jurisdiction whose law does not generally condition perfection on public filing or recording). Filing works to perfect a security interest in nearly all kinds of collateral. See U.C.C. § 9-310 (2001). The principal exceptions are deposit accounts, money, letter-of-credit rights, and goods covered by a certificate of title. See U.C.C. § 9-311(a) (2001); § 9-312(b) (2001).

28. ALI PRINCIPLES, *supra* note 3, at 19.

29. One might infer from U.C.C. § 9-307(c) (2001) that Article 9’s concern that security interests be evidenced by public notice trumps its concern that outcomes be predictable.

30. By “non-bankruptcy substantive law of the jurisdiction where the collateral is located,” I mean the substantive law that the court would apply, taking into account its choice-of-law rules. The *renvoi* would seem to serve no useful purpose in this setting. See Larry Kramer, *Return of the Renvoi*, 66 N.Y.U. L. REV. 979, 997–1002 (1991). Ideally, then, if State A’s choice-of-law rules referred to the law of another state, it would refer only to that state’s local law and not its whole law. Revised Article 9 adopts this approach. See U.C.C. § 9-301.

Whether the validity and priority of a security interest should be determined by a court of the jurisdiction whose substantive law governs (in the example, a State A court) or by another state’s court (with or without the assistance of a State A court) is a separate issue, which I leave to others.

tive Guide on Secured Transactions (“UNCITRAL Secured Transactions Guide”).<sup>31</sup>

*B. Shortcomings of the Lex Situs Approach*

Uniform adoption of the choice of the *lex situs* would enhance predictability greatly but is by no means ideal. The approach may require the bankruptcy court of one state to apply the secured-transactions law of another. Secured-credit regimes are widely diverse, and many secured-transactions laws are complicated. Predictable outcomes are by no means assured, even if judges try their best.

Moreover, even if every bankruptcy court were certain to apply the *lex situs*, a secured party never could be absolutely sure which nation’s secured-transactions law would govern. This uncertainty arises because a secured party never can be certain where tangible collateral will be situated at any given moment in the future. I suspect that, in most cases, this uncertainty would be of little, if any, concern. Most tangible collateral does not move; it just sits there. Or, if it does move, its movement can be anticipated by the secured party. Security agreements typically prohibit the debtor from relocating the collateral without the consent of the secured party. One cannot discount entirely the possibility that, shortly before entering bankruptcy, a debtor may relocate collateral with a view towards depriving the secured party of its security interest. For this strategic behavior to succeed, however, the secured-transactions law of the “new” location must be materially different from that of the “old” location. To the extent that the substantive law of secured transactions becomes uniform, the risk is reduced.

Of course, a more narrowly drawn choice-of-law rule or rule of substantive law might prevent this risk from materializing. Former Article 9 directly addressed the risk that collateral will be relocated by giving effect to perfection accomplished under the law of the “old” situs for a fixed period of time after the collateral is removed to the “new” location,<sup>32</sup> and the UNCITRAL Secured Transactions Guide recommends the

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31. United Nations Commission on International Trade Law, Draft legislative guide on secured transactions: terminology and recommendations 102 (July 17, 2006), <http://daccessdds.un.org/doc/UNDOC/LTD/V06/560/12/PDF/V0656012.pdf?OpenElement> (last visited Apr. 4, 2007) [hereinafter UNCITRAL Secured Transactions Guide] (“The law should provide that, except as otherwise provided . . . , the creation, the effectiveness against third parties and the priority as against the rights of competing claimants of a security right in tangible property are governed by the law of the State in which the encumbered asset is located.”)

32. See former U.C.C. § 9-103(1)(d) (2000). Under revised Article 9, the situs of the collateral is irrelevant to the choice of law governing perfection of nonpossessory secu-

same approach.<sup>33</sup> It remains to be seen whether narrowly drawn rules along these lines will be widely enacted. Another route to the same result may be to use equitable principles (or their non-common-law analog) to protect the secured party.<sup>34</sup> Absent protection of some kind, a secured party will take into account the risk of debtor misbehavior in determining whether, and on what terms, to extend credit. In other words, the cost of credit can be expected to be greater.

Although most types of tangible collateral remain stationary, certain types do move—they are meant to move—across national borders. Creditors of North American railroads face this problem today with respect to rail cars. Creditors secured by these rail cars routinely assume that both U.S. and Canadian law will apply to their secured transactions, and so they perfect according to the laws of each. But the track on which the cars travel extends into Mexico, where security interests may be ineffective. Creditors deal with this by covenant, typically to the effect that at any given time only a specified small percentage of cars (say, five percent) will be physically located in Mexico.<sup>35</sup> Greater predictability would be accomplished if the secured-transactions law of every country were to afford the same recognition to any given security interest. This could be accomplished either by adopting the same substantive law of secured transactions or by including, as part of each nation's secured transactions law, a choice-of-law rule that designates the same "home" jurisdiction for mobile goods. Former Article 9 followed the latter approach,<sup>36</sup> which the UNCITRAL Secured Transactions Guide recommends.<sup>37</sup> Perhaps a less unlikely method for reaching the same result is an international convention. For example, UNIDROIT recently adopted a protocol on railroad rolling stock to accompany the Convention on International Interests in Mobile Equipment ("Cape Town Convention").<sup>38</sup> By adopting the

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rity interests. *See* U.C.C. § 9-301(1) (2001). Accordingly, revised Article 9 has no need for a provision comparable to former U.C.C. § 9-103(1)(d).

33. UNCITRAL Secured Transactions Guide, *supra* note 31, at 106.

34. *See, e.g., In re Howard's Appliance Corp. v. Howard's Appliance Corp.*, 874 F.2d 88 (2d Cir. 1989) (imposing a constructive trust on collateral subject to an unperfected security interest where the secured party's failure to file in the appropriate state resulted from the debtor's wrongful relocation of the collateral).

35. Information from Louis P. Warchot, Senior Vice President for Law, Association of American Railroads.

36. For an example of the latter, see former U.C.C. § 9-103(3) (2000) (applying law of the debtor's location to "goods which are mobile and which are of a type normally used in more than one jurisdiction"). U.C.C. § 9-103(3)(a).

37. UNCITRAL Secured Transactions Guide, *supra* note 31, at 102.

38. UNIDROIT, the International Institute on the Unification of Private Law, adopted The Luxembourg Protocol to the Convention on International Interests In Mobile Equip-

Cape Town Convention and the Rail Protocol, a State binds itself to recognize security interests in railway rolling stock that are created by a debtor situated within any Contracting State.<sup>39</sup>

*C. An Alternative Approach: The Location of the Debtor*

Linking the applicable law to the location of the debtor, rather than the location of the collateral, would eliminate the risk that the potential relocation of collateral imposes on secured parties under the situs rule. A debtor-location rule also would provide a single applicable substantive law with respect to all the collateral of a given debtor, regardless of where the collateral is located and even if it lacks a physical location (as is the case with intangibles). Applying the substantive law of the debtor's location may come close to mirroring the non-bankruptcy outcome, inasmuch as a court having jurisdiction over the debtor can compel the debtor to turn over the collateral to the secured party, even if the collateral is located outside the court's territorial reach.

In the abstract, if asked to create a non-bankruptcy choice-of-law rule (that, in turn, would be followed in bankruptcy), secured creditors might well prefer a debtor-location rule to the costs attendant to a situs rule, i.e., restricting the movement of collateral by contract, monitoring its location, and pricing the remaining risk. In practice, however, their enthusiasm likely would be tempered by concerns over whether a debtor-location rule would become widely adopted and applied. One might expect a state's<sup>40</sup> legislature to be reluctant to require its courts to determine claims against property located within the state's territory by reference to the substantive law of another state. One might expect a similar reluctance from a court asked to apply the substantive law of another state to property subject to its administration. And, to the extent that security interests might be governed by the lex situs outside bankruptcy, linking the applicable law in bankruptcy to the debtor's location would mean that a secured party that wished to reduce its risk would need to incur the costs of satisfying the requirements of two different laws.

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ment On Matters Specific to Railway Rolling Stock on February 23, 2007. The Rail Protocol has not yet entered into force. See <http://www.unidroit.org/english/implement/i-2007-railprotocol.pdf> (last visited Mar. 4, 2007) [hereinafter Rail Protocol].

39. International Institute on the Unification of Private Law, Convention on International Interests in Mobile Equipment, art. 4(1), <http://www.unidroit.org/english/conventions/mobile-equipment/mobile-equipment.pdf> (last visited Mar. 5, 2007) [hereinafter Cape Town Convention].

40. Here, I use "state" to mean "nation," which is the usual meaning in the international choice-of-law context.

Moreover, even if widespread agreement could be reached that the validity and priority of security interests in bankruptcy would be determined by the substantive law of the debtor's location, it is by no means certain that a similar agreement can be reached on determining where a debtor is located. Jurisdiction over a debtor may lie in any one of a number of jurisdictions.<sup>41</sup> The U.S. and Canadian secured-transactions regimes, though similar in many regards, designate different debtor locations for choice-of-law purposes. Under the Canadian Personal Property Security Acts, a corporate debtor having more than one place of business is located at its chief executive office.<sup>42</sup> Under revised Article 9, a domestic corporation is located in its jurisdiction of organization.<sup>43</sup> Likewise, recent international instruments addressing secured transactions differ significantly in their provisions with respect to a debtor's location. For purposes of the United Nations Convention on the Assignment of Receivables in International Trade ("Receivables Convention"), a debtor having more than one place of business is located in the place where its "central administration . . . is exercised."<sup>44</sup> In contrast, for purposes of the Cape Town Convention, a debtor is located in "any Contracting State: (a) under the law of which it is incorporated or formed; (b) where it has its registered office or statutory seat; (c) where it has its centre of administration; or (d) where it has its place of business."<sup>45</sup>

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41. *Cf.* RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 421 (1987) (providing that a foreign state's exercise of jurisdiction with respect to a person is reasonable, and thus a judgment of its courts may be recognized by the U.S., if any one of several relationships between the person and the foreign state is present).

42. *See, e.g.*, Personal Property Act, REVISED STAT. BRIT. COLUM. 1996, ch. 359, § 7(1). Former Article 9 contained a similar rule. *See* former U.C.C. § 9-103(3)(d).

43. *See* U.C.C. § 9-307(e). The Ontario PPSA may soon be amended to adopt a similar approach. *See* Proposed Amendment – 7(3), CONSOLIDATED STAT. ONTARIO 2006, c. 34, Sched. E, § 3(2) (proposed amendment to Personal Property Security Act, CONSOLIDATED STAT. OF ONTARIO 1990, c. P.10, § 7(3)).

44. United Nations Convention on the Assignment of Receivables in International Trade, art. 5(h), <http://www.uncitral.org/pdf/english/texts/payments/receivables/ctc-assignment-convention-e.pdf#search=%22uncitral%20assignment%20receivable%22> (last visited Oct. 9, 2006) [hereinafter Receivables Convention].

45. Cape Town Convention, *supra* note 39, art. 4(1), available at <http://www.unidroit.org/english/conventions/mobile-equipment/mobile-equipment.pdf>. The Cape Town Convention uses a debtor's location primarily to determine whether the Convention applies. *See id.* art. 3(1) ("Convention applies when, at the time of the conclusion of the agreement creating or providing for the international interest, the debtor is situated in a Contracting State"). However, it provides for declarations whereby a Contracting State may exclude from application of the Convention certain transactions "where the centre of main interests of all parties to such transaction is situated" in that Contracting State. *See id.* arts. 50, 1(n) (defining "internal transaction").

Similar differences have arisen in the context of international bankruptcy. The European Union Council Regulation on Insolvency Proceedings provides that “the law applicable to insolvency proceedings and their effects shall be that of the Member State within the territory of which such proceedings are opened,”<sup>46</sup> i.e., “the Member State within the territory of which the centre of a debtor’s main interest [“COMI”] is situated.”<sup>47</sup> The UNCITRAL Model Law on Cross-Border Insolvency takes a similar approach.<sup>48</sup> Under both the EU Regulation and the UNCITRAL Model Law, the place of the registered office is presumed to be a company’s COMI in the absence of proof to the contrary.<sup>49</sup> But the Protocols to the Cape Town Convention provide that a debtor’s COMI “shall be deemed to be the place of the debtor’s statutory seat or, if there is none, the place where the debtor is incorporated or formed, unless proved otherwise.”<sup>50</sup>

As Jay Westbrook ably demonstrates in his contribution to this Symposium, the COMI standard is, and already has been, “subject to various interpretations.”<sup>51</sup> As regards the choice of applicable bankruptcy law, flexibility may have its virtues, and, in the aggregate, these virtues may outweigh the attendant costs.<sup>52</sup> However, secured creditors place a premium on certainty. Unlike tort victims and other involuntary creditors, secured parties choose their debtors and do so with care. Unlike unsecured creditors, who rely generally on a debtor’s creditworthiness, secured creditors extend credit in reliance on their anticipated ability to have recourse against specific assets upon the debtor’s default. Given the unlikelihood of achieving widespread application of a debtor-location rule whose content is reasonably certain, secured creditors might well prefer to incur the costs attendant to the application of the *lex situs*.

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46. Council Regulation (EC) No. 1346/2000 of May 29, 2000, art. 4, § 1, 2000 O.J. (L 160) 1, 5 [hereinafter EU Regulation].

47. *Id.*, art. 3, § 1.

48. UNCITRAL, *UNCITRAL Model Law on Cross-Border Insolvency With Guide to Enactment*, art. 17, § 2(b) [hereinafter *UNCITRAL Model Law*] (defining “foreign main proceeding” by reference to “the State where the debtor has the centre of its main interests”). Bankruptcy Code, 11 U.S.C. § 1502(4) (2005), is to the same effect.

49. See EU Regulation, *supra* note 46, art. 3, § 1; *UNCITRAL Model Law*, *supra* note 48, art. 16, § 3. Bankruptcy Code, 11 U.S.C. § 1516(c) (2005), is to the same effect.

50. Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment, art. I, § (2)(n), <http://www.unidroit.org/english/conventions/mobile-equipment/aircraftprotocol.pdf> (last visited Mar. 5, 2007) (defining “primary insolvency jurisdiction”); Rail Protocol, *supra* note 38, art. I, § (2)(d).

51. Westbrook, *Locating the Eye of the Financial Storm*, *supra* note 5, at 1020.

52. See generally *id.*

The foregoing analysis suggests that there is much to recommend a choice-of-law rule under which a bankruptcy court applies the law of the situs (State A) to determine whether to give effect to a security interest. It also suggests that much might be gained from persuading jurisdictions that do not apply the lex situs to change their choice-of-law rule, at least for bankruptcy purposes if not also for non-bankruptcy purposes. Under the lex situs approach, if the law of State A would permit *SP* to reach the collateral, a bankruptcy court should give effect to *SP*'s security interest, even if the applicable non-bankruptcy law of the forum state would not give effect to this security interest.

Suppose, conversely, that the non-bankruptcy law of the situs (State A) would refuse to permit *SP* to reach the collateral. The approach under discussion would suggest that, because *SP* would be unable to obtain value from the collateral without the debtor's cooperation, the putative security interest would not be recognized in bankruptcy. *SP* would hold an unsecured claim in bankruptcy, regardless of which state is the bankruptcy forum. This result would obtain even if the parties' operations were centered in another nation (State B), the parties had agreed that State B's substantive law would govern the creation of the security interest, State B's substantive law would have given effect to the security interest between the parties, and a State B court actually had issued a judgment determining that the security interest is valid and enforceable between the parties. While this potential state of affairs underscores the desirability of moving towards uniformity in the substantive law of secured transactions, the approach underlying it does provide a significant amount of certainty.

#### *D. Choosing the Law Governing Security Interests in Intangibles*

Whatever the advantages of a choice-of-law rule keyed to the location of the collateral may be, such a rule can have no application to intangibles, which have no physical location.<sup>53</sup> In fashioning a bankruptcy choice-of-law rule that, as a first approximation, tracks non-bankruptcy outcomes, one must take into account the fact that the value of many intangibles depends in large part upon the cooperation of a third person, namely, the person who is obligated on the collateral. For example, the value of a debt owing to the debtor (i.e., a receivable owned by the debtor) depends in part on the obligor's willingness to pay. A secured party who wishes to collect a receivable owed by a recalcitrant obligor

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53. As a formal matter, the law might assign a "situs" to an intangible and use this fictional location for purposes of the lex situs rule.

(to use Article 9 terminology, “account debtor”)<sup>54</sup> and who cannot succeed through persuasion must resort to the judicial process. This fact might argue for a choice-of-law rule keyed to the account debtor. On the other hand, the effectiveness of a secured party’s claim to rights in the receivable as against other claimants (e.g., competing creditors to whom the debtor has also purported to give a security interest) depends on which of the purported assignments is given effect and, if more than one is, on the relative priority of the assignments. This fact might argue for a choice-of-law rule keyed to the debtor.

If we are looking to mimic the non-bankruptcy outcome where the issues concern the relative rights of the debtor, secured party, and other claimants (including the bankruptcy administrator) to intangible property, ought we look to the non-bankruptcy law of the account debtor’s location or to the non-bankruptcy law of the debtor’s location?<sup>55</sup> A typical financing transaction involves the assignment of not one but many (if not all) of the assignor’s receivables, not all of which will be owed by account debtors located in a single jurisdiction (however determined). To reduce the cost of financing receivables, some non-bankruptcy law looks to the location of the debtor-assignor, at least with respect to questions of perfection and priority. This was the approach taken by former Article 9,<sup>56</sup> and it is the rule under revised Article 9<sup>57</sup> and the Receivables Convention.<sup>58</sup> It seems like a plausible rule for a court to apply in a bank-

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54. See U.C.C. § 9-102(a)(3) (2001) (definition of “account debtor”).

55. As the discussion above suggests, even if every jurisdiction applies the law of the debtor’s (or account debtor’s) location, the governing law may differ depending on each jurisdiction’s method of determining where a given debtor (or account debtor) is located. There are problems galore in determining the account debtor’s location for these purposes, depending on how precisely one wishes to mimic non-bankruptcy outcomes. Arguably, it could be any jurisdiction in which a judgment against the account debtor might be entered (i.e., with in personam jurisdiction over the debtor). Or perhaps it should be a jurisdiction that also has in rem jurisdiction over property of the account debtor’s that can be used to satisfy the judgment.

56. See former U.C.C. § 9-103(3) (2000).

57. See U.C.C. § 9-301(1) (2001).

58. See U.C.C. § 9-301(1) (2001); Receivables Convention, *supra* note 44, arts. 22 (the law of the State in which the assignor is located governs priority), 5(i) (defining the “law” of a State to exclude the State’s choice-of-law rules). The UNCITRAL Secured Transactions Guide takes a similar approach. See UNCITRAL Secured Transactions Guide, *supra* note 31, at 104.

Although its primary focus is international interests (including security interests) in mobile equipment, the Cape Town Convention also applies to assignments of “associated rights,” i.e., “rights to payment or other performance by a debtor which are secured by or associated with” the equipment. See Cape Town Convention, *supra* note 39, ch. IX (dealing with, *inter alia*, assignments of associated rights), art. 1(c) (defining “associated

ruptcy proceeding, where the account debtors may be widely dispersed and where applying the substantive law of the account debtor's location might require the bankruptcy court to examine the law of a large number of jurisdictions. And, if the bankruptcy forum also is determined by reference to the debtor's location, a bankruptcy court deciding the validity and priority of a security interest under the substantive law of the debtor's location may be more familiar with the law and thus more likely to apply it correctly.

On the other hand, consider the case in which the non-bankruptcy law governing enforcement of the account debtor's obligation would prevent the secured party from judicially enforcing its security interest against the account debtor. For example, that law may not recognize the validity of the security interest or may afford a remedy only to the original obligee (here, the debtor). As between the debtor and secured party, only the debtor may be able to get value from the receivable through the judicial process. And, if the debtor collects that value, it should go to creditors generally. Suppose also that, as between the secured party and other creditors, a court in the debtor's location would award any collections to the secured party and not to the debtor. One might argue that, to properly reflect the non-bankruptcy outcome, the substantive law of the account debtor's location should apply to receivables that are uncollected at the time the debtor enters bankruptcy, whereas the law of the debtor's location should apply to determine the validity and priority of a security interest in the collections held by the debtor at that time.<sup>59</sup>

This bifurcated approach corresponds roughly with the approach to security interests in goods and other tangible property discussed above. The location of goods is analogous to the location of an account debtor; it is the jurisdiction whose courts have the power to enforce the security interest against the collateral. Consider the example in the preceding

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rights"). The Convention applies "when, at the time of the conclusion of the agreement creating or providing for the international interest, the debtor is situated in a Contracting State." *Id.* art. 3(1).

59. One might say that security interests in pre-bankruptcy collections should be governed by the location of the proceeds, but these are likely to be intangible (most likely in some form of deposit account or investment property).

U.C.C. § 9-408(d) presents a situation similar to the one under discussion in the text. It contemplates security interests that attach to, but are only conditionally enforceable against, the original collateral; however, they are unconditionally enforceable against the proceeds of the collateral. *See* U.C.C. § 9-408(d) (2001). The official comments suggest that, once the proceeds arise, the security interest would attach to them even if the debtor is in bankruptcy. *See* U.C.C. § 9-408, cmt. 7 (2001). The comment assumes the applicability of Bankruptcy Code § 552, which gives effect to certain security interests in property acquired by the debtor during the bankruptcy case.

paragraph, with the collateral being goods rather than receivables. The goods are subject to a security interest that the law of the situs does not recognize. The earlier discussion of tangible collateral suggested that a bankruptcy proceeding should not recognize these security interests, even if they would be enforceable under the non-bankruptcy law of the forum, which might well be the law of the debtor's location.

Even if a bifurcated approach makes theoretical sense, it has serious practical drawbacks where the substantive law of the debtor's location would yield a different result from the substantive law of the account debtor's location. The debtor generally can control the timing of its entry into bankruptcy. Making the relative rights of the secured party and competing creditors turn on whether the receivables have been collected before the debtor enters bankruptcy would enable the debtor to allocate value among its competing creditors by deciding whether and when to collect receivables and whether and when to enter bankruptcy. In addition, the rule may be too complicated to achieve widespread acceptance.<sup>60</sup>

Applying the same choice-of-law rule to all receivables, whether collected or not, would seem to make more sense. The practical considerations described above suggest that the law governing security interests in receivables should be the one applicable to collected receivables, i.e., the law of the debtor's location.<sup>61</sup>

#### IV. GOING BEYOND EFFECTIVENESS AND PRIORITY

The foregoing presents an approach for developing a choice-of-law rule to govern whether a claim should be treated as secured in bankruptcy and, if so, the relative priority of the security interest. We turn now to a brief consideration of other aspects of bankruptcy law that may affect the expected value of a bankruptcy distribution to a secured party. As discussed above, insofar as predictability and certainty are concerned, the choice-of-law rule generally should be one whose application would yield the non-bankruptcy outcome. But the desire to replicate the non-bankruptcy world may conflict with the desire to obtain the benefits of a collective proceeding that takes account of the claims of all (or nearly all) the debtor's creditors. Many bankruptcy rules are reasonably de-

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60. For example, questions may arise concerning when a receivable has or has not been "collected." Consider, for example, a check that is in the process of being collected when the bankruptcy case begins.

61. Distinguishing between tangible and intangible property for choice-of-law purposes creates line-drawing issues that may lead to uncertainty. For example, some legal systems reify certain receivables (and thus treat them as tangible for choice-of-law purposes) that other legal systems treat as pure intangibles.

signed to foster the collectivist goals of a bankruptcy. These goals include maximizing the value of assets, reducing the costs attendant to creditor recovery (including the costs of administering the bankruptcy), and safeguarding the integrity of the proceeding. Most, if not all, of these collectivist rules have incidental effects on the distribution of a bankrupt debtor's assets. In evaluating whether a secured party's distribution should be affected by any particular bankruptcy rule, it is useful to distinguish between those rules where the distributional effect is incidental and those where it is not. To a considerable extent, the difference ultimately may be a question of degree rather than of kind.

Some adjustments to the rights of creditors arise from the fact that a bankruptcy court deals with a large number and wide variety of claims against a debtor. For example, the Bankruptcy Code often reflects a leveling, rather than a precise valuation, of claims. Each unsecured claim is allowed by reference to the amount owing as of the commencement of the case, rather than by what the claim would be worth in the market at that time.<sup>62</sup> A claim for \$10,000 (including principal and accrued interest) that bears interest at ten percent is more valuable outside bankruptcy than one bearing interest at five percent. However, under the Bankruptcy Code, each of these claims is allowed for the same amount, i.e., \$10,000.<sup>63</sup> An unmatured claim for \$10,000 is allowed in its face amount, as is a claim that has been reduced to judgment and as to which execution may issue, as is a claim that has been paid or secured shortly before bankruptcy.<sup>64</sup>

A fair amount of bankruptcy law is devoted to maximizing the total value of the assets that make up the bankruptcy estate. One way in which this maximization is accomplished is by automatically staying the enforcement of security interests, thereby preserving for the estate the benefit of any going-concern value or other synergies.<sup>65</sup> The imposition

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62. See Bankruptcy Code, 11 U.S.C. § 101(5) (definition of "claim"), § 502(b) (2005).

63. *Id.*

64. *Id.* A creditor who receives payment of its unsecured claim shortly before bankruptcy may be obligated to disgorge the payment for the benefit of the bankruptcy estate. Likewise, a creditor who receives a security interest to secure its unsecured claim shortly before bankruptcy may lose the security for the benefit of the bankruptcy estate. See *id.* § 547 (providing for the avoidance of preferential transfers); § 550 (providing for recovery of avoided transfers); § 551 (providing that avoided transfers are preserved for the benefit of the estate).

65. See *id.* § 362(a) (imposing a stay of creditor activity upon the filing of a bankruptcy petition). The court must grant relief from the stay where the collateral is of no greater value in the hands of the estate than in the hands of the secured party or where stay puts the value of the security interest at risk. See U.C.C. § 362(d).

of the automatic stay gives rise to a set of provisions dealing with its effect, including those that determine what is to be done with the collateral while the stay remains in effect and those that address the risks associated with the stay.<sup>66</sup> Although they are not couched in priority terms, the application of these provisions may have distributional effects.<sup>67</sup>

Of particular concern to secured parties are bankruptcy rules that directly address the recognition of a security interest and its priority. This article has already discussed bankruptcy rules that invalidate security interests that are not enforceable outside bankruptcy against certain third-party claimants.<sup>68</sup> It suggested that, if such a rule applies, then the question, “is the security interest enforceable outside bankruptcy against a judicial lien creditor?” would be answered best by reference to the priority rules of the situs of the collateral. To return to an earlier example, suppose tangible collateral is located in State A and the debtor enters bankruptcy in State B. State B’s bankruptcy law invalidates security interests that are junior to the rights of judicial lien creditors but State A’s does not. If this provision of State B’s bankruptcy law applies, then the analysis developed above would suggest that the security interest should be invalidated if, under the law of State A, it is junior to the rights of a lien creditor.<sup>69</sup>

Among the bankruptcy rules that directly address the recognition of a security interest are rules that permit the avoidance of preferential trans-

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66. See, e.g., Bankruptcy Code, 11 U.S.C., § 542(a) (2005) (requiring the secured party to turn over collateral to the trustee in bankruptcy); § 363 (governing the sale and use of collateral); § 362(d)(1) (requiring a court to grant relief from the stay for cause, including lack of adequate protection of a security interest).

67. For example, under non-bankruptcy law, a secured creditor normally is free to take steps to liquidate the collateral and reinvest the proceeds immediately upon the debtor’s default. However, in bankruptcy an undersecured creditor who is stayed from enforcing its security interest is not entitled to be compensated for any reinvestment income of which he is deprived. See *United Sav. Ass’n v. Timbers of Inwood Forest Assoc. Ltd.*, 484 U.S. 365 (1988).

68. See, e.g., Bankruptcy Code, 11 U.S.C. § 544(a) (2005). If one thinks that an unperfected secured party is more likely than an unsecured creditor ultimately to reach the asset in question, one may view the “strong-arm power” as another example of the “leveling” of claims. Alternatively, one might view the rule as, in essence, treating the assertion of jurisdiction by the bankruptcy court over the asset for the purpose of distributing it to creditors as analogous to the acquisition of non-bankruptcy liens by each of the creditors in the case.

69. This example raises another important question: Which state’s bankruptcy avoidance law should apply? Professor Westbrook took “the most tentative and preliminary first steps towards a general analysis” of this issue. Westbrook, *Choice of Avoidance Law in Global Insolvencies*, *supra* note 5, at 537. For the most part, this useful article did not address security interests.

fers.<sup>70</sup> Historically, the avoidance of preferential transfers protected the integrity of the bankruptcy proceeding. These rules blunt the ability of certain creditors to “opt out” of an impending collective proceeding. They also can be viewed as a device for maximizing the value of the bankruptcy estate by discouraging creditors from bringing about a piecemeal distribution before the bankruptcy case has begun. To the extent that a preference law is reasonably designed to accomplish these goals, its distributional effects probably should be treated as incidental. A preference law may also reflect a policy of defeating secured claims in bankruptcy.<sup>71</sup> To that extent, it would not seem to justify a departure from the baseline principle that bankruptcy should respect the non-bankruptcy value of security interests.

Avoidance provisions that address potential injury to all creditors also have a distributional effect. Fraudulent transfer rules might fall in this category, though only roughly speaking. One can easily imagine creditor misconduct that is injurious to some of the other creditors yet gives rise to a remedy that benefits all.<sup>72</sup> To the extent that these remedies are unavailable under applicable non-bankruptcy law, what justifies imposing them in bankruptcy?<sup>73</sup> Arguably, the presence of fraudulent transfer provisions in the bankruptcy law reflects a policy to deter, or condemn, conduct that has the potential to be injurious to many. Even if the bankruptcy law were to incorporate applicable non-bankruptcy fraudulent transfer law, determining the non-bankruptcy choice-of-law rules for fraudulent transfers may be difficult.

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70. See, e.g., Bankruptcy Code, 11 U.S.C. § 547 (2005).

71. As applied to security interests, U.S. preference law may not necessarily reflect either an anti-opt-out or an estate-maximizing policy. Given the automatic stay and the trustee's right to use collateral during the bankruptcy, avoiding a security interest would seem to have a distributional effect without increasing the value of the estate. Although an avoidance that results solely from a delay in perfection might be addressing an opt-out problem (as where the secured party's concern about a potential bankruptcy motivates the secured party to investigate the status of its security interest and fix any shortcoming in perfection), it seems at least equally likely to be promoting an independent distributive goal.

72. See Bankruptcy Code, 11 U.S.C. § 548 (2005) (affording to the trustee in bankruptcy the power to avoid fraudulent transfers and fraudulent obligations); § 544(b) (affording to the trustee in bankruptcy the power to avoid fraudulent transfers and fraudulent obligations that are avoidable under applicable non-bankruptcy law and preserve the entire avoided transfer for the benefit of the estate, even if only a single creditor would have been able to avoid the transfer outside bankruptcy).

73. Jackson has suggested that the avoidance power in Bankruptcy Code § 548 may be to eliminate any need to find an aggrieved creditor under non-bankruptcy law. See JACKSON, *supra* note 9, at 146–47.

Last, there are bankruptcy rules that are openly distributive. Principles of equitable subordination can be used to subordinate secured claims by allocating the value of a secured party's collateral to competing creditors.<sup>74</sup> In some jurisdictions, unsecured claims of a particular type enjoy priority in collateral. To the extent they subordinate claims that would not be subordinated outside bankruptcy and do so without a bankruptcy-related reason, these openly (re)distributive rules impose costs without conferring any offsetting benefits. Redistributive rules that promote the interests of a designated class of creditors may be particularly difficult to remove, as they may represent a strongly held value judgment of the people of the bankruptcy jurisdiction or may be the product of a politically powerful group.

#### V. CONCLUSION

Resolving the tension between, on one hand, replicating non-bankruptcy results so as to increase predictability and reduce uncertainty costs and, on the other hand, achieving the cost savings that come from a single collective proceeding is a difficult task that may never be fully accomplished. There is some experience to suggest that agreement of choice-of-law rules may be easier to forge than agreement on substantive law. One step in the right direction would be the widespread adoption of choice-of-rules that determine whether a creditor holds a secured claim in bankruptcy and, if so, the priority of that claim, by reference to the substantive law of the location of collateral, where the collateral is tangible, and to the location of the debtor, where the collateral is intangible. In addition, where a secured transaction touches more than one state, a universally shared choice-of-law rule giving effect to the bankruptcy avoidance law of a specified jurisdiction would significantly increase the value of the security interest.

As the values promoted by collective insolvency systems coalesce, the differences among non-bankruptcy secured-credit regimes will be reduced. And, to the extent bankruptcy law reflects the values that underlie the non-bankruptcy legal regimes, we will get increasingly consistent results in bankruptcy as the non-bankruptcy laws become increasingly similar. This suggests we ought to proceed along parallel tracks: to move towards generally accepted choice-of-law rules, to regularize the non-bankruptcy law governing creditors' rights (which, in this context, in-

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74. See Bankruptcy Code, 11 U.S.C. § 510(c) (2005). Compare *id.* § 506(c), which allows the trustee in bankruptcy to recover from collateral "the reasonable, necessary costs and expenses of preserving, or disposing of [the collateral] to the extent of any benefit to the holder of [the secured claim]."

cludes not only moving towards consistent secured-transactions laws but also regularizing the ability of creditors to reach assets through the judicial process, with respect to both property claims and in personam claims), and to eliminate the most egregious distributional effects of bankruptcy avoidance powers.

# THE EFFECT OF REORGANIZATION PROCEEDINGS ON SECURITY INTERESTS: THE POSITION UNDER ENGLISH AND U.S. LAW

*Nick Segal\**

## I. INTRODUCTION

This Article outlines the laws regulating the position of secured creditors in both English (administration) and U.S. (Chapter 11) reorganization proceedings. It does so by identifying six core issues that define the position of a secured creditor in such proceedings, and by considering the English and U.S. approaches to each issue. By placing the analysis of the English and U.S. reorganization rules side by side, I have sought to adopt a comparative study in order to allow the similarities and differences of each system's approach to be clearly seen.<sup>1</sup>

As an initial matter, the power to appoint a receiver, and on occasions an administrative receiver, over substantially the whole of the debtor's property remains a distinguishing feature of English law. Despite the general abolition of the right to appoint administrative receivers, the ability to make such appointments continues in a number of significant respects—first, in relation to security agreements created before September 15, 2003, many of which will continue in operation for many years; and second, because of a number of significant exceptions to the abolition of administrative receivership. Furthermore, both as a matter of law and practice, the ability to appoint other types of receiver (where the appointment is not over the whole, or substantially the whole, of the debtor's property) gives secured creditors rights, and a range of practical options, that distinguish the English law position from that in the United States. This is of particular practical significance because enforcement rights in relation to security interests over cash and financial instruments (as defined by the Financial Collateral Arrangements (No. 2) Regulations 2003<sup>2</sup>) are unaffected by the commencement of an administration. Having said that, in the United Kingdom administration is increasingly used in preference to administrative receivership unless there is some particu-

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1. For an excellent general comparative treatment of U.S. and English secured credit law, see GERARD MCCORMACK, SECURED CREDIT UNDER ENGLISH AND AMERICAN LAW (2004). See also PHILIP WOOD, PRINCIPLES OF INTERNATIONAL INSOLVENCY, Chapter 14 (2d ed. 2007).

2. Financial Collateral Arrangements (No.2) Regulations, 2003, S.I. 2003/3226 (Eng.).

lar reason justifying the use of receivership. To this extent, the landscape in the United Kingdom will increasingly reflect that in the United States, insofar as a collective reorganization proceeding will be the bankruptcy proceeding of choice when large debtors get in to financial difficulty.

Nevertheless, there remains a substantial and fundamental difference between the nature and scope of Chapter 11 proceedings and administrations.<sup>3</sup> Administrations can ultimately have only a limited effect on the position of secured creditors—certainly on such creditor's right to enforce their security (although the English courts have yet to explore the limits of this principle). The position in Chapter 11 is very different, principally because of the wide power to cram down secured creditors contained in section 1129(b)(2)(A) of the Bankruptcy Code. Furthermore, because of the court-focused and court-driven nature of Chapter 11 proceedings, secured creditors are required to participate in a court-managed proceeding which is designed to give all stakeholders negotiating leverage. Therefore, even though granted substantial protections by the Bankruptcy Code,<sup>4</sup> secured creditors are required actively to justify and argue for the protection of their rights.

However, while the protections and wide powers given to the debtor in Chapter 11 proceedings, along with the continuous involvement of activist bankruptcy courts, create the conditions for a strong debtor lead procedure, the Chapter 11 process has seen a number of significant changes in recent years, some of which are driven by law reform and some by market developments. Some bemoan but others applaud the fact that it is no longer the force it once was. Amendments to the Bankruptcy Code, made over a decade ago, have given added protections to certain classes

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3. For a useful recent comparison between English corporate rescue and Chapter 11 proceedings, see ROY GOODE, *PRINCIPLES OF CORPORATE INSOLVENCY LAW* 327–28 (3d ed. 2005).

4. There are essentially three basic policies that underlie the treatment of secured creditors under Chapter 11. First, they are entitled to either the collateral or its full value. Second, for the benefit of their debtor or other creditors who might be injured by the repossession of their collateral, they may be required to wait for that to which they are entitled. Third, if secured creditors are required to wait they may be “adequately protected” against loss during their wait. There remains a fundamental policy difference between the English and the U.S. systems. The secured creditor's interest in the collateral is commandeered by the bankruptcy system primarily to prevent two kinds of losses. First, a repossession might force the closing of a business that could otherwise generate enough income to pay not only the secured creditors but other creditors as well. Second, permitting a necessary liquidation of the debtor's assets to go forward in the state courts may result in a windfall to the purchaser at the foreclosure sale and the loss of equity in the property that could have been realized through a commercially reasonable bankruptcy sale for the debtor or other creditors. *See* LYNN LOPUCKI & CHRISTOPHER MIRICK, *STRATEGIES FOR CREDITORS IN BANKRUPTCY PROCEEDINGS* 535–638 (4th ed. 2003).

of creditors—labeled by critics of the reforms as “special interest groups”—including some secured lenders such as aircraft financiers. Additionally, the creditor-friendly changes introduced by the 2005 reforms<sup>5</sup> have improved the position of various creditors and weakened the leverage of the debtor.

These changes can be seen as compounding the trend of increasing creditor control, including secured creditor control. The use of tight covenants in post-petition financing documentation, as well as the appointment of chief restructuring officers at the instigation of creditors early in the Chapter 11 proceeding to support or replace existing management are two examples. Furthermore, the increase in the number of cases in which the debtor’s business is sold during the Chapter 11 proceeding, resulting in proceeds of sale to be distributed to secured and other creditors, has altered the Chapter 11 dynamic and landscape. Similarly, the increasing number of pre-packaged or pre-negotiated reorganization plans (where plan terms are agreed to before the filing) have also had an impact.<sup>6</sup> However, it is also worth noting that the uncertainties over judicial valuations in contested Chapter 11 plans has resulted in the weakening of the bargaining position and priority of such senior creditors.<sup>7</sup>

The automatic stay resulting from the commencement of either a Chapter 11 or an administration proceeding are broadly similar as they relate to secured creditors. Still, the ambit of the Chapter 11 stay is clearly wider in a number respects. In particular, it protects the debtor from informal acts to recover pre-petition claims. Additionally, while both jurisdictions allow secured creditors relief from the automatic stay on broadly similar grounds, the adequate protection doctrine is more clearly articulated under the Bankruptcy Code. There is a point of general significance to be noted here, namely that the Bankruptcy Code tends to deal in depth and detail with important core doctrines, while the Insolvency Act, 1986<sup>8</sup> tends to create broad judicial discretions. Take for example the broad discretion to grant leave to take steps to enforce security, without any statutory explanation as to how the discretion should be exercised, which

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5. Bankruptcy Abuse Prevention and Consumer Protection Act, Pub. L. No. 109-8, 119 Stat. 23 (2005) (codified as amended at 11 U.S.C. § 101 (2007)).

6. See Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?*, 78 AM. BANKR. L.J. 153, 166 (2004).

7. See Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930 (2006).

8. Insolvency Act, 1986, c. 45 (Eng.).

leaves it to the English judges to fill in the gaps in light of the purpose of the relevant statutory provisions.<sup>9</sup>

English and U.S. law also differ in the protection each grants to a secured creditor's rights. While the Bankruptcy Code grants special protection to a secured creditor's rights in cash collateral, the English system grants, on the one hand, more protection in respect of security over "financial collateral" covered by the Financial Collateral Arrangements (No. 2) Regulations 2003 (because the moratorium which arises on an administration is disapplied) and, on the other hand, less protection because following the *In re Spectrum* decision,<sup>10</sup> the proceeds of receivables in English law are likely to be subject only to a floating charge and available to the administrator to use without having to satisfy an adequate protection test.

Additionally, English law respects the after-acquired property clause in winding-up and administration proceedings to a greater extent than applicable U.S. law. However, the practical significance of the differences between the two systems is limited. In administrations, where an asset is acquired after the commencement of the administration, it is necessary to ask whether it represents property of the debtor which directly or indirectly represents floating charge property disposed of by the administrator. Where it does, the secured creditor is treated as continuing to have a floating charge over the asset. If the after-acquired property is not property directly or indirectly representing floating charge property disposed of, and falls within the description of property covered by the fixed charge, then it continues to be subject to the fixed charge. Under U.S. law, if the after-acquired property represents proceeds of collateral subject to the pre-petition security interest, a security interest continues to attach unless the bankruptcy court orders otherwise "based on the equities of the case." Where the Chapter 11 debtor produces a new product after the commencement of the case, and the materials consumed in the manufacturing process are subject to the lender's pre-petition security interest, the bankruptcy court usually has no basis for invoking its equitable power to limit the security interest, so the security interest will continue. This is the same position which applies to the proceeds of floating charge property in an English administration. However, where a post-

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9. This difference in approach can also be seen in the context of reorganization plans that allow the variation or discharge of the rights of creditors, including secured creditors. In England, the entire statutory regime dealing with schemes of arrangement is only three sections long and most of the law (including the rules regulating the limits of majority voting power) is judge made. This approach may be difficult to sustain in the face of increasing numbers of contentious and contested schemes involving bondholders.

10. *In re Spectrum Plus Ltd.* [2005] 2 A.C. 680 (H.L.).

petition product is made using assets or cash not previously subject to the lender's security interest, the new product will not be subject to the lender's lien. This is different from the position in an English administration, although, arguably, the position is the same in an English winding up which divests the debtor of the beneficial interest its property.<sup>11</sup> It is at least arguable that upon the commencement of the winding up, such assets become subject to a statutory trust so that products created therefrom or their proceeds are not property of the debtor to which the security interest can attach.

In an English administration, the debtor has the power to "dispose of or take action relating to" floating charge property, which, in the post-*Spectrum* world, can often be expected to include receivables and book debts, without the need for a court order or permission from the secured creditor. In a Chapter 11 proceeding, there is a distinction made between cash collateral and non-cash collateral. Unless the secured creditor consents to the use of the cash collateral by the debtor, it may not be used unless the court is satisfied that the secured party's interest is adequately protected. The debtor may, however, use, sell, or lease non-cash collateral in the ordinary course of its business without obtaining court approval. If a lender is concerned about his position, he needs to file a request with the court for adequate protection.

In an English administration, the secured creditor will find that his floating charge security interest is subordinated to the costs and expenses of the administration, while his fixed charge is not subject to such costs and expenses. However, in a Chapter 11 proceeding, the secured creditor is always subject to the risk of a surcharge because the Bankruptcy Code permits the debtor to recover administrative expenses from a secured creditor's collateral where they are necessary to preserve or dispose of the collateral, are reasonable, and provide a benefit to the secured creditor. Furthermore, one of the conditions to the confirmation of a plan of reorganization is that the holder of administrative expense claims will be paid in full in cash so that a secured lender can find that his rights have been changed by the plan despite his opposition (as a result of the cram down provisions)<sup>12</sup> and that the administrative expenses of the Chapter 11 case are paid in full on the effective date of the Chapter 11 plan. Furthermore, the secured creditor's pre-petition security interest could be primed and subordinated to new security granted in respect of post-

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11. See *Ayerst v. C. & K. (Construction) Ltd.*, [1976] A.C. 167 (H.L.).

12. Perhaps he has been forced to accept the indubitable equivalent of his pre-petition security interest.

petition financing, where the pre-petition secured creditor's security interest is adequately protected.

As already noted, there is a very substantial difference between English and U.S. law in relation to majority voting and cram-down—that is, the ability to vary or discharge the rights of secured creditors without the consent of each affected creditor. In England, in an administration and company voluntary arrangement (CVA), the secured creditor's right to enforce his security is entrenched and cannot be prejudiced by the administrator's proposals or the terms of the CVA, without the consent of the secured creditor. No such protection arises with respect to schemes of arrangement.<sup>13</sup> However, English law does not have a true equivalent to the cram-down that arises in Chapter 11 proceedings. There is no ability to impose a plan on a class of impaired creditors who are made a party to a scheme of arrangement without the consent of the class as a whole. If the class votes to approve the scheme by the requisite majority, each member of the class may be bound. However, Chapter 11 allows, subject to satisfying the cram-down criteria contained in section 1129(b) of the Bankruptcy Code, an impaired class to be bound by the plan even though the class as a whole has voted against the plan.<sup>14</sup> It is true that the English courts have added their own gloss to the statutory provisions dealing with schemes by holding that where a class of creditors have no economic interest in the debtor, they need not be consulted and their votes on the scheme can be disregarded.<sup>15</sup> Furthermore, the test for determining whether or not a class of creditors has an economic interest has been held to be what the relevant class would receive in the event that the debtor was wound up and the assets sold and distributed in a liquidation.<sup>16</sup> This approach is controversial. First, there is currently a controversy as to the basis on which the debtor's assets should be valued for determining whether a class of creditors has an economic interest. The approach to valuation questions adopted in Chapter 11 proceedings for

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13. A class of secured creditors could have their rights varied pursuant to a scheme of arrangement to which the class was a party if seventy-five percent in value and a majority in number of the class voted in favor of the scheme and the court sanctioned it.

14. Note that it is also not necessary for the impaired class actually to vote on the plan. While it is necessary that a least one other impaired class of creditors has voted in favor of the plan, where a class is totally impaired and the plan provides that members of that class will not receive or retain any property under the plan on account of their claims, the class is deemed to reject the plan. Where an impaired class needs to be crammed-down, the absolute priority rule is triggered and the plan may be confirmed over the opposition of an impaired class if the plan does not discriminate unfairly, and is fair and equitable. *See* 11 U.S.C. § 1129(b)(1).

15. *See In re MyTravel Group Plc.*, [2005] 1 W.L.R. 2365 (C.A.).

16. *See id.* at 2386–88.

the purpose of testing whether a Chapter 11 plan is consistent with the absolute priority rule has been prayed in aid by junior classes of creditors who wish to have the debtor's business valued on the basis of a going concern enterprise value. In addition, there is some uncertainty as to the legal basis for the rule that allows the court to disregard classes of creditors with no economic interest. The statutory provisions in the Companies Act of 1985<sup>17</sup> include no such power. Insofar as the court is exercising its discretion at the required hearing to sanction a scheme of arrangement approved by the requisite majorities of creditors, there seems to be a proper basis for considering whether creditors who have not been made a party to the scheme, and who receive no benefits thereunder, have been fairly treated and a test based on the absence of an economic interest in the estate makes sense. However, it seems more difficult to justify a rule that allows the court to impose the plan on a class of creditors who have been made a party to the scheme and voted against it.

There are, in addition, differences between the rules in the United States and England governing the circumstances in which pre-bankruptcy secured transactions can be set aside as fraudulent transfers, preferences, or transactions at an undervalue. I have not, however, considered these differences (partly because I primarily wanted to pay attention primarily to the way in which secured creditors participate in Chapter 11 and administration proceedings).

I have focused on the operation and effect of the administration and Chapter 11 regimes as they relate to secured creditors and not sought to address the wider debate concerning the policy and principle justifications for the treatment of secured creditors under each system. There is, of course, extensive literature, mainly in the United States, on policy justifications for priority given to secured creditors.<sup>18</sup>

## II. THE ENGLISH LAW BACKGROUND—RECENT DEVELOPMENTS AND THE DISTINCTION BETWEEN FIXED AND FLOATING CHARGES

The secured creditor, particularly the secured creditor holding security interests over the whole, or substantially the whole, of the debtor's prop-

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17. Companies Act, 1985, c. 6 (Eng.).

18. For a useful collection of U.S. materials, see BARRY E. ADLER, FOUNDATIONS OF BANKRUPTCY LAW 23–54 (2005); see also Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795 (2004) (containing useful comparative material and a discussion of the English and U.S. regimes). For an English perspective and excellent citation of the literature in the United States and England, see RIZWAAN JAMEEL MOKAL, CORPORATE INSOLVENCY LAW: THEORY AND APPLICATION 133–87 (2005).

erty,<sup>19</sup> has traditionally enjoyed great freedom of action under English law. For example, the secured creditor has had the benefit of a wide range of contractually defined and self-help remedies which were capable of being exercised without the involvement of a court, and which remained exercisable even after the commencement of reorganisation proceedings. In England, the reorganization proceeding is the administration procedure (which, unlike its U.S. counterpart—Chapter 11 of the Bankruptcy Code—can normally only be commenced upon a finding or declaration that the debtor is, or is likely to become, insolvent).<sup>20</sup>

However, there have been a number of significant changes in English law in recent years that have impacted the secured creditor's position in an administration proceeding.<sup>21</sup> Three are particularly noteworthy: (1) the Enterprise Act 2002;<sup>22</sup> (2) the Financial Collateral Arrangements (No.2) Regulations 2003 (implementing the E.U. Collateral Directive); and (3) the House of Lords judgment in *In re Spectrum Plus Ltd.*<sup>23</sup>

#### A. The Enterprise Act

The Enterprise Act has qualified and significantly reduced the ability of a secured creditor both to enforce its security interest following the

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19. A key concept of English insolvency law after 1986 is that of the administrative receiver. An administrative receiver is "a receiver or manager of the whole (or substantially the whole) of a company's property appointed by or on behalf of the holders of any debentures of the company secured by a charge which, as created, was a floating charge, or by such a charge and one or more other securities." Insolvency Act, 1986, ch. 45, § 29(2). In order to have the full protection and benefit of English insolvency law, a secured creditor needs to have an asset security which gives it the right to appoint an administrative receiver. The term "qualifying floating charge" is also important in this context and means: "a floating charge . . . created by an instrument which . . . purports to empower the holder of the floating charge to appoint an administrator of the company, [or] purports to empower the holder of the floating charge to make an appointment which would be the appointment of an administrative receiver." *Id.* c. 45, Schedule B1, para. 14(2).

20. There is, however no requirement of actual or impending insolvency in relation to an out of court appointment of an administrator by the holder by a qualifying floating charge.

21. It is also worth noting, by way of introduction, that there has been extensive pressure for the reform of the English law of security interests. A series of substantial reports have been prepared—for example, by the Company Law Steering Group and the Law Commission—recommending changes to the English system, including a change to a notice filing system. *See, e.g.*, LAW COMMISSION, PUBL'N NO. 296, COMPANY SECURITY INTERESTS (2005) (Eng.). To date however, the Government has refused to implement the proposed changes.

22. Enterprise Act, 2002, c. 40.

23. *In re Spectrum Plus Ltd.* [2005] 2 A.C. 680 (H.L.).

commencement of an administration proceeding and to block the commencement of such a proceeding. However, such secured creditors retain a privileged and strong position within the administration proceeding.<sup>24</sup>

*B. The Financial Collateral Arrangements (No.2) Regulations 2003*

The Financial Collateral Arrangements (No.2) Regulations have improved the position of secured creditors where they have security over the types of collateral covered by the Regulations<sup>25</sup>—cash or financial instruments including shares, bonds, and any other securities which are “normally dealt in” and which give the right to acquire such shares or bonds.<sup>26</sup> The Regulations disapply certain provisions of the administration proceeding regime, including the moratorium on the enforcement of security, the ability of the administrator to deal with financial instruments subject to fixed and floating charge security, as well as some of the claw-back provisions that are triggered by the commencement of an administration. However, transaction at an undervalue and preference rules still apply.

*C. The Spectrum decision*

While the Regulations represent a positive development for secured creditors, the House of Lords decision in *In re Spectrum* represents a retreat and reduction in their protection in administration proceedings. While the precise impact of the decision remains to be established, for

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24. See *infra* Part III.A.1 (discussing how secured creditors retain a privileged and strong position within the administration proceeding).

25. Note that one of the requirements that needs to be satisfied for the Regulations to apply is that the collateral must be in the possession or under the control of the collateral-taker. The Regulations are, however, silent as to what constitutes possession or control in this context. It is unclear whether an equitable charge or a floating charge (certainly before crystallization) are covered. Note also that, the Regulations provide that the right of a collateral-provider to substitute equivalent financial collateral or to remove excess financial collateral will not prevent the financial collateral being in the possession or under the control of the collateral taker. See GEOFFREY FULLER, CORPORATE BORROWING: LAW AND PRACTICE 78–80 (3d ed. 2006).

26. The ambit of the definition of “financial instruments” is wide, covering:

- (a) shares in companies and other securities equivalent to shares in companies;
- (b) bonds and other forms of instruments giving rise to or acknowledging indebtedness if these are tradable on the capital market; and
- (c) any other securities which are normally dealt in and which give the right to acquire any such shares, bonds, instruments or other securities by subscription, purchase or exchange or which give rise to a cash settlement (excluding instruments of payment).

present purposes it can be taken to establish the rule that most security interests over debts and receivables will be treated as floating, and not fixed, charges. This has a significant impact in relation to administration since an administrator has the ability to “dispose of or take action relating to property which is subject to a floating charge as if it were not subject to the charge.”<sup>27</sup> However, where property is disposed of by the administrator, the floating charge holder has the same priority over acquired property as he had over the disposed property. The combination of this provision of the Enterprise Act and the *In re Spectrum* decision means that in many cases, administrators will now have access to funds to cover the costs of the administration without the need to obtain the consent of the secured creditor. This is an area in which the secured creditor in the United States has a stronger position than his counterpart in England. Under the Bankruptcy Code, the debtor “may not use, sell, or lease cash collateral . . . unless each entity that has an interest in such cash collateral consents,” or the court grants permission based on its satisfaction that the debtor has provided adequate protection of the secured creditor’s interest.<sup>28</sup>

#### *D. Fixed and Floating Security Interests*

In order to understand the impact of bankruptcy proceedings on security interests under English law, it is necessary to take account of the crucial distinction between fixed and floating security interests. Charges<sup>29</sup> may be fixed or floating. A fixed charge is one which attaches as soon as the charge has been created, or the debtor has acquired rights in the asset to be charged, whichever is the later. The effect of this is that the debtor cannot dispose of the asset free from the charge without the chargee’s consent except by satisfying the indebtedness secured by the charge. The floating charge, by contrast, is one which hovers over a designated class

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27. Insolvency Act, 1986, c. 45, Schedule B1, para. 70(1).

28. 11 U.S.C. § 363(c)(2) (2007).

29. The term “charge” is used in this Article as a general description of security interests under English law. While the terms “charge” and “mortgage” are often used interchangeably, there is technically an important distinction between the two concepts. A mortgage is a transfer of ownership to the creditor by way of security upon the express or implied condition that the asset shall be reconveyed to the debtor when the sum secured has been paid. An equitable charge, however, does not involve the transfer either of possession or of ownership, but constitutes the right of the creditor, created either by trust or by contract, to have a designated asset of the debtor appropriated to the discharge of the indebtedness. The right is satisfied out of the proceeds of sale of the asset, where the sale results from the debtor’s voluntary act or takes place under a court order for sale or the appointment of the receiver made on application of the chargee. See ROY GOODE, *COMMERCIAL LAW* 586–87 (3d ed. 2004).

of assets in which the debtor has or will in the future acquire an interest. The debtor has liberty to deal with any of the assets free from the charge so long as it remains floating. When an event occurs which causes the charge to crystallize, it attaches as a fixed security to all the assets then comprised in the relevant class and to any assets of the specified description subsequently acquired by the debtor. Banks and other secured lenders in England will frequently be granted an all assets debenture containing both a fixed and a floating charge. The former covers fixed assets and debts (such as land, intellectual property rights, equipment, shares, and important major contracts), while the latter covers the remaining types of assets such as stock in trade (inventory). In this way, the secured creditor is granted a security interest over all of the debtor's property from time to time. Additionally, the secured creditor is given the right to enforce the security by appointing a receiver under the fixed and floating charges. The receiver, as agent for the debtor, is authorized to take possession of the debtor's assets (and business), continue the debtor's business, and sell its assets to repay the secured debt.

Various consequences flow from creating or characterizing a charge as a floating charge. For example, a floating charge is postponed to the rights of preferential creditors if the secured creditor takes possession of any of the charged assets, or in the event that the company goes into receivership, liquidation, or administration.<sup>30</sup> In addition, a floating charge—given by an insolvent company within the twelve months prior to the onset of insolvency—is void, except as to new value.<sup>31</sup> Furthermore, all floating charges given by a company are required to be registered.<sup>32</sup>

The last thirty years has seen a debate raging in England in relation to the proper characterization of charges over book debts, particularly charges taken by banks labeled in the security documentation as “fixed charges,” but operated in a manner that allows the debtor to pay proceeds into its ordinary bank account and use them in the ordinary course of business. In some respects, the debate in the English courts reflects the

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30. A fixed charge, on the other hand, has priority over all unsecured claims, preferential or otherwise. The Enterprise Act 2002 reduced significantly the range of preferential debts by abolishing the government's preferential status. *See* Enterprise Act, 2002, c. 40, § 251. Formerly, sums payable to the Crown were preferential. This preference had been criticized for many years as causing hardship to the general body of creditors while producing benefits insignificant in terms of total government receipts.

31. Insolvency Act, 1986, c. 45, § 245.

32. A fixed charge is registerable only if taken over a class of asset listed in section 396 of the Companies Act 1985, or if it would have been registerable as a bill of sale if granted by an individual.

twists and turns that took place in U.S. jurisprudence relating to the validity of security interests created for the purpose of accounts receivable financing and of chattel mortgages on stock in trade following the Supreme Court decision in *Benedict v. Ratner*.<sup>33</sup>

In that case, Justice Brandeis<sup>34</sup> had to consider an arrangement in which the debtor agreed to assign to the creditor its present and future accounts receivable as security for a loan. A list of all the accounts outstanding at the date of the loan was delivered to the secured creditor with a comparable list delivered each succeeding month. Under its arrangements with the secured creditor, the debtor continued to collect the accounts and use the proceeds as it saw fit. It did not account to the secured creditor, nor were the account debtors notified of the assignment.<sup>35</sup> Subsequently, a petition in bankruptcy was filed against the debtor, and Benedict was appointed receiver of the debtor and took over collection of the remaining accounts. The secured creditor petitioned in the bankruptcy proceedings that the receiver be required to pay him the balance of his loan from the proceeds of the assigned receivables. Resisting that petition, the receiver cross-petitioned that the secured creditor be required to turn over to the estate the receivables which the debtor had remitted to him previously as well as any proceeds he might have collected.<sup>36</sup>

The District Court and the Second Circuit held in favor of the secured creditor. However, a unanimous Supreme Court reversed. Justice Brandeis, stating the facts, noted that "there was no finding of fraud in fact."<sup>37</sup> Having concluded that the parties' rights depended mainly on New York law, he formulated the basic legal proposition which determined the decision:

Under the law of New York a transfer of property as security which reserves to the transferor the right to dispose of the same, or to apply the proceeds thereof, for his own uses, is, as to creditors, fraudulent in law and void.<sup>38</sup>

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33. *Benedict v. Ratner*, 268 U.S. 353 (1925).

34. For those interested in finding out more about the attitudes, approach, and impact of Justice Brandeis, see EDWARD A. PURCELL, *BRANDEIS AND THE PROGRESSIVE CONSTITUTION: ERIE, THE JUDICIAL POWER, AND THE POLITICS OF THE FEDERAL COURTS IN TWENTIETH-CENTURY AMERICA* (2000).

35. *Ratner*, 268 U.S. at 358.

36. *Id.*

37. *Id.*

38. *Id.* at 360–61. For an excellent account of the impact of the rule in *Benedict v. Ratner*, see 1 GRANT GILMORE, *SECURITY INTERESTS IN PERSONAL PROPERTY* 250–86

As Professor Gilmore has pointed out, after *Benedict v. Ratner*, a lender was required to exercise “dominion” over his security.<sup>39</sup> What came to be accepted as the proper way of asserting dominion in non-notification financing was a requirement that the proceeds of collection be remitted daily by the assignor to the assignee. Nothing was to go directly into the assignor’s bank account; all checks, notes, and acceptances had to be endorsed and delivered to the assignee. Of course, following the remittance there would be what was sometimes referred to as a “re-remittance;” after having passed through the assignee’s hands, the proceeds would end up in the assignor’s bank account. Since receivables were typically assigned to secure a working capital loan, it was necessary that the proceeds eventually be made available for the assignor’s use. But under the rule in *Benedict v. Ratner*, it was fatal for the assignor to take the proceeds immediately; they had to be channeled into his bank account through the assignee.

These developments sound very familiar to the English lawyer who has seen the twists, turns, and agonizing in English case law concerning the characterization of purportedly fixed charges over debts taken by banks, starting with the *Siebe Gorman v. Barclays Bank* decision in 1979.<sup>40</sup> The subsequent debate has not related to whether the debtor has or has not created a security interest at all, but whether the security interest was a fixed or floating charge. Justice Brandeis’ opinion denies the availability of any kind of security interest where the debtor has the power to deal with the collateral without the consent of the secured lender. As a consequence, U.S. law never developed a judicial concept of the equitable floating charge, and from 1925 until the advent of Article 9 of the Uniform Commercial Code in 1962<sup>41</sup> effectively did without floating liens.<sup>42</sup>

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(1965). The *Benedict v. Ratner* decision confirmed a previous line of authority in New York. *See, e.g., Zartman v. First Nat’l Bank of Waterloo*, 189 N.Y. 267 (1907).

39. GILMORE, *supra* note 38, at 260; *see also* MCCORMACK, *supra* note 1, at 108–10 (discussing the “sophisticated avoidance industry” that developed after *Benedict v. Ratner* to permit large scale receivables and other financing and the separate legislative initiatives in various states).

40. *Siebe Gorman & Co. v. Barclays Bank* [1979] 2 Lloyd’s Rep. 142 (Ch.).

41. The Uniform Commercial Code creates the functional equivalent of a floating charge. Article 9-205 states that:

(a) A security interest is not invalid or fraudulent against creditors solely because:

(1) the debtor has the right or ability to:

(A) Use, commingle, or dispose of all or part of the collateral . . . ;

(B) Collect, compromise, enforce or otherwise deal with the collateral;

In the English context, banks have been concerned to show that restrictions in their debentures have established their charges as fixed, while liquidators have been equally astute to seek to strike their charges down as unregistered floating charges or establish that they were only floating charges. This resulted in a substantial volume of litigation after the *Siebe Gorman* decision held that it was possible to take a fixed charge over book debts. The House of Lords in *In re Spectrum* has since overruled *Siebe Gorman*, holding that a secured creditor<sup>43</sup> only had a floating charge over debts where the secured lender's security agreement placed no restriction on the use that the debtor could make of the collected debts paid into the company's ordinary operating account with the secured lender. Accordingly, although the security agreement purported to grant the secured lender a fixed charge in law, it granted only a floating charge, which did not have priority over the claims of preferential creditors.

A debate still rages as to the correct approach to take following the decision in the House of Lords, as well as the nature and extent of restrictions which must be imposed by secured lenders on the debtor's use of proceeds of debts in order to successfully create a fixed charge.<sup>44</sup> This is not the place in which to debate at further length what the correct approach is, though an approach consistent with the rule in *Benedict v. Ratner* would certainly satisfy the *In re Spectrum* test. Furthermore, it is

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(D) Use, commingle, or dispose of the proceeds; or

(2) the secured creditor fails to require the debtor to account for proceeds or replace collateral.

U.C.C. § 9-205 (2000).

42. Joshua Getzler notes that the decision to exclude floating charges arguably may have enhanced rather than degraded disciplined lending, and strengthened the management and monitoring of debtor companies in the United States by requiring notice to assignees of changes in the collateral and giving chargees a strong legal incentive to police the debtor's business lest priority be postponed. Joshua Getzler, *The Role of Security Over Future and Circulating Capital: Evidence from the British Economy Circa 1850–1920*, in JOSHUA GETZLER & JENNIFER PAYNE, *COMPANY CHARGES: SPECTRUM AND BEYOND* 227, 250 (2006).

43. In *In re Spectrum*, the secured creditor was a commercial bank with whom the debtor maintained its ordinary bank accounts, and into which debtor proceeds were paid and withdrawn without restriction. See *In re Spectrum Plus Ltd.* [2005] 2 A.C. 680, 680 (H.L.).

44. See generally Gabriel Moss, *Fictions and Floating Charges: Some Reflections on the House of Lords' decision in Spectrum*, in JOSHUA GETZLER & JENNIFER PAYNE, *COMPANY CHARGES: SPECTRUM AND BEYOND* 1 (2006). Gabriel Moss was lead counsel for the bank in the *Spectrum* case, and was originally instructed by me!

probably the case that nothing short of a requirement that the debtor pay proceeds of book debts into a blocked account—from which withdrawals can only be made with the consent from time to time of the secured lender—will be sufficient.<sup>45</sup>

*E. Failure to Develop Floating Charges in U.S. Law*

In this context, it is interesting to note and impossible to avoid quoting at length the trenchant comments of Dr. Gough concerning the historical development of U.S. law relating to security interests over present and future receivables. In *Company Charges*,<sup>46</sup> Dr. Gough explains:

United States law never developed the equitable floating charge. In the early seventeenth century, the English common law, as it existed in the time of Lord Coke, was exported to North America. The law as expressed in Bacon's Maxim considered then and now that it is impossible to sell or mortgage future property, which is not presently owned, because there was nothing to convey. English equity in the nineteenth century made the conceptual advance that a mortgage over future property could be effective, without new legal action where the property was subsequently acquired. A contract to assign property, supported by money consideration, meant that title in equity passed automatically on the subsequent acquisition. The effectiveness of a charge over future property made it possible for the English equity courts then to invent the floating charge by making the further mental quantum leap by saying that the future property subject to the charge could change from time to time. This was vital to achieve an effective security over circulating business assets.

Meanwhile, the courts of the American states still remained hidebound by seventeenth century common law prohibitions, unable to overcome conceptual constraints in regard to security over future property. In the 1920's, in the New York case of *Benedict v. Ratner*, a security of present and future accounts receivable was as a matter of judicial policy struck down for the reason that the trading power of the company debtor to continue carrying on business by dealing with assets subject to the mortgage was considered incompatible with the notion of a proprietary right arising by way of mortgage in favor of the creditor. Because the mortgagee could exercise no control over the mortgaged assets by taking possession or requiring the debtor specifically to account for them it was held that there could be no security in existence. For good measure, the court linked the reservation by the mortgagor of a

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45. It may well be possible to have debts paid into a blocked account from which withdrawals are rarely made at the same time as the level of borrowings by the debtor debited to another account are allowed to increase.

46. WILLIAM JAMES GOUGH, *COMPANY CHARGES* (2d ed.1996).

right to dispose of the mortgaged assets or apply their proceeds for its own use with bankruptcy law principles, by saying that this arrangement created a conclusive presumption of fraud against creditors and therefore that the mortgage assignment was void. In consequence, the Americans had to create a stock-in-trade security in the form of a security interest over 'inventory plus proceeds' through the introduction of legislation. This fundamental legal reform was ultimately introduced in America in 1951 with the promulgation of the first edition of the now famous Article 9 of the Uniform Commercial Code. The Americans only then achieved by legislative code, containing a complex set of priority provisions, a security somewhat equivalent to that invented in England by the courts of equity nearly a century before.

Traditionally, America never developed bank all assets security securing all moneys under multiple credit lines typical in the English and Australian context of branch banking. Article 9 was necessary in America to provide by legislation an all assets business security, effective for stock-in-trade financing purposes, which was prohibited under its common law. American credit and security techniques placed far greater emphasis on dedicated credit lines financing the acquisition of particular classes of assets. American law and practice had a far greater preoccupation with title security and purchase-money security interests. The elaborate statutory priority rules developed in Article 9 and the purchase-money super-priority naturally reflected these different American perceptions and needs. Legal deficiency in relation to all assets security was not true in England and Australasia, which developed a different system of credit and security law and practice, with the branch banking system and the floating charge being very significant differentiating features. England and Australasia developed in the floating charge a convenient form of business security over stock-in-trade, book debts and other circulating assets. The Anglo-Australasian jurisdictions did not need to enact an Article 9 to enable the taking of all assets security.<sup>47</sup>

### III. THE CORE ISSUES—SIX POINTS OF COMPARISON

#### *A. Secured Creditor's Rights of Enforcement*

##### 1. Secured Creditors' Rights of Enforcement Under English Law

In English law, the position has been radically altered following the implementation of the Enterprise Act 2002 in September 2003. Subject to the exceptions mentioned below, secured creditors with security interests covering the whole or substantially the whole of the debtor's prop-

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<sup>47</sup> *Id.* at 437–38.

erty are no longer able to appoint an administrative receiver, and thereby take control, albeit indirectly, of the realization of the collateral upon enforcement or following the debtor's commencement of an administration proceeding.

Previously, a secured creditor with a security interest including a floating charge in the whole or substantially the whole of the debtor's property could block the commencement by the debtor (or another creditor) of an administration proceeding by appointing an administrative receiver. The court had no jurisdiction to make an administration order in the event that the secured creditor had already appointed an administrative receiver. Administrative receivership was essentially a debt enforcement mechanism for the benefit of the secured creditor who appoints the receiver. The primary function of the administrative receiver was to take control of the debtor's property and effect such disposals as would result in payment of the amount due under the security instrument after allowing for the administrative receiver's remuneration and any sums payable out of floating charge realizations to preferential creditors.<sup>48</sup> Accordingly, the debtor was unable to prevent (by commencing an insolvency proceeding) such a secured creditor from enforcing its security and having management of, and undertaking the process of, selling or otherwise realizing, its assets and business (in so far as they were subject to the security interest). The Enterprise Act 2002, however, largely abolished the institution of administrative receivership, except in the case of charges made before September 15, 2003 and charges exempted from the abolition.<sup>49</sup>

The holder of a fixed and floating charge over the whole or substantially the whole of the debtor's property is now prevented from appointing an administrative receiver. This is true in spite of any provision in the charge which purports to authorize such an appointment. Instead, the legislation now contemplates that the floating chargeholder will normally enforce the security by commencing an administration proceeding. The administration regime has been changed to reflect this development. The *quid pro quo* for the abolition of the right to appoint an administrative receiver is that the chargee enjoys a number of privileges in an administration not available to others.

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48. The receiver owes a primary duty of care to the secured creditor who appointed him, as well as a limited, secondary duty of care to the debtor.

49. The exemptions cover certain important categories of transaction, including capital market arrangements involving a debt of at least £50 million, public-private partnerships, utility projects, urban regeneration projects, and project finance transactions that meet certain criteria. *See* Enterprise Act, 2002, c. 40.

First, the holder of a qualifying floating charge is given the right to appoint an administrator, chosen by him, merely by serving a notice at court with the requisite statutory declaration. Indeed, the chargeholder is able to secure an interim moratorium for up to five business days by filing a notice of intention to appoint an administrator. However, a default or other event is necessary to entitle the chargeholder to enforce the security interest. The secured creditor is also able, like any other creditor, to make an application to the court for an administration order. Where the holder of a qualifying floating charge makes a requisite statement in its application to court, there is an exception to the general rule that the court can only make an administration order where it is satisfied that the debtor is or is likely to become insolvent. Second, whilst the debtor or its directors cannot appoint an administrator out of court, where a petition for winding-up has been presented or an administration application has been made to the court and the petition or application has not been disposed of, no such restriction applies to an appointment by the holder of a qualifying floating charge. Third, where the debtor is in compulsory winding-up (but not in voluntary winding-up) the chargeholder may make an administration application. If the application is granted, the court is required to discharge the winding up order. Finally, the holder of qualifying floating charge who makes an out of court appointment is given the facility of filing the notice of appointment with the court outside court business hours—a point of some considerable practical significance.

## 2. Secured Creditors' Rights of Enforcement Under U.S. Law

In modern U.S. law and practice, when a major corporation finds itself in financial difficulty, it will file for Chapter 11 protection and will be able to stay all enforcement action by secured creditors. There is no enforcement mechanism, such as administrative receivership, which offers a secured creditor the right to initiate and control the process of managing and realizing collateral independent of the bankruptcy proceeding.

If the collateral is personal property or fixtures, Article 9 of the Uniform Commercial Code (U.C.C.) gives the secured creditor enforcement rights, including the right to take possession of the collateral after default.<sup>50</sup> The secured creditor is given the right, after default, to take possession of the collateral either with or without a judicial process.<sup>51</sup> In addition, the secured creditor has the right to “sell, lease, license, or other-

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50. U.C.C. § 9-609 (2000).

51. The secured creditor can only proceed without judicial process if it can do so without a breach of the peace. *Id.* § 9-609(b)(2).

wise dispose of any or all of the collateral in its present condition or following any commercially reasonable preparation or proceeding.”<sup>52</sup> If the collateral is realty, the secured creditor can proceed within the framework of the appropriate state mortgage or deed of trust foreclosure statutes.

Prior to the commencement of bankruptcy proceedings, a secured creditor is given various enforcement options depending on the nature of the collateral. The U.C.C. governs the exercise of enforcement remedies following default in relation to personal property and fixtures. These include the right to repossess the collateral where tangible personality is involved. In relation to collateral in the form of obligations owed to the debtor by third parties (accounts receivable, executory contract rights, general intangibles, chattel paper, or negotiable instruments) the secured creditor has a right of direct collection.<sup>53</sup> In addition, the secured creditor has the right to effect a foreclosure sale.<sup>54</sup>

Despite the fact that corporate reorganizations in the United States began in the nineteenth century with railroad failures and court appointment of receivers in enforcement actions by secured creditors,<sup>55</sup> U.S. law never developed the concept of the private, out of court, receivership. This can be attributed in part to the failure to develop the floating charge concept, and in part to the codification of secured creditors’ enforcement rights under the U.C.C. (which did not include the right).

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52. *Id.* § 9-610(a). This includes the right of the secured creditor to purchase the collateral itself either at a public disposition or pursuant to a private disposition (“only if the collateral is of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations”). *Id.* § 9-610(c).

53. *Id.* § 9-607. Where the original assignment of accounts receivable is on a notification basis, the secured creditor has the right to make direct collections even before default. However, if the assignment of the accounts receivable or other third party obligation is on a non-notification basis—as with a simple security interest in accounts—the secured creditor is not entitled to notify the account debtors to make payment until the debtor defaults.

54. *Id.* § 9-610. In the United States, a sale by a secured creditor following the debtor’s default is often referred to as a foreclosure sale. This is different from strict foreclosure under English law, where the secured creditor retains and takes title to the collateral in satisfaction of the secured obligations.

55. For an excellent treatment of the history of U.S. bankruptcy law, see DAVID SKEEL, *DEBT’S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA* 17–18, 48–70 (2001).

*B. The Automatic Stay*

## 1. The Automatic Stay Under English Law

Upon the commencement of an administration<sup>56</sup> without the consent of the administrator or permission of the court, “no step may be taken to enforce security over the company’s property.”<sup>57</sup> The prohibition on the enforcement of security by a creditor contains a number of component parts.

First, no *step* may be taken to enforce security. The phrase “taking steps” was considered in detail by the Court of Appeal in *Bristol Airport Plc. v. Powdrill*.<sup>58</sup> There, the phrase was given a wide meaning and was held to include a refusal—by those in possession of a chattel who claimed a right of retention over it—to comply with a request from an administrator to deliver up the chattel. This was so even though the refusal involved no positive action by the creditor. Accordingly, in the case of an ordinary possessory lien under English law, the assertion by the lien holder of a right to retain does constitute the taking of a step to enforce security (i.e., the lien), and therefore, in the absence of the administrator’s agreement, requires the permission of the court. However, no steps are treated as being taken to enforce the security in this context before a demand for delivery of the chattel is made by the administrator. In addition, even after a demand for delivery has been made, the lien holder has a reasonable time in which to verify the administrator’s right to possession.

It remains arguable that the exercise of the contractual right—as part of the process of enforcement of security—may amount to a “step.” For example, if a necessary condition precedent to the enforcement of security is the exercise of a right to terminate rights and obligations under a contract (e.g., a bank’s obligation to make further advances) by service of a particular notice or the acceleration of the debtor’s obligations by the making of a demand for repayment, and the purpose of the exercise of the right and service of the notice is to enable the security to be enforced (that is, is with a view to such enforcement and as a necessary link in the chain of events leading to enforcement), then there is an argument that serving the notice is a step.<sup>59</sup> However, in most cases a problem will not

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56. An automatic interim moratorium also applies to the debtor after an application for an administration order has been made, but the administration order has not been granted or dismissed. Insolvency Act, 1986, c. 45, Schedule B1, para. 44(1).

57. *Id.*, c. 45, Schedule B1, para. 43.

58. *Bristol Airport Plc. v. Powdrill*, [1990] Ch. 744.

59. This was a point which the judge refused to decide in relation to a hire purchase agreement in *Re David Meek Plant Ltd.*, [1994] 1 B.C.L.C. 680, 684 (Ch.). The point was

arise since the exercise of such a contractual right will not interfere with the administrator's rights or ability to deal with a particular asset. Where this is not so, it is possible that permission will be required.

Secondly, there must be an *enforcement* of security; what is being done must constitute an enforcement of the security interest. Thirdly, a step must be taken to enforce a "security." This is defined in section 248 of the Insolvency Act of 1986 to mean "any mortgage, charge, lien or other security."<sup>60</sup> It seems from the categories of "security" identified in the definition that only true security interests are covered, or those interests giving proprietary rights in assets belonging to the debtor (or in which the debtor has an interest). Thus, rights which have the same function as security, but do not create proprietary rights in an asset of the debtor (such as set-off) are not included.

The secured creditor may take steps to enforce his security interest where the administrator grants his consent or the court grants leave. The Insolvency Act 1986 does not establish explicitly the basis on which the court is to exercise its discretion to grant leave to lift the stay. However, the case law suggests that English law has developed an approach similar to the U.S. "adequate protection" doctrine.

The Court of Appeal in *In re Atlantic Computer Systems Plc.* recognized that the automatic stay is "intended to assist the [debtor], under the management of the administrator, to achieve the purpose for which the administration order was made."<sup>61</sup> Therefore, the court held that leave should be given where the creditor seeks to exercise his proprietary rights, and the creditor's action is unlikely to impede the achievement of that purpose.<sup>62</sup> However, in other cases, the court went on to say that it:

has to carry out a balancing exercise, balancing the legitimate interests of the [creditor] and the legitimate interests of the other creditors . . . . In carrying out the balancing exercise, great importance or weight is normally given to the proprietary interests of the [creditor] . . . . The underlying principle here is that an administration for the benefit of unsecured creditors should not be conducted at the expense of those who

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also discussed, but not answered, in *Re Olympia & York Canary Wharf Ltd.*, [1993] B.C.L.C. 453, 454 (Ch.), and *Barclays Mercantile Business Finance Ltd. v. Sibec Developments Ltd.*, [1992] 1 W.L.R. 1253, 1259 (Ch.). Professor Goode suggests that "steps to enforce" denotes acts which in some degree interfere with the company's enjoyment of its property or inhibit the administrator's use of such property. Preparatory steps which do not have this effect are outside the mischief of the provision and are not prohibited. See GOODE, *supra* note 3, at 352-54.

60. Insolvency Act, 1986, c. 45, § 248.

61. *In re Atlantic Computer Systems Plc.*, [1992] Ch. 505, 542 (C.A.).

62. *Id.*

have proprietary rights which they are seeking to exercise, save to the extent that this may be unavoidable and even then this will usually be acceptable only to a strictly limited extent.<sup>63</sup>

The *In re Atlantic Computer Systems* case dealt with the position of a chattel lessor and not a secured creditor. An application for leave to lift the stay by a secured creditor was considered in *Re Meesan Investments Ltd.*<sup>64</sup> Here, a pre-administration secured creditor sought leave to enforce its security interest in respect of the debtor's real property. The court held that the secured creditor must show particular prejudice and loss so as to differentiate itself from other pre-administration creditors, although it was not necessary to show that the administrator's conduct was in some way improper or unreasonable.<sup>65</sup> The case concerned a bank which held security over a property which the administrator was seeking to let. The bank was unable to persuade the court that it should be given leave to enforce its security despite the fact that the administrator had been seeking to find a tenant for many months and there was evidence that the secured debt, with accruing interest, was nearing the estimated sale value of the property. However, there were some unusual circumstances. The administrator had eventually decided to abandon the attempt to find a tenant and had decided to find a purchaser for the property instead. He had received an offer for the property before the court hearing in an amount which would ensure that the bank was fully repaid. The administrator was also able to show that it was likely that contract for a sale would be exchanged within a month. The court, therefore, was able to conclude that the bank would be fully repaid within a reasonable period of time. The court was sufficiently concerned about the position of the bank to insist that the administrator "return to court in two months' time if he had not achieved a binding contract of sale and, in that event, to give notice to the bank so that it could make such application or submission it thought appropriate."<sup>66</sup>

## 2. The Automatic Stay Under U.S. Law

When a voluntary or involuntary bankruptcy petition is filed, the automatic stay provided by section 362(a) of the Bankruptcy Code comes into force. The drafters of the Bankruptcy Code considered that:

the automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It gives the debtor a breathing spell from

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63. *Id.*

64. *Re Meesan Investments Ltd.*, [1988] 4 B.C.C. 788 (Ch.).

65. *Id.* at 791.

66. *Id.* at 790.

his creditors. It stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drove him into bankruptcy.<sup>67</sup>

Section 362(a) identifies a number of acts to which the automatic stay applies. They include:

- (1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the [bankruptcy case], or to recover a claim against the debtor that arose before the commencement of the [bankruptcy case] . . . ;
- (2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the [bankruptcy case];
- (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;
- (4) any act to create, perfect, or enforce any lien against property of the estate;
- . . .
- (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the [bankruptcy case];
- . . .
- (8) the setoff of any debt owing to the debtor that arose before the commencement of the [bankruptcy case] against any claim against the debtor.<sup>68</sup>

The ambit of the stay is broader than its English counterpart in a number of important respects. Section 362, like the English Insolvency Act of 1986, prohibits any act by a secured creditor to enforce its security interest or to obtain possession of property of the estate. For these purposes, “property of the estate” includes executory contracts and leases, so that the debtor’s interest in such contracts and leases is protected against termination or other interference that would have the effect of removing or hindering the debtor’s rights in violation of section 362 of the Bankruptcy Code.<sup>69</sup> The prohibition also extends to any attempt to “exercise

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67. H.R. REP. NO. 95-595, at 340 (1977).

68. 11 U.S.C. § 362(a) (2007).

69. *See id.* §§ 362, 363(l), 365(e), 541(a). Note also that most bankruptcy termination clauses may not be enforced after the commencement of a chapter 11 case. These clauses

control over property of the estate.”<sup>70</sup> This has been given a broad meaning to include, for example, attempts by a landlord to terminate a master lease which under state law would have resulted in termination of the interest of the debtor as a sub-lessee.<sup>71</sup> Section 362 also prevents the sole shareholder of a Chapter 11 debtor from filing a tax return claiming a worthless stock deduction which, if done, would have eliminated the debtor’s net operating loss.<sup>72</sup> In addition, it prevents lenders to a holding company that have been granted a pledge on the stock of a subsidiary from—following default—voting the stock in the subsidiary after the subsidiary has filed a Chapter 11 case.<sup>73</sup>

Section 362(a)(4) covers both judicial and non-judicial actions against property of the estate. A wide variety of actions are stayed automatically, including judicial and private foreclosure and self-help remedies against collateral, such as repossession or notification of account debtors. Each act in the foreclosure process is stayed. Similarly, even if property has been repossessed pursuant to a security interest, the sale of that property is stayed.

The stay covers any “act to collect, assess or recover a [pre-petition] claim against the debtor.”<sup>74</sup> The term “act” is broadly construed, and this sub-section is intended to prevent creditor harassment of the debtor in attempting to collect pre-petition debts. The conduct prohibited ranges from that of an informal nature, such as a telephone contact, to more formal judicial and administrative proceedings. However, simple ministerial acts, such as the presentment of a note, are not included. Serving a notice of acceleration of indebtedness may be subject to the effect of the automatic stay, even where the purpose of serving a notice of acceleration is to preserve rights and fix an interest rate rather than to collect indebtedness at the time of the notice.<sup>75</sup>

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are generally unenforceable under sections 363, 365, and 541 of the Bankruptcy Code and any attempted enforcement is stayed.

70. *Id.* § 362(a)(3).

71. *See In re 48th Street Steakhouse, Inc.*, 835 F.2d 427, 431 (2d Cir. 1987).

72. *See Official Comm. of Unsecured Creditors v. PSS Steamship Co.*, 928 F.2d 565, 574 (2d Cir. 1991).

73. *See Official Bondholders Comm. v. Chase Manhattan Bank*, 209 B.R. 832, 838 (D. Del. 1997). In this case, the lenders obtained relief from the automatic stay in the holding company’s Chapter 11 case, permitting them to vote the shares which served as their collateral.

74. 11 U.S.C. § 362(a)(6).

75. *See In re Texaco Inc.*, 73 B.R. 960, 967 (Bankr. S.D.N.Y. 1987). Where the notice of acceleration will not give the creditor an advantage over other unsecured creditors, filing of such notice may be permitted by the court. Note also that “although section 362

In addition to the self effectuating injunction of section 362, under section 105 of the Bankruptcy Code, the court has the discretionary power to stay action by creditors not subject to the automatic stay. Unlike the section 362 stay, a section 105 stay is not automatic. Therefore, a creditor whose action is not within the scope of the section 362 stay may continue to act, pending the court's determination. The standard for relief under section 105 is vague, and as a consequence, provides the court with considerable latitude in determining when the automatic stay should be extended. Specifically, section 105(a) requires the court to find that the relief requested is "necessary or appropriate" to carry out the provisions of the Code.<sup>76</sup> Thus, under section 105, depending on the circumstances, a debtor may be able to extend the stay to creditor actions against third parties such as guarantors or co-debtors.

Of the various exceptions to the automatic stay, one is of particular interest to secured lenders. Section 362(b)(3) of the Bankruptcy Code excepts "any act to perfect, or to maintain or continue the perfection of, an interest [such as a security interest] in property" if "applicable law . . . permits perfection of an interest in property to be effective against a person entity [including the debtor in possession] that acquires rights in such property before the date of perfection," or if the act occurs within thirty days after the transfer becomes effective between transferor and transferee.<sup>77</sup> Accordingly, if a creditor is granted a purchase money security interest in an item of collateral and the borrower files a bankruptcy petition the following day (and before the creditor has filed a U.C.C. financing statement with respect to the collateral), the creditor will be free to file the necessary financing statement without a violation of the automatic stay because Revised U.C.C. section 9-317(e) permits a secured party to file with respect to a purchase money security interest within twenty days after the debtor receives delivery of the collateral and still has priority over any intervening lien creditor. Note also that section 362(d)(2) of the Bankruptcy Code allows a secured creditor to obtain relief from the automatic stay where "the debtor does not have an equity in [the collateral]; and [the collateral] is not necessary to an effective reorganization."<sup>78</sup>

The Bankruptcy Code permits parties to request that the court determine whether the interest of a secured lender in property (including a

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stays foreclosure, it need not be read to preclude acceleration." *In re LHD Realty Corp.*, 726 F.2d 327, 332 (7th Cir. 1984).

76. 11 U.S.C. § 105(a).

77. *Id.* §§ 362(b)(3), 546(b)(1), 547(e)(2)(A).

78. *Id.* § 362(d)(2).

security interest) is adequately protected<sup>79</sup> when the trustee or debtor in possession is using, selling, leasing, or borrowing against the property, or when the secured lender is otherwise stayed from enforcing its interest. These sections do not authorize the court to impose adequate protection. Instead, the parties may agree on appropriate protection, the secured creditor may request particular protection, or the trustee or debtor in possession may propose protection that it believes is adequate. Any such agreement is subject to court approval, and in the absence of agreement, the court must determine whether in fact the protection is adequate. "Adequate protection" is mandated by certain provisions of the Bankruptcy Code when requested by an entity with an interest in property in which the estate also has an interest. An entity is entitled to adequate protection as a matter of right, not merely as a matter of discretion, when the entity is stayed from enforcing its interest when the estate proposes to use, sell, or lease property in which the entity has an interest, or when property on which the entity has a lien is to be used as collateral for a loan. Adequate protection is required to protect a secured creditor's interest in property. Yet protection for the entire bundle of rights of the secured creditor is not required. In effect, protection is required only for the value of a secured creditor's interest in the property. If a secured creditor's claim exceeds the value of its interest in property, only the interest is entitled to protection. The remainder of the claim is unsecured and does not give rise to an interest in property that requires protection.

The claim of an oversecured creditor will generally increase over time as it accrues interest. Even if the value of the property is constant, any equity cushion will decrease as the amount of the claim increases. Nevertheless, adequate protection is not intended to protect the creditor's right to continue to accrue interest. Put another way, the oversecured creditor's allowed secured claim for post-petition interest is limited to the amount that a creditor was oversecured at the time of the filing. Consequently, the creditor is not entitled to a constant equity cushion. Instead, a decrease of the equity cushion as interest accrues should not adversely affect the viability of the cushion, at least until the cushion becomes insufficient to continue to protect the petition date amount of the secured claim against declines in the value of the property. An oversecured creditor is not entitled to receive periodic cash payments for accruing post-petition interest as part of that creditor's adequate protection in order to preserve the value of its equity cushion or otherwise. It is the decline in the value of the collateral against which protection is provided, not the perpetuation of the ratio of collateral to debt.

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79. *Id.* § 361 (defining "adequate protection").

Although a secured party is entitled to protection of the value of its interest, it is not entitled to profit from the trustee's services that might enhance the value of the interest. Section 506(c) permits the trustee to recover from the property costs and expenses of preserving or disposing of the property concerned to the extent of any benefit to the secured creditor. A secured creditor is not entitled to protection against such expenses any more than protection against the accrual of interest, the more so because section 506(c) permits the trustee to recover the expenses from the collateral even when the claim is undersecured. However, when the secured creditor is diligently seeking relief from the automatic stay, or to prevent or condition the use of collateral by the debtor under section 362(d) or 363(e), section 506(c) is narrowly applied to prevent the estate from profiting at the expense of a secured creditor who is seeking to remove its collateral from the control of the debtor, and the issue of costs of preservation or disposal should be determined in the early stages of the litigation, perhaps at a preliminary hearing.

The most important message of the Bankruptcy Code with respect to the treatment of an entity with an interest in property of the estate, or in the possession of the estate, is that its remedies may be suspended, even abrogated. The right of recourse to collateral may be terminated as the collateral is consumed in the business, as long as the value of its secured position is adequately protected. However, courts are divided on the question of whether the value to be protected is the value of the interest as of the date of the request for protection, or as of the commencement of the case.

Adequate protection may take many forms, only some of which are illustrated in section 361. When the collateral consists of inventory and accounts, adequate protection may require the provision of necessary accounting information, as well as additional or replacement collateral to compensate the creditor for its inability to enforce its after acquired property clause and the loss of collateral that would result from the debtor's use of the proceeds of the inventory or accounts. When the collateral consists of rents from real estate, adequate protection, at least for an interim period, may consist of a requirement that some portion, or all of the rents, be applied in a certain manner, perhaps to pay taxes, other senior liens, or interest. Of course, in some instances in which the value of the collateral is not declining, nothing more than insurance, taxes, and appropriate reporting may be needed to protect the value of the secured position.

The first suggested alternative of section 361 requires the debtor to make a cash payment, or periodic cash payments, to the affected secured lender to the extent that the stay of section 362, the use, sale, or lease

under section 363, or the grant of lien under section 364 results in a decrease in the value of such entity's interest in the estate's property. The payments are intended to protect the secured lender against a decrease in the value of the property, which would directly affect his interest in the property.<sup>80</sup>

The second alternative suggested in section 361 provides an additional or replacement lien to the extent necessary to compensate for a decrease in value of the secured creditor's interest in the debtor's property. Again, this does not necessarily mean that the creditor's "cushion" is to be protected, although a creditor may be entitled to some cushion as part of the value of its interest in property. Each case must be decided upon its particular facts.<sup>81</sup>

The grant of additional or replacement liens may be particularly appropriate when the affected creditor holds a "floating lien" on after-acquired property, such as inventory or accounts. The lien on collateral acquired after commencement of the case is cut off by section 552(a). If the debtor proposes to use, sell, or lease the collateral in the continuing operation of the debtor's business, the amount and value of the creditor's collateral may decrease if it is not replaced by newly acquired inventory or accounts. Although technically the creditor's interest can continue in the proceeds, notwithstanding section 552(a), the proceeds are likely to be cash that will need to be spent in the continuing operation of the business. This cash will be cash collateral, the use of which requires adequate protection. One likely form of protection is to continue the lien of the creditor on accounts or inventory acquired after commencement of the case, as long as it is clear from the facts that this will provide adequate protection, while at the same time not creating a windfall to the secured creditor. Often, new inventory will be acquired with the proceeds of inventory or accounts. However, it may be difficult to trace the proceeds into the new inventory. Permitting attachment of a security interest to the after-acquired property may remove this problem.

The last alternative for adequate protection is a catch-all, permitting such other relief "as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property."<sup>82</sup>

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80. *Id.* § 361(1).

81. *Id.* § 361(2).

82. *Id.*

*C. The After-Acquired Property Clause*

## 1. The After-Acquired Property Clause in English Insolvency Proceedings

Under English law, an agreement for security over after-acquired property is treated as creating a present (not a contingent) security interest that cannot take effect until the property has been acquired. Once value has been given for the grant of the security interest, each asset coming in under the after-acquired property clause is deemed to have been given for new value. The agreement for security over after-acquired property constitutes a present security; it creates an inchoate security interest which waits for the asset to be acquired so that it can fasten onto the asset. However, upon acquisition of the asset, the security interest takes effect as from the date of the security agreement.<sup>83</sup>

The commencement of a winding up proceeding does not prevent the after-acquired property clause from having effect. A new asset arising after the commencement of the debtor's winding-up becomes instantly caught by the secured creditor's security interest (provided that the consideration for the security interest was already executed before the commencement of the winding up—that is, the secured lender had already advanced funds to the debtor).<sup>84</sup>

The after-acquired property clause is effective to catch property coming into the company's hands after the commencement of the winding up despite section 127 of the Insolvency Act 1986, which renders void any disposition of the company's property made after the commencement of the winding up. Since the security interest relates back to the time of the security agreement there is no conflict with section 127.<sup>85</sup>

There are some exceptions to, and criticisms of, this rule. Sums recovered by a liquidator as a result of a successful preference claim have been held to be designated to benefit only unsecured creditors, thereby falling outside assets charged by a security agreement.<sup>86</sup>

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83. See ROY GOODE, *LEGAL PROBLEMS OF CREDIT AND SECURITY* 69–71 (3d ed. 2003).

84. *In re Lind* [1915] 2 Ch. 345 (C.A.); *In re Reis* [1904] 2 K.B. 769 (C.A.).

85. Note also that the exercise of a power of sale by a mortgagee or receiver after commencement of the winding up does not contravene the prohibition in section 127 against post-commencement dispositions, since to the extent that the asset being sold is subject to the security interest it is not property of the debtor at all. See *Sowman v. David Samuel Trust Ltd.*, [1978] 1 W.L.R. 22 (Ch.).

86. *In re M.C. Bacon Ltd.*, [1991] Ch. 127, 137; See *In re Yagerphone, Ltd.*, [1935] Ch. 392, 396.

It was . . . established long before 1986 that any sum recovered from a creditor who has been wrongly preferred enures for the benefit of the general body of creditors, not for the benefit of the company or the holder of a floating charge. It does not become part of the company's assets but is received by the liquidator impressed with a trust in favor of those creditors amongst whom he has to distribute the assets of the company.<sup>87</sup>

This approach is the result of a construction of the statutory right of action to recover a preference and the purpose for which such a right of action was created. It was not intended to be exercised so as to enable a secured creditor to obtain the benefit of the proceedings brought by a liquidator. However, recoveries by a liquidator for "misfeasance" (breach of duty) against directors and others will usually fall within the property charged. This is because the section which creates the right for a liquidator to bring a misfeasance action, unlike the sections dealing with preferences (and the sections dealing with transactions at an undervalue and claims against directors resulting from wrongful trading), does not create a separate right or remedy available to a liquidator, but merely a special procedure for recovery by the company of its claims arising from a breach of duty.<sup>88</sup> Thus, whereas the cause of action, which is the subject of a misfeasance summons, may exist prior to the winding up of the company, and thus are subject to the floating charge and after-acquired property clause, rights of action for wrongful trading, preferences, and transactions at an undervalue exist solely by virtue of the winding up of the company and cannot exist before such winding up.

Administrators are also given the power to bring proceedings to recover property invoking the statutory avoidable preference and transaction at an undervalue provisions. The same approach as that applied in a winding-up to recoveries for preference and transactions at an undervalue should apply in administrations.<sup>89</sup>

There has been some debate as to whether the rule is justified or whether it runs counter to the policy of insolvency law.<sup>90</sup> Professor Goode has concluded that insofar as English law allows the chargee to increase his security margin during the preference period (generally six months prior to the commencement of the liquidation), the criticism is

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87. See *In re M.C. Bacon Ltd.* [1991] Ch. at 137.

88. Insolvency Act, 1986, c. 45, § 212.

89. See GAVIN LIGHTMAN & GABRIEL MOSS, *THE LAW OF RECEIVERS AND ADMINISTRATORS OF COMPANIES* 241–43 (3d ed. 2000).

90. See GOODE, *supra* note 83, at 69–71; see also Paul Matthews, *The Effect of Bankruptcy upon Mortgages of Future Property*, 1 LLOYD'S MAR. & COMM. L.Q. 40 (1981) (U.K.).

well taken.<sup>91</sup> However, enhancement of the security margin of the secured creditor outside this period seems to be unobjectionable. The secured creditor is entitled to assert security rights over future property without putting in fresh value because he is not taking out of the estate more than he put into it; within the debtor's acceptance of the after-acquired property clause, the money would never have been advanced in the first place.

Professor Goode's position, of course, reflects the position that exists under the U.S. Bankruptcy Code. Section 547(c)(5) deals with the preference period, where the debtor receives after-acquired inventory (stock in trade or accounts receivable debt) subject to the security agreement. This provision requires the bankruptcy court to examine the collateral/debt amounts at two points: (1) at the start of the preference period, and (2) at the moment of the filing of the Chapter 11 petition. The provision condemns a security interest as preferential to the extent that the lender has improved its position between those two dates.

The impact of an administration proceeding on the rights of a secured creditor to property acquired by the debtor during the administration proceeding is in large part regulated by the relevant provisions in the Insolvency Act of 1986. The administrator "may dispose of or take action relating to property which is subject to a floating charge as if it were not subject to the charge."<sup>92</sup> Where property is disposed of in reliance on this power, "the holder of the floating charge shall have the same priority in respect of acquired property as he had in respect of the property disposed of."<sup>93</sup> "Acquired property" means "property of the company which directly or indirectly represents the property disposed of."<sup>94</sup> In other words, the priority previously enjoyed in relation to the disposed of property carries through to its products or proceeds. These statutory provisions effectively validate in administrations the operation of the after-acquired property clause.

It should also be noted, however, that the administrator may, with the permission of the court, dispose of property subject to a security other than a floating charge as if it was not subject to the security. The court's power to grant permission is exercisable only on the application of the administrator and only where it is satisfied that the "disposal of the property would be likely to promote the purpose of the administration in respect of the company."<sup>95</sup> It is a required condition of any order giving

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91. See GOODE, *supra* note 83, at 71.

92. Insolvency Act, 1986, c. 45, Schedule B1, para. 70(1).

93. *Id.*, c. 45, Schedule B1, para. 70(2).

94. *Id.*, c. 45, Schedule B1, para. 70(3).

95. *Id.*, c. 45, Schedule B1, para. 71.

leave to dispose of the property that the net proceeds of sale plus the amount by which those proceeds fall short of the value of the property determined by the court as the net amount which would be realized by sale on the open market by a willing vendor are to be applied in discharging the sums secured by the displaced security.

## 2. The After-Acquired Property Clause in U.S. Bankruptcy Proceedings

Under the Uniform Commercial Code, a security agreement may validly create a security interest in collateral acquired after its execution.<sup>96</sup> However, section 552 of the Bankruptcy Code limits the effect of such after-acquired property clauses in a subsequent bankruptcy case. Generally, a pre-petition security interest does not attach to property acquired after the commencement of the bankruptcy case.<sup>97</sup>

However, if the security agreement provides that the security interest extends to "proceeds, product, offspring, or profit" of the collateral, the security interest of the lender in such collateral is valid in the bankruptcy case unless the court, after notice and a hearing, limits this post-petition effect of the security interest "based on the equities of the case."<sup>98</sup> The legislative history relating to this provision indicates that the exception to the post-petition effect of the security interest is intended to cover a situation where assets of the estate, not subject to the security interest, are utilized in the completion and sale of collateral at an expense to the debtor's estate and thereby depleted the funds available for the general unsecured creditors to the benefit of the secured creditor.

Thus, it has been held that a lender's security interest in pre-petition crops extends to post-petition crops produced with the proceeds of pre-petition crops,<sup>99</sup> and a secured creditor's perfected security interest in rents and profits on real property extend to post-petition rents and profits.<sup>100</sup> However, a bank's pre-petition security interest was held not to attach to crops planted after the petition was filed.<sup>101</sup> In addition, a creditor's lien in hotel revenues, which were characterized as "accounts" under Article 9 of the U.C.C. rather than "rents" under section 552 of the

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96. U.C.C. § 9-204 (2000).

97. See, e.g., *Alliance Capital Mgmt. L.P. v. County of Orange* (*In re County of Orange*) 179 B.R. 185 (Bankr. C.D. Cal. 1995) (pre-petition security interest of lenders, on certain tax and other future revenues of a Chapter 9 county debtor, to secure repayment of general revenue bonds terminates under section 552(a); noteholders thus had no lien against debtor's post-petition revenues).

98. 11 U.S.C. § 552(b)(1).

99. E.g., *In re Thacker*, 291 B.R. 831 (Bankr. S.D. Ill. 2003).

100. E.g., *In re SLC Ltd. V*, 152 B.R. 755 (Bankr. D. Utah 1993).

101. E.g., *Matter of Hunerdosse*, 85 B.R. 999 (Bankr. S.D. Iowa 1988).

Bankruptcy Code,<sup>102</sup> did not extend to post-petition revenues.<sup>103</sup> Moreover, a creditor's lien on "rents, income and profits" from a debtor's farmland did not extend to new crops which the debtor plants post-petition by utilizing post-petition income and funds from another party.<sup>104</sup>

In order to avoid to the greatest extent possible the limitations contained in section 552, security agreements will usually provide for a security interest in proceeds, rents, issues, and profits. If all of the materials consumed in the manufacturing process (and perhaps the funds used to pay the labor component) are subject to the lender's security interest, the bankruptcy court should have no basis to invoke its equitable power to limit the security interest. In addition, the security documentation may contain provisions to facilitate the creditor's tracing of proceeds of collateral.

*D. The Debtor's Power to Use Collateral and Sell the Collateral Free and Clear of the Security Interest*

1. Debtor's Right to Use Secured Assets in Administration Proceedings

An administrator is deemed to act as agent of the debtor in exercising his powers.<sup>105</sup> These powers, which are wide-ranging, are to be exercised to enable the administrator to achieve the statutory purpose of the administration procedure. Since the Enterprise Act of 2002, there is one statutory purpose within which there is a threefold hierarchy. Paragraph 3(1) of Schedule B1 to the Insolvency Act of 1986 states:

*Purpose of administration*

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102. Section 552(2) of the Bankruptcy Code states that where the pre-petition security interest extends to:

property of the debtor acquired before the commencement of the case and to amounts paid as rents of such property or the fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties, then such security interest extends to such rents and such fees, charges, accounts, or other payments acquired by the estate after the commencement of the case to the extent provided in such security agreement except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

11 U.S.C. § 552(2) (2000).

103. *In re Northview Corp.*, 130 B.R. 543 (9th Cir. Bankr. App. 1991).

104. *E.g., In re Olsen*, 87 B.R. 148 (Bankr. D. Colo. 1988).

105. Insolvency Act, 1986, c. 45, Schedule B1, para. 69.

3(1) The administrator of a company must perform his functions with the objective of—

- (a) rescuing the company as a going concern, or
- (b) achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration), or
- (c) realising property in order to make a distribution to one or more secured or preferential creditors.

(2) Subject to sub-paragraph (4), the administrator of a company must perform his functions in the interests of the company's creditors as a whole.

(3) The administrator must perform his functions with the objective specified in sub-paragraph (1)(a) unless he thinks either—

- (a) that it is not reasonably practicable to achieve that objective, or
- (b) that the objective specified in sub-paragraph (1)(b) would achieve a better result for the company's creditors as a whole.

(4) The administrator may perform his functions with the objective specified in sub-paragraph (1)(c) only if—

- (a) he thinks that it is not reasonably practicable to achieve either of the objectives specified in sub-paragraph (1)(a) and (b), and
- (b) he does not unnecessarily harm the interest of the creditors of the company as a whole.<sup>106</sup>

To enable the administrator to achieve the statutory purpose, he has broad management powers in relation to the debtor's property, including the power to "do anything necessary or expedient for the management of the affairs, business and property of the [debtor]."<sup>107</sup> Furthermore, as noted, the administrator is given certain powers to deal with charged property. In many cases, in order to achieve the statutory purpose of administration, the administrator will need to be able to use or dispose of all the debtor's property, including that part of it which is charged to a secured lender.

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106. *Id.*, c. 45, Schedule B1, para. 3.

107. *Id.*, c. 45, Schedule B1, para. 59(1). The administrator's powers are set out in a long list in Schedule 1 to the Insolvency Act.

In the case of assets subject to any security which when created was a floating charge, the administrator is given the power to dispose of such assets, or otherwise take action relating to such property, as if the assets were not subject to the floating charge. Accordingly, the administrator can deal with such assets and dispose of them as he sees fits without reference to the floating chargeholder, and, presumably, without being fettered by any contractual restrictions contained within the floating charge, such as a negative pledge clause.<sup>108</sup> This power to use assets enables the administrator to trade the debtor's business notwithstanding the existence of the floating charge security. As noted above, where the security interest over debts and receivables is a floating charge, the administrator will have the ability to fund the administration by using proceeds resulting from repayments of debts and receivables without needing to obtain the consent of the secured lender. The secured lender is protected because he is granted the same priority as he had in relation to the floating charge assets in respect of any of property directly or indirectly representing the disposed of assets. Accordingly, if the administrator, for example, sells plant machinery subject to the floating charge, the proceeds of the sale will fall within the floating charge and the holder of the charge will be entitled to the same priority as against third parties (e.g., holders of subsequent floating charges) in respect of the proceeds as he had over the disposed of plant machinery.<sup>109</sup>

If the administrator wishes to dispose of collateral subject to a fixed charge, he must apply to the court for an order authorizing him to do so. The court may make such an order only where the court thinks that disposal of the property would be likely to promote the purpose of administration. The court must make it a condition of any such order that the net proceeds of disposal together with any further sums required to be added to the net proceeds so as to produce the amount determined by the court as the net amount which would be realized on the sale of the property at market value be applied towards discharging the sums secured by the fixed charge. Accordingly, the administrator is able to dispose of fixed charge assets where, for example, he wishes to sell the whole of the debtor's business and assets (where such a sale promotes the statutory purpose), even if the fixed charge holder does not give his consent.

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108. If the floating charge assets are to be regarded in the administrator's hands as not being subject to the charge, then it follows that the contractual provisions in the floating charge relating to dealings with such assets will not operate so as to bind the administrator. Otherwise the contractual stipulations would be promoted to a status superior to the proprietary rights granted by the security.

109. Note that the administrator is obliged to set aside a prescribed part of the debtor's net property for unsecured creditors out of floating charge assets coming into his hands.

## 2. Debtor's Right to Use Secured Assets in Chapter 11 Proceedings

The existence of a lender's security interest in property of the debtor—either because it is pre-petition property subject to a pre-petition security interest or because it is post-petition proceeds of pre-petition collateral in which a security interest has attached pursuant to section 552(b) of the Bankruptcy Code—does not prevent the debtor from using, selling, or leasing the collateral (and perhaps drastically reducing its value) if the debtor complies with the provisions governing such use, sale, or lease set forth in section 363 of the Bankruptcy Code.

While section 363 contains important protections for secured lenders, a lender can almost never rely on the statutory provisions to provide complete protection. The vigorous involvement of the secured lender in asserting its rights under section 363 is considered absolutely essential to prevent a diminution in its collateral position. A passive lender may find (perhaps too late) that the debtor has persuaded the court to “rubber stamp” its proposed uses of the lender's collateral, which imperils its value. Furthermore, not all the protective provisions are automatic. Thus, a lender's security interest in collateral will receive protection from the court only if the lender so requests.

Under section 363(a), “cash collateral” includes cash and cash equivalents (such as deposit accounts, negotiable instruments and documents of title) in which a secured party has an interest. Cash collateral also includes proceeds of pre-petition collateral, such as post-petition collections of pre-petition accounts, to the extent the security interest in such proceeds is recognized as valid under the Bankruptcy Code.

Unless the secured party with an interest in cash collateral consents to its use by the debtor, cash collateral may not be used unless the court authorizes such use after notice to interested parties and the opportunity for a hearing. At any such hearing, or at any time thereafter, the secured party having an interest in cash collateral may request the court to “prohibit or condition such use,” to the extent necessary to provide adequate protection of the secured party's interest in such cash collateral. The secured party will have the burden of proving its interest in cash collateral. However, the debtor must show that the creditor's interest is adequately protected before the court will authorize the debtor's use of a lender's cash collateral.<sup>110</sup>

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110. An example is helpful in understanding the application of section 363 of the Bankruptcy Code. Assume that a lender provided working capital financing to the debtor prior to the filing of the Chapter 11 petition by making advances based on “eligible” accounts and inventory. Assume further that the lender either does not desire to continue financing the debtor on a post-petition basis, or, if such financing is contemplated, it is

Typically, court authorization to use cash collateral will be sought immediately upon filing of the Chapter 11 petition or very shortly thereafter. Because a pre-petition secured lender has the right to adequate protection in order to safeguard its interests, the lender has significant bargaining leverage in arriving at a consensual arrangement for the debtor to use cash collateral.

The most common form of adequate protection provided to a pre-petition lender for the use of its cash collateral is a replacement lien on other assets of the debtor. For example, a creditor may be offered as adequate protection a lien on accounts that the debtor intends to create with the use of the cash collateral or a lien on some of the debtor's fixed assets.

Because the use of cash collateral by a debtor does not involve the advance of new funds to the debtor, but rather involves the use by the debtor of funds that are subject to the lender's security interest, the grant of a replacement lien is not intended to provide a lender with additional security over and above what it holds at the time the use of cash collateral is authorized. Rather, the purpose of a replacement lien on assets of the debtor is to provide protection to the lender in the event that the lender's collateral position is adversely affected by the debtor's use of its cash collateral. Thus, for example, a lender may be granted a replacement lien on post-petition inventory acquired by the debtor, and the lender will be able to look to that inventory as security in the event of a dissipation of its cash collateral.

The trustee or debtor in possession has the right to use, sell, or lease non-cash collateral (such as inventory, machinery, and equipment) in the ordinary course of its business without obtaining court approval. As a result, a lender will be required to initiate a request for specific adequate protection for such use, and it is recommended that such protection be requested as early as possible during the case as permitted by section 363(e) and Federal Rule of Bankruptcy Procedure 4001(b).

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uncertain whether cross-collateralization provisions can be obtained in a financing order. Subsequent to the filing of the Chapter 11 petition, the debtor receives collections on the pre-petition accounts that would ordinarily be remitted to the pre-petition lender to pay down the loan. Upon the filing of the Chapter 11 petition, such collections constitute cash collateral and the debtor may use such cash collateral subject to the limitations of section 363 of the Bankruptcy Code. Under these circumstances, the pre-petition lender will be concerned as to whether the debtor will be permitted to use the lender's cash collateral and for what purposes. If adequate safeguards on the use of a pre-petition lender's cash collateral are not imposed, the lender could see an important element of its collateral dissipated in the daily operations of an unprofitable debtor. *See* ROBERT J. ROSENBERG ET AL., *COLLIER LENDING INSTITUTIONS AND THE BANKRUPTCY CODE* § 4.05 (1986).

As with the use of cash collateral, adequate protection should include replacement liens and additional liens on property of the debtor. However, because non-cash collateral is subject to depreciation during the course of the case (whereas cash collateral has a fixed value), the lender may be successful in a request to obtain periodic cash payments equal to the amount of the depreciation if he can demonstrate that his collateral is so depreciating. Such payments are expressly authorized as a form of adequate protection.

Under section 363(b)(1), the use, sale, or lease of the debtor's property outside the ordinary course of business requires court approval after notice and a hearing to interested parties. For example, if the debtor proposed to sell one of its several manufacturing plants, it would require court approval under section 363(b)(1). For court approval, the sale must be in the best interests of the estate, requiring findings of a fair and reasonable price and good faith. Sales of certain personally identifiable information are subject to further limitation.

If the debtor would like to sell property in which another party has a security interest, it must also comply with section 363(f). Generally, the requirements of section 363(f) are met either by obtaining the consent of the party holding the lien, or by having the lien or security interest attach to the proceeds of the sale. Obviously, such sales can be either very favorable or adverse to the lender. If, for example, the property is sold at an amount in excess of the debt to the lender, the lender will, in effect, have had the bankruptcy court conduct a foreclosure sale for its benefit (without the attendant potential liability arising from a lender's non-bankruptcy conduct of a foreclosure sale), and obtain repayment. However, in other situations, the debtor may propose to sell the property at a price which the lender believes is less than the actual value of the property. A lender, under such circumstances, could object to the proposed sale as not being in the best interest of the estate. In the alternative, a lender could, unless the court orders otherwise, "bid in" its secured claim (i.e., apply the amount of its claim as an offset against the purchase price), purchase the property and resell the property at a higher value.

#### *E. Post-Petition Financing, Expenses, and Surcharges*

##### 1. The Administration Expenses Doctrine and Secured Creditors Under English Law

The provisions governing the payment by the administrator of expenses incurred by him during the administration and for payment of his remuneration are contained in paragraph 99 of Schedule B1 of the Insolvency Act 1986 (and rule 2.67 of the Insolvency Rules 1986), which fo-

cuses on the position when the administrator vacates office. These provisions impose a statutory charge over the debtor's property in the custody or control of the administrator at the time of his vacation of office, and are of no effect before then. Although, strictly, sums payable under the statutory charge only become payable when the administrator vacates office, it is well understood that administrators will, in the ordinary way, pay expenses of the administration as they arise during the continuation of the administration. What is picked up at the end of the administration by the statutory charge are those sums payable under the statutory charge which have not at that point been paid.

In recovering his expenses and remuneration, the administrator is only entitled to resort to assets that are the property of the company. His rights are subordinate to those of a holder of a fixed charge, but take priority over claims secured by a floating charge.

The ranking of the administrator's entitlement to expenses and remuneration from floating charge assets is as follows:

- (1) sums payable in respect of debt or liability arising under a contract made by the administrator, or a contract of employment adopted by the administration, before cessation of his appointment;
- (2) the administrator's remuneration and expenses (which between themselves are to rank in the order set out in the Insolvency Rules);<sup>111</sup>
- (3) the prescribed part which the administrator is required to set aside for ordinary unsecured creditors from assets subject to a floating charge if created on or after 15 September 2003 and remaining after preferential debts have been paid.<sup>112</sup>

The term "expenses" was not defined in the Insolvency Act 1986. However, the Insolvency Rules were amended in 2003 by adding Rule 2.67, which lists nine categories of expenses, including "necessary disbursements by the administrator,"<sup>113</sup> and provides that they are payable in the order listed in Rule 2.67(1). The reference to expenses in paragraph 99 is to mean and comprise the items listed in Rule 2.67(1).

Prior to the enactment of the Enterprise Act 2002, there was considerable uncertainty as to which liabilities could be treated as expenses. For example, there was an issue as to whether the statutory language allowed claims arising under pre-administration contracts to be paid as expenses

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111. Rule 2.67(1) of the Insolvency Rules, 1986, S.I. 1986/1925, contains a list of nine items, the first of which is "expenses properly incurred by the administrator in performing his functions in the administration of the company."

112. Insolvency Act, 1986, c. 45, Schedule B1, para. 99.

113. Insolvency Rules, 1986, Rule 2.67(1)(f).

in circumstances where the benefit of a contract had been used by the administrator to assist the administration (e.g., rent payable under pre-administration real estate leases where the leased property had been occupied during the to the estate's benefit). Under the old law, the statutory reference was to "expenses incurred by the administrator," which limited expenses to claims for which the administrator was personally liable. The law thereby excluded liabilities arising under pre-administration contracts, and only liabilities under contracts "entered into" by the administrator were covered by the other provisions relating to the administrator's statutory charge. However, the courts had held that, separately from and in addition to the statutory charge provisions in the Insolvency Act of 1986, the court has the power, at its discretion, to direct an administrator to discharge liabilities out of assets in his hands even if they are not technically "expenses."<sup>114</sup> The court's jurisdiction was held to arise because the administrator is an officer of the court, and by virtue of the administration moratorium on the enforcement by creditors of their rights.

It has been held recently that the changes made by the Enterprise Act 2002 have significantly amended the law. In *Re Trident Fashions*,<sup>115</sup> the court held that business rates on property occupied by the company during the administration were to be treated as an expense (a "necessary disbursement") because Rule 2.67 had changed the law so that the position in administrations is now the same as that in liquidations. Liabilities incurred by the company after the commencement of the administration must be paid as necessary disbursements; the liability to pay business rates arose by reference to the company's period of occupation.

The liquidation language had been held<sup>116</sup> to exclude any exercise of discretion by the court in determining whether the liquidator should pay expenses falling within the liquidation rule.<sup>117</sup> Where a liability falls within the applicable rule, it has to be paid, and the court has no discretion to exercise. This decision does not address the treatment of liabilities under pre-administration contracts.

It remains to be seen whether this approach will be followed when the issue is tested at the appellate level. At the time of writing, the decision is

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114. *In re Atlantic Computer Systems Plc.* [1992] Ch. 505, 520–30 (C.A.).

115. *Re Trident Fashions*, [2007] E.W.H.C. 400 (Ch.); see also *Freakley v. Centre Reinsurance Int'l*, [2006] U.K.H.L. 45. The decision of the House of Lords in *Freakley* related to the law prior to the changes made by the Enterprise Act 2002. Administration expenses used (in section 19(4) of the Insolvency Act) to have to be "expenses properly incurred by the administrator," but now the reference in the Act is to the "[administrator's] expenses." Insolvency Act, 1986, c. 45, Schedule B1, para. 99(3).

116. See *In re Toshoku Finance U.K. Plc.* [2002] 1 W.L.R. 671 (H.L.).

117. See Insolvency Rules, 1986, Rule 4.218.

controversial, not least because a principled basis for analyzing the nature of expenses in an administration remains to be established.

It should be noted that where the administrator needs to borrow funds for the purpose of the administration, these provisions allow him to do so, and to create new, post-administration security interests, with priority over pre-administration floating charge assets. However, there is no ability to prime and subordinate assets subject to a pre-administration fixed charge.

## 2. Post-Petition Financing in Chapter 11 Cases and the Impact on Pre-Petition Secured Creditors

The Bankruptcy Code contains various provisions designed to assist a debtor in obtaining post-petition financing in connection with the debtor's Chapter 11 proceedings. The Code authorizes various different types of financing that may be permitted starting with unsecured borrowing and concluding with the creation of new first priority liens ranking ahead of existing pre-petition security interests.

Section 364(a) permits a debtor to obtain unsecured credit or incur post-petition unsecured indebtedness in the "ordinary course of business." No court approval is required for such transactions provided that the ordinary course of business standard is satisfied. Post-petition indebtedness, incurred by a debtor in the ordinary course of business, and interest payable on such indebtedness, is entitled to an administrative expense priority that is *pari passu* with all other administrative expenses, and is senior to all other priorities (e.g., wage claims and tax claims) in the Bankruptcy Code priority ranking scheme, with the exception of "super-priorities" (which are senior to administrative expense priorities).

Under section 364(b), the bankruptcy court, after proper "notice and a hearing," may approve an unsecured post-petition loan or extension of credit that is not in the ordinary course of business. Any such loan or extension of credit will have the same administrative expense priority as any extension of credit under section 364(a).

Most potential post-petition lenders are understandably reluctant to advance funds to the debtor and receive solely an administrative expense claim. Despite the impressive-sounding first priority status accorded the administrative expense claim granted to a post-petition lender pursuant to a court-authorized section 364(b) lending arrangement, in a liquidation, the lender's administrative expense claim will be *pari passu*, rather than senior to, all other administrative expenses. Other administrative expense claims would include claims of all parties who have provided goods or services to the debtor during the Chapter 11 period (including, but not limited to, supplier's claims, fees of attorneys, accountants and special

consultants, and the fees of any professionals retained by the official creditors' committee and equity security holders' committee). In addition, if a Chapter 11 case is subsequently converted to a liquidation case under Chapter 7, Chapter 7 administrative expense claims will be senior to the Chapter 11 administrative expense claims. Upon liquidation, after payments to all secured creditors, all entities holding claims entitled to superpriority, and all holders of Chapter 7 administrative claims, little may be left for post-petition lenders who hold claims with Chapter 11 administrative expense status.

For these reasons, a post-petition lender will usually require additional protection before agreeing to provide a debtor with post-petition financing. Section 364(c)(1) permits a post-petition lender to obtain such additional protection by obtaining "superpriority" over all administrative expenses.<sup>118</sup> To obtain a superpriority claim, court approval is required, and a showing must be made that the debtor is unable to obtain unsecured credit allowable as an ordinary administrative expense. To support the request for a superpriority, a lender will need to testify in court that it will not advance funds to the debtor unless it receives a superpriority claim.

Section 364(c) also provides a method for a post-petition lender to receive, either in addition to, or exclusive of, a superpriority claim, security interests in assets of the debtor. However, as with any post-petition financing under section 364(c), in which the lender is granted a superpriority, if the lender is granted liens and security interests in assets of the debtor, the financing arrangement must be approved by the bankruptcy court after notice and a hearing. In addition, the financing arrangement requires a showing that unsecured credit allowable as an administrative expense cannot otherwise be obtained by the debtor. If the foregoing requirements are met, the post-petition financing may be secured (pursuant to section 364(c)) by a lien on unencumbered property of the debtor, or by a junior lien on property of the debtor, that is already subject to a lien.

Section 364(d) is a less common method of providing secured post-petition financing to a debtor than section 364(c), because section 364(d) financings generally adversely affect the security position of a pre-petition secured lender. Section 364(d) permits the debtor to obtain credit secured by a senior or equal lien on property of the debtor that is already subject to a lien. As a result, in the absence of consent by the existing

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118. Note that some courts insist on a "carve out" from superpriority status and post-petition liens in a reasonable amount designed to provide for the payment of the fees of the debtor's and creditors' committee's counsel and possible trustee's counsel in order to preserve the adversary system. *E.g.*, *In re Ocean Power Corp.*, 2007 WL 949598 (Bankr. S.D.N.Y. 2007).

lienholder, attempted financings under section 364 are likely to be vigorously opposed by the lender whose lien is to be “primed.” To obtain financing under section 364(d), the debtor must demonstrate to the court that it cannot otherwise obtain financing, and that the “primed” lender either consents or will be provided “adequate protection” of its interest in its collateral. Thus, section 364(d) permits the bankruptcy court to “prime” the lien of one lender in favor of another lender if the court determines that the interest of the lender being primed is afforded “adequate protection.” Courts have held that a primed lender has been afforded adequate protection if: (1) the debtor demonstrates that sufficient equity will remain in the collateral after the senior or additional lien is granted to cover the indebtedness of the primed lender; or (2) the proceeds from the loan to be secured by the senior or additional lien will result in an increase in the value of the collateral.<sup>119</sup> However, courts and commentators have criticized the granting of priming liens on collateral where the existing creditor is undersecured. In cases permitting an undersecured creditor’s lien to be primed, some courts have found that adequate protection is afforded based on the likelihood that the collateral value will be enhanced.<sup>120</sup> A debtor seeking approval of a priming lien, but not offering additional collateral to the existing secured creditor, would need to put forward strong evidence (including credible financial projections) to establish that the proposed priming financing will enhance collateral value.

A court must value the collateral in order to determine whether sufficient equity is in a lender’s collateral to justify granting an additional or senior lien on such collateral, or whether the proceeds from the loan to be secured by the senior or additional lien would result in an increase in the value of the collateral. To value the collateral properly, the court must determine which valuation standard should be used. Some courts have used a going concern (rather than a liquidation) analysis to value existing facilities after determining that the debtor is not likely to be liquidated.<sup>121</sup> Courts have also found that a primed lender can be afforded adequate protection if the lender is granted replacement liens on the debtor’s other assets.<sup>122</sup>

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119. See, e.g., *In re Chicago, Missouri and Western Ry. Co.*, 90 B.R. 344 (Bankr. N.D. Ill. 1988).

120. E.g., *In re Sky Valley*, 100 B.R. 107 (Bankr. N.D. Ga. 1988).

121. E.g., *In re Beker Industries Corp.*, 58 B.R. 725 (Bankr. S.D.N.Y. 1986).

122. E.g., *In re TNT Farms*, 226 B.R. 436 (Bankr. D. Idaho 1998).

### 3. The Expenses Doctrine in Chapter 11 and Its Impact on Secured Creditors

The Bankruptcy Code establishes different levels of priority for expenses—priority and superpriority. Section 507 is entitled “priorities,” but it does not encompass the full range of the Code’s priority rules. Other sections confer “super” priorities on a claimant.

In a Chapter 7 liquidation, expenses generally rank after the claims of secured creditors. In a Chapter 11 case, the timing and ordering of payments depends on the terms of the plan of reorganization. The plan must comply with certain core rules. First, the plan can only be confirmed if priority claims are paid in full in cash on the effective date of the plan. In addition, a secured creditor’s collateral can, in certain circumstances, be surcharged with the costs and expenses of preserving the collateral thereby ensuring that the secured creditor does not recover the full value of his security.

Section 503 of the Bankruptcy Code provides for the “allowance” of administrative expenses. Section 503(a) authorizes a party to file a request for payment of an administrative expense. Section 503(b) provides that administrative expenses of the type described therein are to be allowed by the court after notice and a hearing. While there are various exceptions, administrative expenses are generally those that are incurred by the estate after the commencement of the Chapter 11 case.

Section 503 derives its importance from section 507. Section 507 provides that certain categories of expenses and claims<sup>123</sup> have priority in the distribution of the assets of the estate. Section 507 lists ten categories of priority claims. The second priority, set forth in subsection 507(a)(2), consists of administrative expenses allowed under section 503(b). The impact of section 507, and hence of section 503, is somewhat different in cases filed under different chapters of the Code.

In a Chapter 7 case, property of the estate is distributed according to the distribution schedule of section 726. This section provides that property is first distributed by payment of claims of a kind and in the order specified in section 507. But all of these claims rank after secured claims. Therefore, secured creditors are entitled to be paid full up to the value of the collateral securing their claim before unsecured claims are paid at all.

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123. One of the most important concepts in the Bankruptcy Code is that of a “claim.” Claims are paid, if allowed, and claims are discharged. “Claim” is defined very broadly, and is intended to cover all legal obligations of the debtor no matter how remote or contingent. *See* 11 U.S.C. § 101(5)(A) (2007). Even a right to an equitable remedy can constitute a claim, including rights giving rise to the remedy of an injunction or specific performance if the debtor’s breach gives rise to a right to payment.

In a Chapter 11 case, payments are made according to the terms of a confirmed plan of reorganization (as opposed to a distribution by the trustee). A plan can only be confirmed if it provides for the full payment of section 507(a) priority claims in cash, unless the holder of the claim has agreed to a different treatment. As a result, some of these claims may fail to be paid before secured claims.

Section 503(b) states that the administrative expenses “include” the nine listed categories. Section 102(3) further provides that the terms “include” and “including” are not to be construed as limitations. The result is that the nine described categories cannot be considered an exhaustive list of all of the types of claims that are entitled to administrative priority treatment. The court may determine that additional types of claims are expenses that should be accorded administrative priority in a particular case. A court is not free to determine that a claim qualifying as an administrative expense under the express language of section 503(b) should not share in administrative priority with other administrative expenses, or should be subordinate to payment of other administrative expenses.

In general, all claims allowable under section 503(b) as administrative expenses share equally as first-priority claims. However, section 507(b) of the Code grants a “superpriority” to certain administrative expense claims of secured creditors, which come into being due to a shortfall arising between the adequate protection ordered by the court under sections 362, 363, or 364, and the actual loss in value of the property in which the secured creditor has a lien. A claim enjoying this “superpriority” has priority over all other unsecured claims, including those entitled to administrative priority under section 507(a)(1).

The order of priority of administrative claims can also be affected by an even greater “superpriority” arising under section 364(c) of the Code when necessary to enable the trustee to obtain unsecured credit. This claim is given priority even over the superpriority claim of section 507(b). Section 364(c) provides that the court may authorize the estate to obtain credit with a priority over all other administrative expenses if the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as a mere administrative expense.

The first of the specified types of claims allowable as administrative expenses are those described by section 503(b)(1)(A) as “the actual, necessary costs and expenses of preserving the estate.”<sup>124</sup> Section 503(b)(1)(A) makes no attempt to enumerate potential items of expense that fit within the phrase other than to state that it does include “wages, salaries, or commissions for services rendered after the commencement

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124. 11 U.S.C. § 503(b)(1)(A) (2000).

of the case” and certain back pay awards pursuant to a judicial or National Labor Relations Board proceeding. Based on the wording of section 503(b)(1)(A), courts have developed several tests for determining whether a particular claim qualifies for being an actual and necessary cost of preserving the estate. Many courts have stated generally that for a debt to qualify as a necessary preservation expense, the debt must satisfy two requirements: (1) it must have arisen from a transaction with the estate; and (2) it must have benefited the estate in some demonstrable way.<sup>125</sup>

The general bankruptcy rule, as noted above, is that, absent an express agreement to the contrary, the expenses associated with administering a bankruptcy estate are not chargeable to a secured creditor’s collateral or claim. Instead, the expenses but must be borne out of the unencumbered assets of the estate. But an important exception to this general rule is set out in section 506(c), which permits a debtor to recover administrative expenses from a secured creditor’s collateral if three conditions are satisfied: (i) the expenses are “necessary” to preserve or dispose of the collateral; (ii) the expenses are “reasonable”; and (iii) the incurrence of the expenses provides a “benefit” to the secured creditor. Similarly, expenses may be recoverable where the secured creditor expressly or impliedly consents to the incurrence of the expense, or caused the expense. In addition, as amended in 2005, section 506(c) expressly includes as part of the amounts that may be charged against the secured party’s collateral all *ad valorem* property taxes with respect to the collateral.

In general, a secured creditor receives a “benefit” within the meaning of section 506(c) if the relevant expense preserved or increased the value of its collateral. The general concern underlying this requirement is the prevention of a windfall to the secured creditor. A secured creditor should not reap the benefit of actions taken to preserve the secured creditor’s collateral without shouldering the cost. In addition, expenses are “necessary” to the extent that they relate to the preservation or disposition of the secured creditor’s collateral, and then only to the extent they are not attributable to any unwarranted delay by a party other than the secured creditor. Finally, expenses are “reasonable” to the extent that they are incurred in the ordinary course at a reasonable price.

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125. *E.g.*, *In re Smith*, 315 B.R. 77 (Bankr. W.D. Ark. 2004).

*F. The Ability to Vary and Cram Down Security Interests Within the Bankruptcy Proceedings*

1. The Ability of Administration Proceedings to Vary and Cram Down Security Interests

Unlike Chapter 11, the administration procedure does not incorporate a mechanism for varying or discharging creditors' rights. The administrator is required to prepare proposals to be placed before creditors and on which creditors are allowed to vote. However, these are merely proposals for achieving the purpose of administration—how he proposes to manage the business, affairs, and property of the debtor so as to rescue the company as a going concern, or, if that is not reasonably practicable or produces a result for the company's creditors that as a whole is worse than an alternative course of action, pursue a course of action that will produce a better result for creditors than a winding up.

In most cases, the administrator's statement of proposals has to be accompanied by an invitation to creditors to attend the initial creditors' meeting at which the proposals are considered. The date set for this meeting must be "as soon as is reasonably practicable after the debtor enters administration," and "in any event, within a period of ten weeks beginning with the date on which the company enters administration."<sup>126</sup> At the meeting of creditors, creditors may approve the administrator's proposals with or without modification. But, where there are modifications, the administrator must give his consent. The "majority (in value) vote of those present and voting, in person or by proxy," is required to pass a resolution to approve the administrator's proposals.<sup>127</sup> Any resolution, however, is invalid if those voting against it include more than half of the creditors to whom notice of the meeting was sent, and who are not, to the best of the belief of the chairman at the meeting, persons connected with the company.

At such a creditors' meeting, however, a secured creditor is entitled to vote only in respect of the balance (if any) of his debts, after deducting the value of his security as estimated by him. Accordingly, a partly secured creditor will only be entitled to vote on the administrator's proposals to the extent of his shortfall. The unsecured creditors are the constituency who control approval of administration proposals.

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126. Insolvency Act, 1986, c. 45, Schedule B1, para. 51(2). Note that these time limits may be varied by the court on an application of the administrator, or by up to twenty-eight days with the consent of creditors. *See id.*, c. 45, Schedule B1, para. 51(4).

127. Insolvency Rules, 1986, Rule 2.43.

The reason for this is that an administrator's statement of proposals may not include "any action which affects the right of a secured creditor of the company to enforce his security."<sup>128</sup> Thus while the secured creditor is disenfranchised and prevented from voting on the administrator's proposals to the extent that the value of his collateral exceeds his secured debt, he is protected because of the limits imposed on what can be included in the administrator's proposals. As a practical matter, therefore, the administrator must agree with the secured creditor on a course of action at least in so far as the administrator needs to propose steps which would affect the right of the secured creditor to "enforce" his security. It remains to be seen as to what action can be proposed which affects the position, but not the enforcement rights, of the secured creditor.

There are, however, certain circumstances in which the administrator does not need to convene an initial creditors' meeting to consider his proposals. The administrator can dispense with the initial creditors' meeting, and does not need to have his proposals approved, where his "statement of proposals states that [he] thinks that (a) the company has sufficient property to enable each creditor to be paid in full, (b) that the company has insufficient property to enable a distribution to be made to unsecured creditors . . . , or (c) that it is not reasonably practicable to rescue the company as a going concern or implement an alternative strategy which produces a better result for creditors than the winding up."<sup>129</sup> This authority to dispense with the need to summon an initial creditors' meeting was introduced by the Enterprise Act 2002 and applies in circumstances where there is likely to be nothing of substance that a creditors' meeting could decide.

Even though the administrator is not required in these circumstances to summon a creditors' meeting on his own initiative, he is required to do so if requested by creditors whose debts amount to at least ten percent of the total debts of the company. Where a creditors' meeting is held, and the administrator has included in his statement of proposals that the debtor has insufficient property to enable it to make a distribution to unsecured creditors, then the secured creditor is entitled vote in respect of the full value of his secured debt without deducting the value of his security.<sup>130</sup>

The English equivalent to the Chapter 11 plan of reorganization is contained in separate statutory provisions in the Insolvency Act 1986 and the Companies Act 1985. A company voluntary arrangement (CVA) is made

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128. Insolvency Act, 1986, c. 45, Schedule B1, para. 73(1).

129. *Id.*, c. 45, Schedule B1, para. 52(1).

130. Insolvency Rules, 1986, Rule 2.40(2).

pursuant to the provisions of Part I of the Insolvency Act 1986 and is a composition in satisfaction of the debtor's debts or a scheme of arrangements of its affairs resulting from acceptance of a proposal made to creditors. Such a proposal can be made by the directors of the debtor whether or not the debtor is insolvent or likely to become insolvent. It can also be proposed by an administrator, and the administrator's proposals, where necessary, can include a statement that the administrator intends to achieve the purpose of administration by proposing a CVA.

Thus, a CVA may run in parallel with an administration, but, without an administration, the CVA process does not generate an automatic stay.<sup>131</sup> For this reason, many CVAs are conducted within the framework of administration. The normal procedure in these circumstances is for the administrator to continue to manage the debtor until the CVA is approved. At that point, the administrator will pass over assets or trading surpluses to the supervisor of the CVA for distribution among creditors. Usually, the supervisor is the administrator himself.

When a CVA proposal is made by an administrator, a creditors' meeting must be summoned, at which creditors vote on the CVA proposal. A creditor entitled to vote is bound by the CVA even if he did not receive notice of the meeting, or, having received notice of the meeting, he chooses not to attend or to vote by proxy. Thus, a creditor not entitled to vote is not bound by a CVA. The general rule is that every creditor who has notice of the creditors' meeting is entitled to vote at the meeting. In order for the CVA to be approved, there must be a majority vote in excess of three-quarters of the creditors present (in person or by proxy). As with the administrator's proposals, a meeting summoned to approve a CVA must not approve any proposal which "affects the right of the secured creditor of the company to enforce his security, except with the concurrence of the creditor concerned."<sup>132</sup>

As an alternative to a company voluntary arrangement, an administrator can propose a scheme of arrangement under section 425 of the Companies Act of 1985. This section declares that where any compromise or arrangement is proposed between a company and its creditors, or any class of them, the court may order a meeting of the creditors to be called. Additionally, if three-fourths of creditors present either in person by proxy agree to the compromise or arrangement (and it is also sanctioned by the court), it will be binding on all the creditors and on the company.

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131. Note there is separate moratorium proceeding available to small companies only, which does give rise that an automatic stay.

132. Insolvency Act, 1986, c. 45, § 4(3).

Schemes of arrangement are binding only on those creditors who are made a party to the scheme. It is not necessary for the debtor to have a scheme of arrangement with all creditors. However, it is necessary for the debtor to identify the separate classes of creditors, and for each separate class to approve the scheme by the requisite majority. There is no equivalent to the Chapter 11 concept of cram-down. Whereas a Chapter 11 plan of reorganization can be confirmed even if a class of creditors votes against it (provided that the conditions to a cram-down contained in the Bankruptcy Code are satisfied), if a separate class of creditors votes against a scheme of arrangement they cannot be bound. The responsibility for determining what creditors are to be summoned to any meeting as constituting a separate class rests upon the debtor. If the meeting is incorrectly convened or constituted, or any objection is taken to the presence of any particular creditors as having interests competing with the others, the objection must be taken at this stage.<sup>133</sup> A scheme of arrangement can relate to the debtor's secured creditors, but secured creditors are likely to be a separate class (or perhaps classes) which can only be bound if the class votes by the requisite majority to support the scheme. Furthermore, in the context of an administration, it seems that a scheme cannot be proposed without the consent of all the secured creditors, where the scheme affects the enforcement rights of secured creditors.

In order for the scheme to become effective, it must be sanctioned by the court at a hearing held after creditors have voted. Importantly, even though there is no statutory authority on this point, the court may ignore the fact that a class has not consented to the scheme if it is proved that upon an immediate distribution of the assets, none would be available for that class.<sup>134</sup> It has been held that creditors' meetings are unnecessary where a scheme involves no risk to them.<sup>135</sup> Additionally, it has been held that where one class of creditors had voted against the scheme, and so was consequently not bound by it, the court could sanction the scheme in so far as it affected the remaining creditors who had voted in favor of

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133. The classic test of what is a class for these purposes was laid down by Lord Justice Bowen in *Sovereign Life Assurance v. Dodd*, [1892] 2 Q.B. 573, 583 (C.A.), stating that "it must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest." There have recently been a number of significant cases considering the classes question. See, e.g., *In re Hawk Ins. Co. Ltd.*, [2002] B.C.C. 300, 309–10 (Ch.).

134. See *In re MyTravel Group Plc.*, [2005] 1 W.L.R. 2365 (C.A.); *In re Oceanic Steam Navigation Co.* [1939] 1 Ch. 41 (C.A.); *In re Sorsbie* [1904] 1 Ch. 12 (C.A.).

135. See *Re A.G.L. Sydney Ltd.*, (1994) 13 A.C.S.R. 597 (N.S.W. Sup. Ct.) (Austl.).

it.<sup>136</sup> There is currently considerable controversy in England as to whether it is proper to value the debtor's assets on a break up or liquidation basis, rather than on the basis of a going concern enterprise value when determining whether a class of creditors, including secured creditors, has an interest in the assets of the debtor and would be entitled to a distribution therefrom.<sup>137</sup>

## 2. The Cram-Down of Secured Creditors Under Chapter 11<sup>138</sup>

Confirmation of a plan of reorganization is the statutory goal of every Chapter 11 case. Section 1129 of the Bankruptcy Code provides the requirements for such confirmation, containing Congress's minimum requirements for allowing an entity to discharge its unpaid debts and continue its operations. These requirements are numerous, and differ depending on whether confirmation is consensual or not. If consensual confirmation is sought, section 1129(a) governs. It contains thirteen paragraphs, each of which contains a separate requirement that must be met in order to confirm the plan. Among the critical requirements are the best interest of creditors test and the feasibility test.

If non-consensual confirmation is sought, then section 1129(b) controls, which incorporates all but one of the paragraphs of section 1129(a). It adopts twelve of the thirteen section 1129(a) requirements, omitting only the requirement that all classes consent or be unimpaired. In addition, section 1129(b) adds two more requirements. First, the plan may not unfairly discriminate against dissenting classes. Second, the plan's treatment of such dissenting classes must be fair and equitable.

Before the court hears evidence on these matters, however, much will have happened. The plan proponent will have drafted and disseminated a disclosure statement approved by the court regarding the effect of the plan. The creditors and interest holders will have been solicited for their votes, and will have voted. Parties in interest will have filed any objections they may have. Only after this large amount of work has been done will the court then allow the proponent to demonstrate that its plan deserves confirmation.

Although section 1129(b)(1) sets out a complete test for non-consensual confirmation, Congress added a subsection to illustrate some of the components of the fair and equitable rule. This section has re-

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136. *Barclays Nat'l Bank Ltd v HJ de Vos Boerdery* 1980 (4) SA 475 (S. Afr.).

137. See Michael Crystal & Rizwaan Jameel Mokal, *The Valuation of Distressed Companies: A Conceptual Framework, Parts I & II*, 3 J. INT'L CORP. RESCUE 63, 123 (2006).

138. See WILLIAM MILLER COLLIER, COLLIER ON BANKRUPTCY § 1129.05 (Lawrence P. King ed., 1996), for a general discussion of this topic.

ceived the lion's share of judicial attention, representing a carefully delineated explanation of various types of fair and equitable treatment. The preamble to section 1129(b)(2) states that "[f]or the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements." What follows is an extensive list of possible non-consensual treatments of secured and unsecured creditors, and of interest holders.

The first subparagraph of section 1129(b)(2) states that it applies with respect to a class of "secured claims." Under the Code, a secured claim is one that is either "secured by a lien on property in which the estate has an interest" or one that is "subject to setoff under section 553."<sup>139</sup> The amount of the claim secured is limited "to the extent of the value of such creditor's interest in the estate's interest in such property," or "to the extent of the amount subject to setoff." There are three possible situations which involve a class of secured claims. First, a creditor may have collateral that is worth more than the amount of its allowed claim. For example, a creditor may have a claim of \$50 secured by collateral having a value of \$75. In this case, the creditor has one claim, and it is a secured claim of \$50. In addition, a creditor might also have taken security pre-bankruptcy which has subsequently become worthless. If the claim was \$50, and the value of the collateral is now zero, the creditor has one claim, but it is unsecured and will not be subject to section 1129(b)(2)(A). A final example is representative of most litigated cases, where a creditor may have a claim in excess of the value of its collateral. To reverse the prior example, the claim may be for \$75, and be secured by a lien on property worth only \$50. In this case, the creditor has two claims: a secured claim for \$50, and an unsecured claim for the deficiency for \$25. Only the secured claim will be subject to section 1129(b)(2)(A).

Section 1129(b)(2)(A) lists three possible treatments of a secured claim, any one of which will independently satisfy the fair and equitable requirement. First, the plan proponent may seek to satisfy the claim in full by giving the creditor a note in the amount of the secured claim secured by the same collateral. Second, the plan proponent may also seek to sell the collateral free of the lien, and transfer the lien to the proceeds of sale. Third, the proponent may seek to give the creditor the "indubitable equivalent" of its claim.

Section 1129(b)(2)(A)(i) provides the terms under which the plan proponent may unilaterally write a new loan. First, the holder of the claim must "retain the lien securing [its] claims" regardless of who winds up

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139. 11 U.S.C. § 506 (2007).

with the property. Secondly, the holder of the claim must “receive on account of such claim deferred cash payments totalling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder’s interest in the estate’s interest in such property.” The primary issue litigated under section 1129(b)(2)(A)(i) is the appropriate interest rate that the deferred payments will bear. As indicated in the legislative history, if the interest rate is a “market rate,” then the principal of the note needs only to equal the allowed amount of the claim. If the plan proponent chooses a rate which is less than the “market” rate, then the stream of payments will not have a present value equal to the allowed amount of the claim. There is no requirement that the lender’s pre-petition security agreement or mortgage be used in order for the lender to retain its lien. As noted by the Court of Appeals for the Fifth Circuit: “We interpret the plan as ensuring [retention of a lien] if the debtor fails to comply with its debt service obligations, [the secured creditor] would have the right to foreclose.”<sup>140</sup>

Many loans amortize between the date of issue and maturity; that is, they call for payments which, if timely made, will leave a zero principal balance at maturity. A reorganized debtor’s projected cash flow, however, may not support a fully amortizing loan. The legislative history suggests that balloon payments may be appropriate, or that a plan may adopt non-standard repayment schedules adapted to the reorganized debtor’s business needs. The secured creditor’s protection here is the feasibility requirement of section 1129(a)(11). If the plan calls for minuscule payments for twenty years, and a balloon payment on resale at the end of that period, then plan’s feasibility, and possibly good faith, could be called into question.

A second example of fair and equitable treatment is contained in section 1129(b)(2)(A)(ii). It provides that a plan is fair and equitable as to a secured creditor if the plan provides for the sale, subject to section 363(k), of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of that subparagraph. This clause anticipates six components: (1) a sale; (2) subject to section 363(k); (3) of property subject to the lien; (4) which sale is free and clear of the liens; (5) with the liens to attach to the proceeds; and (6) deferred payments or indubitable equivalent.

The plan must anticipate a sale, either contained in the plan itself, or post-confirmation. Inclusion of the sale in the plan is not troublesome, as

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140. *Matter of Briscoe Enterprises, Ltd.*, 994 F.2d 1160, 1169 (5th Cir. 1993).

section 1123 expressly anticipates that a sale of all or some assets can be a means to implement the plan.

The sale must be subject to section 363(k) of the Bankruptcy Code. This section provides that “unless the court for cause orders otherwise the holder of [the secured] claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.” This gives the secured creditor protections against attempts to sell the collateral too cheaply. If the secured party thinks the collateral is worth more than the debtor is selling it for, it may effectively bid its debt and take title to the property.

The final option under section 1129(b)(2)(A) is that a plan may be confirmed against a secured creditor’s wishes if the plan provides “for the realization by such holders of the indubitable equivalent of such claims.” Two examples will illustrate the operation of this provision. First, abandonment (or other unqualified transfer) of the collateral to the secured creditor satisfies this requirement. Second, provision of a payment stream with a present value less than the allowed amount of the claim will not suffice. Third, plans which call for substitute collateral, although contemplated by the legislative history of the Code, have also been disfavored unless the creditor receives a “substitute of the most indubitable equivalence,” providing for present value and safety of principal. In cases of this sort, whether the substitute collateral’s value exceeds the allowed secured claim is critical. Plans which propose to give an oversecured creditor no payments for a period followed by transfer if the collateral is not sold by a certain time, however, have met with favor so long as the court is satisfied that there will always be more value in the property than the lender’s lien.

#### IV. CONCLUSION

The secured creditor is still treated differently in U.K. and U.S. rescue/reorganisation proceedings. While the law in both jurisdictions has changed and continues to change in ways that bring the two systems closer together—in large part because of the changing role and conception of the rescue/reorganisation proceeding itself—the secured creditor’s position is significantly stronger in the United Kingdom.

The administration procedure pays considerable deference to the wishes and interests of the secured creditor, first by allowing the holder of a qualifying floating charge to control key aspects of the case (the law allows such a secured creditor to commence an administration without a court application, to trump the company’s choice of administrator if the company files for administration, and requires the administration to be

conducted for the benefit of the secured creditor—by realizing the company's property to make a distribution to the secured creditor where neither a rescue nor a restructuring that achieves a better recovery than a liquidation are reasonably practicable) and secondly by immunising him from the adverse effects of the procedure (by ensuring that the administrator's proposals and any CVA proposed by the administrator cannot affect his right to enforce his security).

While the Chapter 11 regime provides substantial protections for pre-petition secured creditors, the nature of the process, even after the 2005 reforms, means that secured creditors have significantly less control than in administration proceedings, are forced to be more active in and to litigate over the protection of their rights and outcomes are less predictable, in large part because of litigation risk.

Furthermore, the difference in deference applies not only in the debtor—secured creditor relationship but also at the level of the inter-creditor relationship—a key pressure point in most large rescue and reorganisation proceedings. In the United Kingdom, the rights, freedom of action, and position of senior creditors have been well respected and protected although the extent of these protections (particularly in light of the complex financing structures with multiple tiers of secured debt and inter-creditor agreements) may well come to be tested in the next, perhaps more litigious and U.S.-style, era of restructurings.

# WHERE ARE ALL THE TRANSNATIONAL BANKRUPTCIES? THE PUZZLING CASE FOR UNIVERSALISM

*Robert K. Rasmussen*\*

Universalism is on the march. For a century the goal of bringing some degree of harmonization to the world's varying insolvency regimes seemed something of a quixotic quest. Scholars repeatedly touted the welfare gains that would result if the world were to move toward a system that assigned a single forum the lead role in sorting the financial distress of insolvent debtors.<sup>1</sup> The near-consensus in the academy had little impact on practice, however, as countries clung stubbornly to territorialism. Each country asserted primary jurisdiction over the assets found within its borders, and would pay little heed to the work of other courts in countries where the debtors' assets were located.<sup>2</sup> The cries of the academic commentators went unheeded.

The tide has seemingly turned.<sup>3</sup> The European Union has adopted rules designed to deal with the financial distress of an enterprise with assets in various member countries.<sup>4</sup> It requires that the jurisdiction in which the "centre of main interests" of the enterprise is located take the lead in sorting out the affairs of the troubled firm.<sup>5</sup> The international organization charged with proposing model commercial laws—UNCITRAL—has drafted a law that would provide coordination in the case of a transna-

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\* Milton Underwood Professor of Law, Vanderbilt University Law School. I would like to thank Douglas Baird, Don Bernstein, Andy Kaufman, and Stephen Lubben, and as well as the participants at the *Bankruptcy in the Global Village* Symposium, the 2007 Annual Meeting of the American Law and Economics Association, and faculty workshops at the Seton Hall and Toronto law schools for helpful discussions on the themes in this Article.

1. See, e.g., John Lowell, *Conflict of Laws as Applied to Assignments for Creditors*, 1 HARV. L. REV. 259, 264 (1888).

2. See Douglas G. Boshkoff, *Some Gloomy Thoughts Concerning Cross-Border Insolvencies*, 72 WASH. U. L.Q. 931 (1994).

3. See Ian F. Fletcher, *Maintaining the Momentum: The Continuing Quest for Global Standards and Principles to Govern Cross-Border Insolvencies*, 32 BROOK. J. INT'L L 767 (2007); John Pottow, *The Myth (and Realities) of Forum Shopping in Transnational Insolvency*, 32 BROOK. J. INT'L L 785 (2007) [hereinafter Pottow, *Myth (and Realities)*].

4. See Council Regulation 1346/00, *Insolvency Proceedings*, 2000 O.J. (L160) 1 (EC).

5. *Id.*; Case C-341/04, *Eurofood IFSC Ltd.*, 2006 E.C.R. I-3813.

tional insolvency.<sup>6</sup> The United States has recently turned the proposed law into positive law by adding Chapter 15 to its bankruptcy code.<sup>7</sup> While there are differences between the E.U. Regulation and Chapter 15 of the U.S. Bankruptcy Code (Chapter 15), they share the same core commitments.<sup>8</sup> With Europe and the United States both adopting the universalist stand, its triumph now seems inevitable.

Overlooked in the discussion over whether the universalist program is better than its competitors is an assumption that rests uneasily with the realities of modern bankruptcy practice. The aim of this Article is to expose this assumption, demonstrate how it cannot be squared with the observed practices handling the financial distress of transnational enterprises, and suggest how, in light of the dynamics on the ground, the discussion on transnational insolvencies needs to evolve.

The literature on transnational insolvencies assumes that multiple insolvency proceedings will inevitably result once a transnational enterprise becomes financially distressed. It is a staple of the literature that a business with substantial assets in more than one country will be subject to bankruptcy proceedings in more than one country. Creditors seeking to get paid will attempt to seize assets in any country they are located. Thus, for those who view the prior century's commitment to territorialism with alarm, globalization raises the stakes. As more and more countries have a worldwide footprint, the number of companies whose fate will be left to competing bankruptcy systems increases. In other words, the number of insolvency proceedings an insolvent company faces is solely a function of the number of jurisdictions in which it has substantial assets. The universalist concern is that when a company faces an array of insolvency proceedings, this raises the possibility that the multiple courts will not be able to work together, and the company will be forced into liquidation.

If this assumption were accurate, one would expect that it would be easy to identify many instances where a financially distressed enterprise is subject to multiple insolvency proceedings. Companies increasingly have a global reach, and we would thus expect a surfeit of multiple proceedings. Yet the puzzle is that we see so few such cases relative to the

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6. U.N. COMM'N ON INT'L TRADE LAW [UNCITRAL], UNCITRAL MODEL LAW ON CROSS-BORDER INSOLVENCY WITH GUIDE TO ENACTMENT art. 1, U.N. Sales No. E.99.V.3 (1997).

7. 11 U.S.C. § 1501 (2006).

8. For a comparison of the two approaches, see Jay Lawrence Westbrook, *Multinational Enterprises in General Default: Chapter 15, The ALI Principles, and The EU Insolvency Regulation*, 76 AM. BANKR. L.J. 1 (2002) [hereinafter Westbrook, *Multinational Enterprises*].

number of financially distressed debtors with multinational operations. There are undoubtedly debtors who have bankruptcy proceedings in more than one country. It is not that cases that involve multiple proceedings do not exist. Yet there seem to be many fewer cases than one would expect if one were to give full credence to the fears of those studying the field. The number of financially distressed transnational enterprises far exceeds the number of situations involving multiple insolvency proceedings.

This Article proposes an answer to this puzzle. The answer is that debtors and their senior creditors control the extent to which distressed transnational businesses are subject to more than one bankruptcy proceeding. In other words, the implicit assumption is that the number of bankruptcy proceedings to which a debtor is subject is determined by its existing deployment of assets and liabilities. In fact, however, there are ways in which debtors and their senior creditors have the ability to determine the number of countries that will be involved in resolving the companies' financial distress.

The fact that the number of forums involved in the bankruptcy of a transnational enterprise is to a large degree within the control of the debtor and its senior creditors requires that we reorient our focus on transnational insolvencies. The risk of inefficient liquidations that motivated the universalist agenda does not loom large in today's environment. Liquidations occur only when those in charge of the debtor decide that the assets should be sold. In this respect, international bankruptcy practice is converging with American bankruptcy practice.<sup>9</sup> In both settings, the crucial question is the extent to which debtors use the discretion they have to make value-maximizing decisions. Creditors—especially senior lenders—have had increasing input into the crucial decisions that face a financially distressed company.<sup>10</sup> The forces

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9. I will admit to an American bias in perspective here. I have at best a passing familiarity with the bankruptcy practices in other countries. Also, the transnational insolvency cases of which I am aware have a substantial connection with the United States. The extent to which we see a general convergence among bankruptcy regimes and the extent to which the handling of the affairs of a transnational debtor depends on which countries are involved are interesting questions that are beyond the scope of this Article.

10. The rise of creditor control in Chapter 11 and the reasons for it have been the subject of a series of Articles that I have written with Douglas Baird. See Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209 (2006) [hereinafter Baird & Rasmussen, *Private Debt*]; Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673 (2003); Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751 (2002). Others have noticed this trend as well. See Stephen J. Lubben, *The "New and Improved" Chapter 11*, 93 KY. L.J. 839 (2005); Jay Lawrence Westbrook, *The*

that have allowed creditors to exert greater control over the affairs of a troubled company in America do not stop at our national borders. The next generation of transnational bankruptcy scholarship should focus less on the relations between nations and more on the dynamics of control.

#### I. GLOBAL COMPANIES AND TRANSACTIONAL INSOLVENCIES

Three basic paradigms dominate the transnational insolvency literature. The first, which seems to have the greater number of adherents in the academy, is universalism.<sup>11</sup> In its most utopian form, a universalist approach envisions a single set of insolvency rules applied by a single forum. Few expect to witness the emergence of such a system anytime soon. The more attainable universalist approach, often referred to as procedural universalism, is a system that would allow for the coordination of multiple bankruptcy proceedings. When a company with operations across the globe runs into financial distress, it will be subject to an insolvency proceeding in each country where it has substantial assets. The universalists seek a rule that identifies which country will take the lead in sorting out the debtor's affairs. By and large, universalists envision that the country that is the "home" of the debtor will be the one which is the situs of the main proceeding. The role of the other countries is to implement the decisions that have been made in the main jurisdiction. Of course, the primary decision in any bankruptcy is the fact of the company, whether it is to be rescued or liquidated.

Another paradigm, cooperative territorialism, takes a different path.<sup>12</sup> Like universalism, it recognizes that the territorial approach to transnational financial distress risks inefficient liquidations. Companies that are worth more if kept together will be liquidated as each nation focuses blindly on the assets within its territorial boundaries. Yet scholars em-

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*Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795 (2004); David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917 (2003) [hereinafter Skeel, *Creditors' Ball*].

11. Jay Westbrook has been the most tireless proponent of universalism. Of his many contributions, two in particular set forth his overall vision. See Jay Lawrence Westbrook, *A Global Solution to Multinational Default*, 98 MICH. L. REV. 2276 (2000) [hereinafter Westbrook, *A Global Solution*]; Jay Lawrence Westbrook, *Theory and Pragmatism in Global Insolvencies: Choice of Law and Choice of Forum*, 65 AM. BANKR. L.J. 457 (1991) [hereinafter Westbrook, *Theory and Pragmatism*]. Andrew Guzman has bolstered the universalist case with an economic analysis of the problem. See Andrew T. Guzman, *International Bankruptcy: In Defense of Universalism*, 98 MICH. L. REV. 2177 (2000).

12. Lynn LoPucki is the architect of this approach. See Lynn M. LoPucki, *The Case for Cooperative Territoriality in International Bankruptcy*, 98 MICH. L. REV. 2216 (2000); Lynn M. LoPucki, *Cooperation in International Bankruptcy: A Post-Universalist Approach*, 84 CORNELL L. REV. 696 (1999).

bracing this approach believe that the self-interest of states means that they are unlikely to cede control over assets in their jurisdiction to other nations.<sup>13</sup> They also worry that, for some companies, it is difficult to identify which country is the home country. More recently, cooperative territorialism scholars have raised the concern that the home jurisdiction is malleable enough to allow for forum shopping, which will have a pernicious effect on transnational bankruptcy practice.<sup>14</sup> To avoid these ills, those in favor of cooperative territorialism counsel that each country should retain control over the assets it has, but in administering these assets, the affected countries should attempt to work together. Stated somewhat simplistically, universalism seeks cooperation through ex ante commitments whereas cooperative territorialism seeks cooperation on an ex post basis.

A third approach would give more decision-making power to the businesses themselves. Companies would, in advance, commit to having either one or multiple bankruptcy proceedings.<sup>15</sup> Under this approach, an enterprise that believed that its value would be maximized through a single proceeding could commit to such an action, and all states would respect this choice. Conversely, companies that thought that multiple proceedings would be better for handling their insolvency could choose that route. This approach differs from the prior two in that it allows companies rather than legislation to determine the number of bankruptcy proceedings and the location of those proceedings.

Underlying all of these approaches is an assumption about the relationship between transnational enterprises and insolvency laws. The assumption is that having assets in multiple countries inevitably leads to the commencement of multiple insolvency proceedings. When assets are spread across the world, it is inevitable that more than one country's bankruptcy law will be invoked. Creditors in each country will turn to local assets in an attempt to satisfy their claims. These efforts will eventually lead to the invocation of insolvency proceedings in each country where the debtor has substantial assets. It is the existence of these multiple proceedings that all transnational bankruptcy scholarship addresses.

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13. See Frederick Tung, *Is International Bankruptcy Possible?*, 23 MICH. J. INT'L L. 31 (2001); Frederick Tung, *Fear of Commitment in International Bankruptcy*, 53 GEO. WASH. INT'L L. REV. 555 (2001).

14. See, e.g., Lynn M. LoPucki, *Universalism Unravels*, 79 AM. BANKR. L.J. 143, 143 (2005). For a thoughtful reply, see Pottow, *Myth (and Realities)*, *supra* note 3.

15. I have argued for this approach in prior work. See Robert K. Rasmussen, *Resolving Transnational Insolvencies Through Private Ordering*, 98 MICH. L. REV. 2252 (2000); Robert K. Rasmussen, *A New Approach to Transnational Insolvencies*, 19 MICH. J. INT'L L. 1 (1997).

As Jay Westbrook has noted, “a global market requires a global bankruptcy law.”<sup>16</sup> This conflict among bankruptcy laws is the territorialist reality that fuels the agenda of reform advocates.

The focus in this literature tends to be on countries and creditors. Because of what John Pottow has aptly labeled “pride,” countries have a tendency to assert a substantial interest in the assets within their territorial boundaries rather than defer to decisions made elsewhere.<sup>17</sup> Creditors create the problem because their narrow self-interest leads them to file chase assets wherever those assets can be found. It is rapacious creditors starting insolvency proceedings in all jurisdictions where the debtor has substantial assets that form the backdrop for all discussions of transnational insolvencies.

## II. THE SCARCITY OF MULTIPLE PROCEEDINGS

The traditional account of transnational insolvencies suggests that there would be many businesses that are subject to multiple insolvency proceedings. Once a company has significant assets in more than one country, the actions of creditors will inevitably trigger multiple insolvency proceedings. Indeed, according to this story, we would expect to see an insolvency proceeding in every jurisdiction where the debtor had sufficient assets to make it worth a creditor's effort to invoke local debt collection mechanisms.

The empirical reality, however, appears to be quite different. Unfortunately, I do not know of any thorough empirical study that provides solid

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16. Westbrook, *A Global Solution*, *supra* note 11, at 2287; *see also* Guzman, *supra* note 11, at 2177 (“The growth of international business, therefore, has brought with it a growth in the number of international business failures.” (footnote omitted)); Westbrook, *Multinational Enterprises*, *supra* note 8, at 1 (“The steady expansion of international trade has become perhaps less significant than its consequence, the growth of multinational enterprise, which in turn has lead inevitably to the increased incidence of multinational financial failure.”); Jay Lawrence Westbrook & Jacob S. Zeigel, *The American Law Institute NAFTA Insolvency Project*, 23 BROOK. J. INT'L L. 7, 8 (1997) (“The paradigm case for the Project is the bankruptcy of a company with headquarters in one of the NAFTA countries and with suppliers, lenders, operations, assets, employees, and stockholders in all three.”); Barry L. Zaretsky, *Bankruptcy in the Global Village: Introduction*, 23 BROOK. J. INT'L L. 1, 1 (1997) (“As cross-border economic activity has increased dramatically, so have questions about reconciling the various systems for dealing with business failure.”); Westbrook, *Theory and Pragmatism*, *supra* note 11, at 457 (stating that “the emergence of worldwide defaults” is one consequence of “[t]he surging growth of transnational enterprise”).

17. *See* John A. E. Pottow, *Greed and Pride in International Bankruptcy: The Problems of and Proposed Solutions to “Local Interests,”* 104 MICH. L. REV. 1899, 1901 (2006) [hereinafter Pottow, *Greed and Pride*].

data on the percentage of companies with transnational operations that become subject to bankruptcy proceedings in more than one country. The evidence that is available, however, suggests that multiple-proceeding cases are much less frequent than they would be if the standard account of transnational insolvency were accurate. In the last ten years, 1,448 public companies filed for bankruptcy under Chapter 11 of the U.S. Bankruptcy Code (Chapter 11).<sup>18</sup> One would guess that a large number of these companies—probably a substantial majority—had assets in other countries. Yet few of these cases involved multiple proceedings. Indeed, it is relatively easy to identify large transnational companies that addressed their problems in a single bankruptcy forum. Below are a few notable examples.

#### A. *United Airlines*

One would think that if there was ever a worldwide company, it would be United Airlines (“United”). United was (and still is) one of the world’s largest airlines. As of 2003, it had over 1,600 daily departures to over 110 destinations across 23 countries.<sup>19</sup> The company is part of a global network which operates flights in every corner of the world. The revenues that United generates reflect its international character. In 2003, sixty-four percent of United’s revenues came from North America, fifteen percent from the Pacific, thirteen percent from Europe, and three percent from Latin America.<sup>20</sup> Its planes and employees circled the world on a constant basis. In every country it operates it needs landing slots, maintenance, fuel, ticket agents, and the like. Few would question that United has “profound effects on the dozens of nations around the globe” in which it operates.<sup>21</sup>

When United encountered financial distress in 2002, however, this did not trigger the host of ills that the universalists fear. Creditors in the various countries where United was operating at the time did not rush to grab assets to satisfy their debts. United did not face a host of conflicting and competing bankruptcy proceedings. Rather, United landed in a single bankruptcy court in the United States.<sup>22</sup> United was a transnational debtor, but the bankruptcy case was domestic.

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18. See THE 2006 BANKRUPTCY YEARBOOK & ALMANAC 31 (Kerry A. Mastroianni ed., 2006).

19. UAL Corp., UAL Corporation and Subsidiary Companies Report on Form 10-K for the Year Ended December 31, 2003, at 3 (2004), available at [http://media.corporate-ir.net/media\\_files/NYS/UAL/reports/UAL10K2003.pdf](http://media.corporate-ir.net/media_files/NYS/UAL/reports/UAL10K2003.pdf).

20. *Id.* at 7.

21. Pottow, *Greed and Pride*, *supra* note 17, at 1900.

22. *In re UAL Corp.*, No. 02-B-48191 (Bankr. N.D. Ill. 2006).

### B. *Sea Containers*

*Sea Containers* provides another example of a case which would seem to present the conditions that universalists fear would lead to multiple proceedings. *Sea Containers* has \$1.67 billion in assets and 8,000 employees worldwide. Its operations consist primarily of two discrete businesses: a railroad based in the United Kingdom and a joint venture with General Electric Co. (GE) to lease sea containers.<sup>23</sup> This latter operation is one of the four largest of its type in the world.<sup>24</sup> *Sea Containers*, as a complement to this latter business, manufactures and repairs containers in Charleston, South Carolina; Yorkshire, England; and Santos, Brazil.<sup>25</sup> The company has offices in London, Genoa, New York City, Rio de Janeiro, Singapore, and Sydney.<sup>26</sup>

While *Sea Containers* had substantial assets, it also had substantial debts. It owes more than \$1.5 billion. Thus, if one credits the asset values it reports, *Sea Container* is marginally solvent. However, the company could not service its debt. In particular, it could not meet a \$110 million payment on publicly issued notes that were maturing in late 2006. To resolve its problems, *Sea Containers* filed a Chapter 11 bankruptcy petition in Delaware.<sup>27</sup> To date, this remains the only insolvency proceeding involving the company.

### C. *Exide*

*Exide* is the world's largest manufacturer and distributor of batteries. Its Web site boasts that it manufactures and distributes batteries in eighty-nine countries.<sup>28</sup> In fiscal year 2001, it had worldwide sales of \$2.4 billion.<sup>29</sup> If one were to look at *Exide* in fiscal 2001, it would be difficult to imagine a more transnational operation. Fifty-two percent of the company's sales were in Europe, forty-five percent in North Amer-

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23. See *Sea Containers Ltd.*, Company Profile, <http://www.seacontainers.com> (last visited May 18, 2007).

24. See *id.*

25. *Sea Containers Ltd.*, Containers: Factories, [http://www.seacontainers.com/fr\\_containers.asp](http://www.seacontainers.com/fr_containers.asp) (last visited May 18, 2007).

26. *Sea Containers Ltd.*, Home Page, <http://www.seacontainers.com> (last visited May 18, 2007).

27. *In re Sea Containers Ltd.*, No. 06-11156 (Bankr. D. Del. filed Oct. 15, 2006).

28. *Exide Technologies*, About *Exide Technologies*, [http://www.exide.com/about\\_exide.html](http://www.exide.com/about_exide.html) (last visited May 20, 2007).

29. *Exide Corp.*, Form 10-K (Annual Report), at 2 (June 29, 2001), available at <http://files.shareholder.com/downloads/XIDE/126418007x0xS1045969-01-500609/813781/filing.pdf>.

ica, and three percent in the Asia Pacific region.<sup>30</sup> Exide at that time employed approximately 20,000 people. While 8,400 of them were in North America, more were employed in Europe.<sup>31</sup> The company owned real estate in the United States, Australia, England, France, Germany, Italy, New Zealand, Poland, Portugal, and Spain.<sup>32</sup> Its largest single facility was a five million square-foot manufacturing plant in Italy.<sup>33</sup>

After the turn of the century, Exide found itself heavily indebted. The debt had been incurred as part of its expansion into the Asia Pacific region.<sup>34</sup> Despite its global reach, Exide resolved its financial distress in a single insolvency proceeding, which, as with *Sea Containers*, was a Chapter 11 case filed in Delaware.<sup>35</sup>

What allowed these three companies to avoid the ills posited by the universalists? In each case there was a debtor with substantial assets in numerous countries. Creditors of each company could be found in various jurisdictions as well. Yet in all cases there was only a single insolvency proceeding. There were no competing courts or cooperating courts; there was only a single court where the affairs of each debtor were hammered out.

Part of the explanation lies in corporate structure. Each of these companies, as is the case with the vast majority of large, publicly held companies, was not housed within a single legal entity. Rather, each was a corporate group. For example, when United Airlines filed for bankruptcy in Chicago, there were in fact twenty-eight separate bankruptcy petitions filed.<sup>36</sup> One was by the parent company and twenty-seven were by its subsidiaries. The cases were procedurally consolidated into a single proceeding.<sup>37</sup>

The twenty-eight companies owed the bulk of United's debt and owned the majority of the enterprise's assets. To be sure, United had two foreign subsidiaries: Four Star Insurance Company and Kion de Mexico. United decided not to put either of its two foreign subsidiaries into insolvency proceedings. They continued to run their operations in the ordi-

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30. *Id.*

31. *Id.* at 14.

32. *Id.* at 16.

33. Exide Technologies, Form 10-K (Annual Report), at 17 (Aug. 19, 2002) [hereinafter Exide Corp., Annual Report 2002], available at <http://files.shareholder.com/downloads/XIDE/126418007x0xS950109-02-4366/813781/filing.pdf>.

34. *See id.* at 2.

35. *Id.*

36. *In re* UAL Corp., Nos. 02-48191-02-48218 (Bankr. N.D. Ill. filed Dec. 9, 2002).

37. *In re* UAL Corp., No. 02-B-48191 (Bankr. N.D. Ill. Dec. 11, 2002) (order directing joint administration of cases), available at <http://www.pd-ual.com/Downloads/UAL%20Joint%20Administration%20Order.pdf>.

nary course of business, and they remain subsidiaries of the new, reorganized United.

Yet corporate structure is only part of the story. Corporate structure allows the debtor to pick and choose which entities file for bankruptcy. Yet the debtor also needs a mechanism to ensure that the entities that it does not put into bankruptcy are not forced into bankruptcy by unpaid creditors. What we observe here is creative financing designed to ensure that the foreign operations remain outside of insolvency proceedings. Consider in this regard the Exide bankruptcy. Exide and four of its domestic subsidiaries filed for bankruptcy in Delaware.<sup>38</sup> Exide's foreign lenders, who were owed money by Exide's foreign subsidiaries, agreed to a standstill, and the bankruptcy case proceeded in this country. To be sure, the foreign subsidiaries may have needed access to capital. Yet this was accommodated within the American Debtor-in-Possession (DIP) financing package. The DIP loan included a \$65 million sub-facility that Exide could draw upon to lend to its foreign subsidiaries. So long as the lenders of the foreign subsidiaries adhered to the standstill and the trade creditors were paid in the ordinary course of business, Exide could address its financial distress in a single forum. In the end, after two years in bankruptcy, Exide emerged from Chapter 11 as a Dutch company.

In addition to corporate structure and financing, the goals which those in control of the companies sought to achieve played a large role. To illustrate this point, consider Sea Containers. The company in the 1980s and 1990s had diversified its operations. It began as a marine container leasing company in 1965, and it eventually sought to expand beyond its core business. Perhaps most notably, it bought the Hotel Cipriani in Venice and the Venice Simplon-Orient Express tourist train.<sup>39</sup> Early this decade, however, the company decided that it needed to focus on its core business. It sold many of its discrete businesses, leaving the company with its railway and sea container operations as its primary lines of business. Indeed, in 2006 it even sought a buyer for the railroad.

Despite the sale of its assets, Sea Containers could not service its debt. The company, however, had already decided on what business strategy to pursue; it wanted to shed all of its extraneous business and focus on its container operations. All it needed to do was to adjust its debts so that its obligations would be in line with its revenues. Accordingly, Sea Containers began discussions with an ad-hoc committee of noteholders. The

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38. Exide Technologies, Annual Report 2002, *supra* note 33, at 2.

39. News Release, Orient Express Hotels Trains & Cruises, Company Profile (July 2006), at 2, *available at* [http://www.oeh.com/binaries/Company%20Profile%2017.10.06\\_tcm4-76330.pdf](http://www.oeh.com/binaries/Company%20Profile%2017.10.06_tcm4-76330.pdf).

company had issued four series of notes, one of these was to mature in October 2006. The company had hoped to reach agreement on a consensual restructuring of the public debt without the need for an insolvency proceeding, but it could not find common ground with its noteholders before the principal payment became due.

To forestall default on the public notes, Sea Containers had an American subsidiary file a petition for bankruptcy under Chapter 11. Immediately thereafter, the parent company, which is chartered in Bermuda, and another subsidiary, this one chartered in the United Kingdom, also filed for bankruptcy under Chapter 11.<sup>40</sup> As all of the notes had been issued by the parent company, the filing prevented the holders of the notes from taking any collection action.<sup>41</sup> Neither the parent nor the two subsidiaries contained any of the operating assets of the company. Both the railroad and the sea container business continued to operate and pay their debts in the ordinary course.

Not only can we readily find cases in which the debtor can structure its bankruptcy proceedings such that it does not encounter multiple forums, but we can also find situations in which *debtors* themselves invoke the multiple forums as part of their strategy for addressing the problems that they face. One example of this is the Enron bankruptcy. Enron filed a bankruptcy proceeding in the United States, but it also filed insolvency proceedings in England, Canada, Japan, and Thailand. The assets owned by Enron were indeed liquidated, but this was not the inefficient liquidation that is the stuff of universalists' nightmares. With Enron, the causal arrow ran in the other direction. It was not that the multiple proceedings led to Enron's liquidation. Rather, it was the decision to liquidate Enron's assets that led to the multiple proceedings. Enron had engaged in aggressive expansion overseas. These assets, by and large, were dedicated assets such as power plants, dams and water facilities. There was little reason to believe that these assets should be kept together in a sin-

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40. The use of a subsidiary to establish venue in a chosen court is a common practice in American bankruptcy litigation. Perhaps the most notable use of this maneuver was when Eastern Airlines established venue in the Southern District of New York by placing the subsidiary that ran Eastern's hospitality suites for its frequent fliers into bankruptcy there, even though this subsidiary was solvent. Six minutes later, the parent company filed in the same district, basing venue on the fact that an affiliate already had a case pending in that court. Robert K. Rasmussen & Randall S. Thomas, *Timing Matters: Promoting Forum Shopping by Insolvent Corporations*, 94 NW. U. L. REV. 1357, 1365 (2000).

41. See 11 U.S.C. § 362 (2006).

gle enterprise. Rather, they needed to be sold to the highest bidder.<sup>42</sup> Here, local insolvency proceedings provided a convenient vehicle to dispose of these businesses. Sales conducted by the local bankruptcy courts assured the buyers that they would get clean title to the purchased assets.

The ongoing Calpine bankruptcy is yet another example of the debtor deciding to open multiple proceedings. Calpine is a large energy producer with assets in the United States, Canada, and Mexico.<sup>43</sup> Calpine had grown aggressively through acquisitions which it financed with debt. When Calpine sought bankruptcy protection, its attorneys made a decision to file cases in both the United States and Canada, but not in other jurisdictions where it owned assets. Moreover, only some of Calpine's subsidiaries in these countries filed for bankruptcy. The reason for this decision was that the attorneys concluded that the two-case strategy offered more flexibility than if Calpine had proceeded in the United States alone, and that only certain of the subsidiaries needed to address their problems as part of an insolvency proceeding.

The care that goes into deciding how many proceedings are opened and for what purpose highlights a distinction between transnational insolvencies and domestic insolvencies that is too often overlooked. Two decades ago, Thomas Jackson justified American bankruptcy law as solving a collective action problem.<sup>44</sup> Left to their own devices, creditors would pursue their state law collection remedies. This dogged pursuit of their narrow interests would lead to an inefficient piecemeal liquidation of the business.

The analogy does not translate perfectly to the international setting. As mentioned above, transnational businesses, by and large, are structured as corporate groups. The assets of the business within one country tend to be owned by a domestic corporation in that country, with the stock of that company owned by a foreign parent. When a creditor seeks to realize on its assets, it sues the domestic corporation. Each country, however, has a system designed to deal with the financial distress of its domestic entities. By and large, these systems prevent a destructive piecemeal liquidation of the domestic entity. Thus, national insolvency laws simply do not suffer from the lack of coordination evinced by the state law debt collection system.

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42. On the lack of going concern in Enron and the controlled sale of all of its assets, see Douglas G. Baird & Robert K. Rasmussen, *The Four (or Five) Easy Lessons of Enron*, 55 VAND. L. REV. 1787 (2002).

43. *In re Calpine Corp.*, 2007 WL 685595, at \*2-3 (Bankr. S.D.N.Y. Mar. 5, 2007) (order regarding replacement post-petition financing, objection to claims, and value of secured claims).

44. See THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* (1986).

This does not imply that Chapter 15, the UNCITRAL Model Law, or the E.U. Insolvency Regulation is necessarily a poor or misguided idea. Each may provide a useful default rule, especially in those cases where a transnational company becomes financially distressed very quickly, and those in control do not have a chance to decide on the best course of action prior to filing for bankruptcy. Yet when debtors are not in a “free fall” situation, the coordination mandated by these laws may not matter all that much. In many instances transnational defaults can be handled in a single case. In other situations, debtors can use corporate structure to decide precisely how many proceedings will be opened and in which countries. Corporate structure and creative financing allow bankruptcy lawyers several degrees of freedom when planning a case.

To be sure, there is not infinite flexibility in this regard. One could imagine a world in which capital structure decisions are designed to ensure that the threat of inefficient multiple proceedings are eliminated at the lending stage. For example, assume that the debtor and its lenders decide that American law provides the framework under which they would want to work out any future financial distress. Assume also that, prior to the execution of the loan, the debtor had no relationship at all with the United States. It would be relatively easy to form an American company, have the loan made to that company, and have other members of the corporate group guarantee the obligations. The new American company would then distribute the borrowed funds to the operation companies on an as-needed basis. All new borrowing activity would be undertaken by the American company. This action would place all of the debt in the American subsidiary. If financial distress were to arise, the American subsidiary could file for bankruptcy under American law.

Such a “bankruptcy-centric” view of capital structure, however, runs aground on reality. There are numerous forces that affect a company’s capital structure to a vastly greater degree than does the possibility of a future bankruptcy proceeding. Tax law, for example, imposes severe limits on freedom in this regard. Imagine a typical case in which the parent company is an American holding company, its main operating subsidiary is also an American company, and it also has two foreign subsidiaries. The simple structure of a loan to the American parent with guarantees by all of the subsidiaries is not a realistic probability. This is due to the effect of section 959 of the U.S. Tax Code—the so-called “deemed dividend” provision.<sup>45</sup> The net effect of this provision is that if the foreign subsidiaries were to guarantee the loan to the American parent, this would subject all of the income of the foreign subsidiary to United States

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45. 26 U.S.C. § 959 (2006).

income tax. The same result would occur if the American parent were to pledge more than two-thirds of the stock of the foreign subsidiary to back up the loan. The economic effect of subjecting the foreign subsidiaries' income to United States tax exceeds any benefit gained in having an optimal structure in place to deal with any future financial distress.<sup>46</sup>

While tax law thus limits the freedom of lenders to structure their transactions, there are still ways that lenders can limit the possibility of conflicting bankruptcy proceedings at the lending stage. For example, if the foreign subsidiaries are not contributing much to the overall asset package, the lender may be content to have the foreign subsidiaries enter into negative covenants limiting the amount of debt that the foreign subsidiaries can incur. Such a limitation would have two effects. The first is to preserve value for the lender, in that the lender has a direct claim against the parent and also can get a lien on up to two-thirds of the foreign subsidiaries' stock. This would provide the lender with a first position on the equity of the foreign subsidiary. Second, by limiting the amount of debt in a foreign subsidiary, the lender limits the risk that that subsidiary would be insolvent and the risk of being thrown into a foreign insolvency proceeding over the parent's objection.

Of course, a potential future bankruptcy proceeding is far from the only, or even most important, factor when a debtor plans its capital structure. It may have economic reasons to put debt into the foreign subsidiary. Debt is a tax shield, and the value of that shield may be more to the foreign subsidiary than it is to the parent. Also, there may be substantial value in the assets of the foreign subsidiary that the debtor would like to borrow against, but an American lender would hesitate to lend because it cannot lock up the assets.

Yet another factor driving capital structure is convenience. Businesses often need access to banking services on a constant basis. Operating companies issue commercial letters of credit, send wire transfers, and deposit funds on a daily basis. It is often cheaper to buy these services from a local bank that finances the company's working capital needs. Forcing all of these relationships to a foreign bank in order to control the location of any future bankruptcy proceeding would make little sense.

When there are reasons for having a subsidiary incur debt, one pattern that we see is to have each local subsidiary establish its own line of credit with a local bank. This local borrowing creates a tax shield for the foreign subsidiary. Additionally, it allows the enterprise to borrow against

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46. Of course, as is seen in *Sea Containers*, one can place the parent company in Bermuda. So long as there is one member of the corporate group in the United States, Chapter 11 will be an option.

the foreign assets. It also creates a relationship with a local bank that can provide needed services. While incurring debt at the subsidiary level creates the risk of multiple insolvency proceedings because the enterprise now has multiple creditors chasing assets in various jurisdictions, planning on the eve of bankruptcy can alleviate the threat. One potential tactic is to get a standstill agreement as in *Exide*. Under such an understanding, the lenders agree not to enforce their loans against the foreign assets.<sup>47</sup> Indeed, standstill agreements are a common practice. For example, John Armour and Simon Deakin have documented how the so-called “London Approach” to corporate restructuring rests on standstill agreements.<sup>48</sup> In its traditional form, the London Approach was the U.K. method for resolving the financial distress of large corporations. By and large, the debt of these corporations was held by London Banks. When the borrowers encountered financial distress, the lenders would agree to a standstill. Under a standstill, all of the banks agree not to collect on outstanding loans. They would then restructure the business outside of formal insolvency proceedings. To the extent that the American parent can assuage the fears of the foreign lenders, these lenders can execute a standstill and proceed under Chapter 11.

Even when the foreign lenders get nervous and call their lines of credit, adroit action on the part of the debtor’s professionals can prevent a foreign proceeding. For example, it is possible to get takeout financing in the DIP loan. In such a loan, the debtor borrows a sufficient amount to both fund its needs for the reorganization effort and to pay off the foreign lender. Such action ensures that the foreign lender cannot open up a new insolvency proceeding and create the threat of multiple proceedings.

Current bankruptcy practice thus does not leave one overly concerned with the thought that failure to adopt a purely universalist regime has led to great inefficiencies of the type that motivates the universalist project. This does not mean that there is no cause for concern. Debtors have some degree of control over where their affairs will be handled. The question which the transnational insolvency literature has to address is whether this discretion will be used in a socially satisfactory manner.

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47. In *Sea Containers*, the private lenders had a security interest in basically all of the assets of the company. Although the company was in default under both of its two main credit facilities, neither lending group sought to place the debtor in insolvency. The aim of the United States Chapter 11 case is simply to restructure the public debt, which is junior to the secured debt.

48. See John Armour & Simon Deakin, *Norms in Private Insolvency: The “London Approach” to the Resolution of Financial Distress*, 1 J. CORP. L. STUD. 21 (2001).

## III. CREDITOR CONTROL AND TRANSNATIONAL INSOLVENCIES

Transnational insolvency practice has developed the ability to avoid some of the more dire expectations of scholars. To be sure, there are undoubtedly cases in which the unexpected happens and the debtor finds itself thrust into bankruptcy proceedings with little opportunity for advance planning. The risk of uncoordinated proceedings may have been reduced, but not eliminated. So called "free falls" will still occur. Yet such cases may well become a residual category. For an increasing number of financially distressed companies, which country or countries handles the reorganization effort will be the result of conscious planning on the part of the debtor and its senior creditors. This development opens up new areas of scholarly inquiry. Much of the academic attention in the transnational insolvency literature has been focused on which actions countries should take to mitigate the problems caused by local creditors triggering competing proceedings around the globe. The more pressing issue today is to understand the implications of modern transnational reorganization practice.

For example, one overlooked policy question that needs to be addressed is the extent to which debtors should retain the freedom they have in restructuring their affairs. As recounted above, debtors today often choose which country is going to be the venue of the main reorganization effort and the extent to which the courts of other countries will be involved. The welfare effects of this practice have yet to be considered by either scholars or policymakers. To do this, one first has to assess the factors that drive a debtor's decisions as it slides into bankruptcy. The bankruptcy practice of today looks fundamentally different from the practice of two decades ago. At that time, it was common to view Chapter 11 as a haven for the very managers that were responsible for leading the company into financial distress. Many European practitioners viewed such a system with disbelief. Today, however, Chapter 11 has been transformed. Managers often are replaced even before the case is filed. Moreover, the new CEOs tend to be cut from a different cloth: they often are professionals who specialize in turnaround work, do not plan to remain with the company for a long time, and their prospects for future employment depend on how well they maximize the returns to the company's investors, primarily its private debt holders.<sup>49</sup>

Even in cases in which old managers stay in place, they are not immune from the actions of creditors. The lenders providing the financing for the bankruptcy case can exert enormous influence on whether the

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49. See Baird & Rasmussen, *Private Debt*, *supra* note 10, at 1235.

debtor is restructured or its assets sold to the highest bidder.<sup>50</sup> Sophisticated lenders are going to keep managers on a short leash. Jamie Sprayregen, perhaps the most prominent attorney representing debtors in Chapter 11 cases before he joined Goldman Sachs last year, has opined that “the central purpose of the restructuring market . . . is to serve as the means by which the economy recycles assets and maximizes value, thereby maximizing creditor recoveries.”<sup>51</sup>

There is a vibrant and deepening literature that explores the control that creditors can exert in the domestic context.<sup>52</sup> One can find tentative support for the new practices as well as opposition to them. This literature to date has focused primarily on the American market. While a plausible working assumption may be that the trends one finds in America extend to transnational insolvencies worldwide, this is merely an assumption. More work exploring the dynamics of transnational insolvencies needs to be done.

A difficulty in attempting to evaluate practice in this area, both domestically and internationally, is that bankruptcy practice is by no means static.<sup>53</sup> Two examples illustrate the point. The first is the rise of second liens. A second lien is created when the lender takes a security interest in the assets of the debtor, even though all of these assets have been pledged to a prior lending group. Second liens have begun to replace traditional mezzanine financing for a substantial number of companies.<sup>54</sup> A loan accompanied by a second lien has the same priority of payment as the first loan. In this crucial respect, it is not a traditional subordination

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50. These lenders may come onto the scene when bankruptcy is filed through a debtor-in-possession financing package. This financing may be done in large part by those who hold substantial portions of the company's existing secured debt. Alternatively, the financing may come through the use of cash collateral. In such a situation, the debtor will be solicitous of the concerns of its existing secured lending syndicate.

51. James H.M. Sprayregen et al., *Chapter 11: Not Perfect, But Better than the Alternatives*, 14 J. BANKR. L. & PRAC. 6, art. 1 (2005).

52. See Lubben, *The “New and Improved” Chapter 11*, *supra* note 10; George W. Kunej, *Hijacking Chapter 11*, 21 EMORY BANKR. DEV. J., 19 (2004); Westbrook, *The Control of Wealth in Bankruptcy*, *supra* note 10; Baird & Rasmussen, *Private Debt*, *supra* note 10; Baird & Rasmussen, *Chapter 11 at Twilight*, *supra* note 10; Harvey R. Miller & Shai Y. Waisman, *The Creditor in Possession: Creditor Control of Chapter 11 Reorganization Cases*, 21 BANKR. STRATEGIST 1 (2003); Skeel, *Creditors' Ball*, *supra* note 10; Baird & Rasmussen, *The End of Bankruptcy*, *supra* note 10; Barry Adler et al., *Bankruptcy Initiation in the New Era of Chapter 11* (working paper).

53. Douglas Baird and I explore these ongoing changes in Douglas G. Baird & Robert K. Rasmussen, *Common Pools, Common Disasters, and the Anticommons: Hedge Funds in Modern Reorganization Law*, (working paper) [hereinafter Baird & Rasmussen, *Hedge Funds in Bankruptcy Law*].

54. On second liens, see Baird & Rasmussen, *Private Debt*, *supra* note 10, at 1247.

agreement under which the subordinated party does not receive a payout until the superior party is paid in full. The rights of payment of both first-lien holders and second-lien holders enjoy the same priority. However, second liens have a second position as to collateral backing the loans. Those holding a second lien cannot seize their collateral and realize on it ahead of the first-lien holder.

The crucial document in a second-loan transaction is the inter-creditor agreement, which specifies the relationship between the first lender and the second. Bankruptcy is one of the issues over which the parties negotiate at the time that the second-lien financing is being put in place. One typical provision allows the second-lien holder the option to buy out the position of the senior lender. One possibility given the dynamic of the market is that we may see lenders owning both the first and second liens.<sup>55</sup>

The effects of second-lien financing on domestic reorganization practice have yet to be fully felt. Second-lien financing arose at a time of quiescent bankruptcy activity. The combination of low interest rates and abundant liquidity has meant that relatively few companies have filed for Chapter 11 relief in the past two years. Indeed, 2006 saw the least number of large, publicly held companies filing for bankruptcy since 1984.<sup>56</sup> One thing appears clear: given the way that the amount that the second-lien lenders lend to the debtor is determined, it is unlikely that there will be any value left for unsecured creditors when the company files. Second-lien lenders tend to value the company on an enterprise basis, and lend close to such value. When the value of the business declines, the money owed to the first- and second-lien holders will exceed the value of the company. Thus, we can expect to see bankruptcies in which the only groups in the money are the first- and second-lien holders.

While silent lines are often no longer completely “silent,” it is usually the case that the inter-creditor agreement provides that the second-lien holder automatically consents to a cash collateral order to which the first-lien holder has consented. This provision provides a great deal of discretion to the first-lien holder in crafting the bankruptcy financing package. Moreover, the second-lien market differs between Europe and the United States. In the United States, the assumption is that Chapter 11 will be

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55. Steven S. Kerr & Joanna Rovito, *Second-Lien Evolution Creates Higher Recovery Prospects—At First-Lien Lenders' Expense*, in STANDARD & POORS, A GUIDE TO THE LOAN MARKET 46, 48 (2005), available at [http://www2.standardandpoors.com/spf/pdf/fixedincome/loan\\_market\\_2005\\_pg46-54.pdf](http://www2.standardandpoors.com/spf/pdf/fixedincome/loan_market_2005_pg46-54.pdf).

56. See News Release, Admin. Office of the U.S. Courts, Bankruptcy Filings Decline in FY 2006 (Dec. 5, 2006), available at [http://www.uscourts.gov/Press\\_Releases/bankruptcyfilings120506.html](http://www.uscourts.gov/Press_Releases/bankruptcyfilings120506.html).

used. The inter-creditor agreement dictates the extent to which the senior lien holder gets to “drive the bus.” Oftentimes, the second-lien holder will agree not to contest certain aspects of the proceeding. In Europe, which has a greater tradition of out-of-court restructurings than exists in the United States, the inter-creditor agreement devotes efforts towards standstill agreements. These agreements have the effect of buying time for the company to restructure its operations. The rise of second liens and the continued development of inter-creditor agreements provide a new mechanism to ward off the evils chronicled by those espousing the universalist position.

A second development which is altering both domestic and international bankruptcy practice is the rise of hedge funds.<sup>57</sup> The standard operating assumption of American bankruptcy law is that it is, by and large, a forum for parties who do not want to be there. The debtor and its creditors entered their relationships with hope for the best, but the worst materialized. The banks, the management, the public lenders, and the trade creditors had to make the best of a bad situation. Bankruptcy placed them in a collective forum where they would chart a new course of action.

Hedge funds have rendered this conception obsolete. Those creditors who want no part of bankruptcy have an exit option: they can sell out to the various hedge funds that take a stake in many cases. Some hedge funds seek to profit solely based on their informational advantage and the desire of creditors for liquidity. They will purchase the claims of trade creditors, buy up public bonds, and purchase loans on the secondary market. These funds make their profit on the basis of paying less for the claims than they will ultimately be settled for at the end of the day.

Other hedge funds, however, play the loan-to-own game. They view bankruptcy as a potential vehicle for an acquisition. They acquire claims with the expectation that they will be long-term investors in the company.<sup>58</sup> For example, Ed Lempert and his hedge fund, ESL, bought Kmart while the company was in Chapter 11.<sup>59</sup>

These financial developments do not end at the oceans' shores. Hedge funds prowl the world looking for opportunities to invest their bugling war chests. Indeed, hedge funds are a major source of second liens, both in America and in Europe. They are already playing major roles in notable bankruptcies. For example, in the ongoing Delphi bankruptcy, the

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57. See Baird & Rasmussen, *Hedge Funds in Bankruptcy*, *supra* note 53.

58. For a description of this activity, see David A. Skeel, Jr., *The Past, Present and Future of Debtor-in-Possession Financing*, 25 *CARDOZO L. REV.* 1905, 1929–32 (2004).

59. While Kmart is primarily an American company, it does have foreign subsidiaries. None of these foreign subsidiaries were subject to insolvency proceedings.

current plan is to restructure the company using a \$3.4 billion infusion by a consortium of hedge funds.<sup>60</sup> The managers of Delphi chose this package over another one offered by a competing group of hedge funds.<sup>61</sup>

Hedge funds have the effect of increasing the concentration of claims. With the existence of hedge funds, there are fewer dispersed investors. Indeed, to the extent one concludes that these developments increase the likelihood that a company's assets are deployed to their highest-valued use, this would suggest a different policy prescription than the one offered by the universalists. Rather than nudging countries to coordinate their laws, those involved with transnational insolvencies should push countries to facilitate the claims-trading market. The fewer the participants, the more likely it is that they will be able to reach an agreement on how best to deploy the company's assets. With fewer players in the game, it may become even easier for debtors to limit themselves to a single forum and only use a second forum when those in control decide that such action will increase value.

To the extent that one views the changing state of affairs positively, future reforms should attempt to harness the power of the creditors. We do not need coordination among bankruptcy courts; what we need is coordination among lenders. Devices such as second liens and entities such as hedge funds may serve to increase such coordination.

On this vision, efforts by lawmakers to decide *ex ante* which is the "correct" forum for transnational insolvencies seem misguided. Allowing those with their hands on the levers of control to select the bankruptcy forum may well increase value. A single American proceeding to reorganize Exide and multiple proceedings to sell Enron may have been the correct decision. It is difficult to imagine a set of binding rules that would have allowed both Enron and Exide to accomplish what each company needed.

On the other hand, the increasing complexity of the interests that are held by hedge funds may make it more difficult to reach consensus on what should happen to the debtor. Should this happen, the changes that we are witnessing do not enhance value but dissipate it. For example, it takes little to imagine a hedge fund threatening to launch a value-destroying second proceeding in order to force payment on its claims. Indeed, there have already been situations in the sovereign debt markets in which a hedge fund aggressively pursued its legal rights to increase its return even though such action had the effect of impairing restructuring

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60. Nick Bunkley, *Parts Firms Drawing Investors; Operations Tilted Away from Detroit Toward World Market*, INT'L HERALD TRIBUNE, Feb. 1, 2007, at 12.

61. *Id.*

efforts. Along these lines, hedge fund activity seems to be at odds with the clubby nature of the London Approach.

Of course, the market may adjust to these threats. In the medium run, more money is made by finding solutions that maximize value rather than by strategies that simply transfer value. Still, as we go forward in thinking about transnational insolvency law, this is the type of risk that we should be worried about. We should not make it easier for a recalcitrant creditor to initiate an insolvency proceeding. Indeed, given the increasing concentration of debt claims, we could imagine fairly high triggers designed to protect against opportunistic behavior.

#### IV. CONCLUSION

Ten years ago, transnational insolvency law seemed to be a growth industry. Worldwide economic growth and the lowering of transaction costs promised to create more companies whose reach exceeded national borders. Such growth in transnational business would lead to growth in transnational insolvency. We have indeed seen the growth in business, but we have yet to see the accompanying explosion in transnational insolvency. This does not mean that transnational companies do not file for bankruptcy—they do. However, the fear of uncoordinated proceedings running up costs and liquidating viable companies has not become reality. By and large, it may be the case that the ills so apparent to academics were apparent to practitioners and their clients as well. Ultimately, markets reward those who can find value.

The challenge for the next generation of transnational insolvency scholarship is threefold. The first part is to understand current practices. The number of bankruptcy cases involving multiple proceedings is far less than the number of cases involving debtors with foreign subsidiaries. We need to better appreciate this dynamic. We lack comprehensive data on how many transnational enterprises resolve their financial distress in a single insolvency proceeding. The second part is to assess the welfare effects of this practice. American bankruptcy law has come to be characterized by creditor control. Given the fluidity of capital markets, it should come as no surprise to see this same pattern played out with transnational companies. Finally, the third part is to reevaluate our efforts. To the extent that we applaud or condemn the current trend, there is little to suggest that bankruptcy laws can halt its development. Rather, our reform efforts have to take shape against the backdrop of this practice. In doing so, we need to reorient our focus. Rather than focus on countries and the extent to which they cooperate, we need to focus on the market players who are creating modern transnational insolvency practice.

# GROUP INSOLVENCY—CHOICE OF FORUM AND LAW: THE EUROPEAN EXPERIENCE UNDER THE INFLUENCE OF ENGLISH PRAGMATISM

*Gabriel Moss QC\**

## I. INTRODUCTION

When the first humans came down from the trees and stood up straight, they operated in groups—usually closely knit family groups of persons related to each other. As with humans, so with artificial legal persons. Since business is done in groups of related entities, so rescue and restructuring, bankruptcy, and liquidations need to take place in the same groups.

Although the EC Regulation on Insolvency Proceedings,<sup>1</sup> the European statute which applies generally on this subject, looks like a relatively recent document, it is in substance the text of the failed convention on the same subject which had been negotiated for many years prior to its failure to come into effect in 1996.<sup>2</sup> Thus the text and the concepts of the EC Regulation were already long out of date at the time that the EC Regulation, containing a very similar text to that in the failed 1996 convention, came into force on May 31, 2002.<sup>3</sup>

The other important background point is that in Europe, not only the continental but also the U.K.-type systems of law,<sup>4</sup> generally enforce a strict separation between different legal entities and deal with each entity

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1. Council Regulation 1346/2000, 2000 O.J. (L 160) 1 (EC). The text can be found with a commentary in GABRIEL S. MOSS ET AL., *THE EC REGULATION ON INSOLVENCY PROCEEDINGS: A COMMENTARY AND ANNOTATED GUIDE* (2002). Although the body of the statute has not changed, the annexes, which, among other things, list the types of proceedings and the types of liquidators covered, have been updated from time to time to deal with the expansion of the number of countries affected (now twenty-six, i.e., the twenty-seven E.U. countries excepting Denmark) and changes in domestic procedures in the various countries covered.

2. The EC Regulation's history is set out by Professor Fletcher in Chapter 1 of MOSS ET AL., *supra* note 1.

3. Council Regulation 1346/2000, art. 47, 2000 O.J. (L 160) 1 (EC).

4. See *Salomon v. Salomon & Co.*, [1897] A.C. 22 (H.L.), and the many cases which have followed it in over 100 years.

separately, especially in the context of insolvency proceedings.<sup>5</sup> There are exceptions, and the United Kingdom, for example, in exceptional circumstances, allows substantive consolidation of estates.<sup>6</sup>

The negotiators of the original Convention on Insolvency Proceedings (Convention) were aware that no provision whatsoever was being made for groups as such. Thus paragraph 76 of the Virgos-Schmit Report on the Convention states:

The Convention offers no rule for groups of affiliated companies (parent-subsidiary schemes).

The general rule to open or to consolidate insolvency proceedings against any of the related companies as a principal or jointly liable debtor is that jurisdiction must exist according to the Convention for each of the concerned debtors with a separate legal entity.

Naturally, the drawing up of a European norm on associated companies may affect this answer.<sup>7</sup>

There was thus an awareness of a problem in relation to groups but any solution was put off to another day. There is no sign that the European Legislature is about to discuss groups, but the author knows that UNCITRAL has started work on the subject.

By the time the EC Regulation came into force, the nature of trading in groups had changed further in that some groups operated their businesses in terms of “divisions” which cut across different corporate personalities. A system which ignored these commercial realities was bound to set up difficult tensions and conflicts.

## II. A BRIEF DESCRIPTION OF JURISDICTION AND CHOICE OF LAW UNDER THE EC REGULATION

The EC Regulation applies to all companies whose “centre of main interests” is located within the European Union<sup>8</sup> (except Denmark<sup>9</sup>—this exception is hereafter assumed rather than restated). This is irrespective

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5. *Polly Peck Int'l Fin., Ltd. v. Polly Peck Int'l Plc.* (*Re Polly Peck Int'l Plc.*), (1996) 2 All E.R. 433 (Ch) (Eng.), [1996] B.C.C. 486, 495.

6. *Re Bank of Credit and Commerce Int'l SA* (No. 2), [1992] B.C.C. 715 (CA Civ. Div.)

7. The Report, which never acquired official status as a result of the failure of the Convention, but which has been cited extensively to explain the EC Regulation, appears as Appendix 2 in MOSS, *supra* note 1.

8. The European Union now consists of twenty-seven countries, Bulgaria and Romania having joined on January 1, 2007. Dan Bilefsky, *Romania and Bulgaria Celebrate Entry into European Union*, N.Y. TIMES, Jan. 2, 2007.

9. Council Regulation 1346/2000, Recital (33), 2000 O.J. (L 160) 1 (EC).

of the place of registration of the company.<sup>10</sup> The rule of allocation between European Union (E.U.) Member States is that jurisdiction to open main proceedings is in the Member State where the center of main interests of the company within the European Union is located.<sup>11</sup> Jurisdiction to open secondary proceedings is found in any Member State where there is “establishment” of the corporate entity.<sup>12</sup>

There is no definition of “centre of main interests” in the text of the Regulation itself, but there is in the Recitals a sentence which has since, rather inaccurately, been referred to as a “definition.” This is contained in the text of Recital (13): “The ‘centre of main interests’ should correspond to the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties.”<sup>13</sup>

As a definition this is both brief and rather vague, and is in fact not intended to be a definition but rather a concise description. The words used are copied from the first subparagraph of paragraph 75 of the Virgos-Schmit Report.<sup>14</sup> What happened was that since the Convention never took effect, the Virgos-Schmit Report never acquired official status. However, the Community legislator, in order to help people understand the EC Regulation, took some phrases from the Virgos-Schmit Report, such as the one above, for explanatory effect.

However, to take the introductory subparagraph of paragraph 75 of the Virgos-Schmit Report as a definition is plainly wrong.<sup>15</sup> The rest of

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10. *In re BRAC Rent-A-Car Int'l, Inc.*, [2003] EWHC (Ch) 128, [2003] 1 W.L.R. 1421 (Eng.).

11. Since some Member States, such as the United Kingdom, are themselves multi-jurisdictional states, it is important to note that the EC Regulation provides no rule for the allocation of jurisdiction between the different legal jurisdictions *inside* the Member State. Thus if, for example, jurisdiction in a particular case is allocated to the United Kingdom because the center of main interests is there, the question of which country within the United Kingdom has jurisdiction to open the proceedings, i.e., England and Wales, Scotland, or Northern Ireland, is a matter of U.K. law rather than European community law.

12. The author is ignoring for present purposes the ability in some situations to open independent territorial proceedings prior to the opening of main proceedings in the center of main interests.

13. Council Regulation 1346/2000, Recital (13), 2000 O.J. (L 160) 1 (EC).

14. MOSS ET AL., *supra* note 1, app. 2.

15. The European Court of Justice, in Case C-341/04, Eurofood IFSC, Ltd., 2006 E.C.R. I-3813, at paragraph 33, uses the word “definition” in relation to Recital (13), but in the context this is simply the equivalent of “[t]he scope of that concept is highlighted” in paragraph 32. On this basis, Registrar Jaques in *Stojecvic v. Komercni Banka A.S.* (December 20, 2006) rejected the submission that Recital (13) contained a definition. *Id.* at para. 31 (unreported; text of judgment on file with author).

paragraph 75 goes on to explain the “centre of main interests” concept in more detail and is the nearest thing we have to an authoritative explanation of what was intended by the concept. The final sub-paragraph of paragraph 75 states that “[w]here companies and legal persons are concerned, the Convention presumes, unless proved to the contrary, that the debtor’s centre of main interests is the place of his registered office. This place normally corresponds to the debtor’s head office.”<sup>16</sup>

To understand the import of this statement, one has to recall that domestic law in Europe has two different approaches. In the United Kingdom, for example, the historic approach was based on the place of registration. According to this approach, if there were to be proceedings in more than one country, the main proceedings would take place in the jurisdiction of the place of registration, and proceedings in other jurisdictions would be ancillary to the main proceeding.<sup>17</sup>

In Europe (excluding Scandinavia), on the other hand, the approach was to focus on the “seat” of the company,<sup>18</sup> which is most likely the idea behind the “centre of main interests” concept. Article 3 of the EC Regulation, which lays down the rules of allocation for opening main and secondary proceedings, is in reality a compromise between the two approaches. Although in substance the “seat” approach has won, Article 3 of the EC Regulation takes on the appearance of a compromise by using a new concept—“centre of main interests”—and introducing a presumption, rebuttable by appropriate evidence, that the “centre of main interests” is in the place of registration.<sup>19</sup> Finally, the last subparagraph of paragraph 75 of the Virgos-Schmit Report tactfully glosses over the conflict and simply points out that the registered office is normally the debtor’s “head office.”<sup>20</sup>

### III. PRACTICAL PROBLEMS

From a practical point of view, having separate main proceedings in each place where each subsidiary in a group is registered is wasteful, duplicative, expensive, and likely to impede a rescue, reconstruction, or beneficial realization of the business of the group. In theory, in a large group spread over the European Union, one can have twenty-seven<sup>21</sup> or

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16. MOSS ET AL., *supra* note 1, app. 2 at 282.

17. *In re* English Scottish and Australian Chartered Bank, [1893] 3 Ch. 385, 394 (U.K.).

18. See MOSS ET AL., *supra* note 1, at para. 3.11.

19. Council Regulation 1346/2000, art. 3(1), 2000 O.J. (L 160) 1 (EC).

20. MOSS ET AL., *supra* note 1, app. 2 at 282.

21. Note that the EC Regulation only applies in twenty-six out of the twenty-seven countries, Denmark being excluded.

more different main proceedings governed by different systems of law with different “liquidators” (a term which is defined in the EC Regulation to include, among others, administrators)<sup>22</sup> operating under twenty-seven different systems of law,<sup>23</sup> answerable to twenty-seven different courts and speaking (not quite) twenty-seven different languages.<sup>24</sup> It is difficult to see how any sensible rescue, reconstruction, or beneficial sale can take place in such a situation. If in fact the group trades in “divisions,” cutting across different legal entities, the position becomes even more difficult.

A number of the group cases which have arisen of course have a strong U.S. connection. There is often an ultimate parent in the United States and there may well be a European subgroup centered on the United Kingdom. The business may nowadays be global and the places of incorporation may well not correspond to the place where business is actually conducted.

#### IV. THE ENGLISH CASE LAW EXPERIENCE

In a purely domestic context in England, the normal practice would be for the same persons to be appointed as, say, administrators to each company in a group of companies in financial trouble. This made the coordination of a rescue, reconstruction, or beneficial sale relatively easy compared to each proceeding being led by a different person from a different organization.<sup>25</sup> The advent of the EC Regulation meant that in appropriate cases, a similar pragmatic approach could be taken in relation to foreign-registered subsidiaries.

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22. Council Regulation 1346/2000, art. 2(b), 2000 O.J. (L 160) 1 (EC). See also the list, in Annex C to the EC Regulation, referred to by Article 2(b). The list has been updated from time to time. *See supra*, note 1.

23. In practice, an underestimate, since the United Kingdom itself (which for this purpose excludes small offshore islands such as the Channel Islands and the Isle of Man but includes Gibraltar) have four legal systems, i.e., England and Wales, Scotland, Northern Ireland, and Gibraltar, and there are material differences in insolvency law and procedure between them.

24. The language situation is complicated. Some countries, e.g., Germany and Austria, share the same language, but others have more than one official language, e.g., Belgium (French and Flemish), Finland (Swedish as well as Finnish), Ireland (Irish and English), and the United Kingdom (where Welsh is an official language within Wales).

25. English courts are relatively relaxed about the potential conflicts of interest and expect liquidators and others to work out ways of dealing with them as and when they arise. *Re Esal (Commodities) Ltd.*, (1988) 4 B.C.C. 475 (CA Civ. Div.).

*A. Enron Directo SA, Lightman J., July 4, 2002*

The first opportunity arose in the case of Enron Directo Sociedad Limitada (Enron Directo), a Spanish-incorporated Enron European company trading in Spain on a daily basis but whose headquarters' functions were carried out from European group headquarters in London. The judge accepted the argument that the center of main interests of this Spanish-registered company was in the United Kingdom and made an administration order as a main proceeding within the EC Regulation.<sup>26</sup> The other relevant European Enron companies incorporated in England were already in administration.<sup>27</sup> Thus the insolvency administration of *Enron Directo* could be run in the context of the insolvency administration of the group by the same administrators. Since, under Article 4 of the EC Regulation, English law applied to the proceedings in *Enron Directo*,<sup>28</sup> there was no question of consolidating either assets or liabilities with any other company, since English law does not permit this, save in very exceptional and rare cases.<sup>29</sup>

*B. Re Daisytek-ISA Ltd. (Re Daisytek)*<sup>30</sup>

*Re Daisytek* was the case which really stirred things up in Continental Europe. Assisted by the successful written argument in the *Enron Directo* case, the judge in *Re Daisytek* made administration orders as main proceedings, not only for English companies in the European subgroup, but also for French- and German-registered companies.<sup>31</sup> This was again on the basis that whilst current operations may have been going on in France and Germany, the head-office functions were carried out in England.<sup>32</sup>

As sometimes happens in England, the administration order appeared immediately but the judgment setting out the detailed reasons appeared some time later. To the author's understanding, this is wholly unknown in Continental Europe, where what in England are called the "order" and

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26. There is, unfortunately, no judgment, but the written argument accepted by the judge can be found on the Web site of the International Insolvency Institute. Skeleton Argument on Behalf of the Petitioner, *In re Enron Directo Sociedad Limitada*, High Court (Chancery), available at [http://www.iiiglobal.org/country/european\\_union/Enron\\_Directo\\_Skel.pdf](http://www.iiiglobal.org/country/european_union/Enron_Directo_Skel.pdf).

27. *Id.*

28. Council Regulation 1346/2000, art. 4, 2000 O.J. (L 160) 1 (EC).

29. *Re Bank of Credit and Commerce International SA* (No. 2), [1992] B.C.C. 715 (CA).

30. [2003] B.C.C. 562 (Ch).

31. *Re Daisytek-ISA Ltd.*, [2003] B.C.C. 562 (Ch).

32. *Id.*

“judgment” are always in the same document. It thus created an unfortunate impression when the order was presented, without the reasoned judgment (which was not yet written), to the French and German courts, and they were told that they were required to recognize the orders automatically and without enquiry pursuant to Article 16 and subsequent articles of the EC Regulation.<sup>33</sup>

The other difficulty at the time was that under Continental European systems such as those of France and Germany, directors have a statutory obligation to file a proceeding in court within a short period of obtaining knowledge of the insolvency of their company or face civil and criminal sanctions.<sup>34</sup> It was not clear at the time of *Re Daisytek* whether a filing in respect of a French or German company in England would be sufficient compliance with this obligation.

In France, the director who had himself caused the English filings made a separate filing, to protect his personal position, with a local commercial court.<sup>35</sup> This needed to be on notice to the public prosecutor, who takes part in the hearing.<sup>36</sup> One also must remember here that commercial court judges in France are not professional judges or even legally qualified, although they do have legal assistance. The French court could not believe that the English court had really intended to put a French-registered company into administration in England and considered that the English court must have confused the separate French entity with a branch of the English parent.<sup>37</sup> The French court thus considered the English administration order to be void and made a French administration order.<sup>38</sup>

Under the French system, the English administrators could apply to set aside this order and, as one would expect, did so, but failed to have it set aside.<sup>39</sup> They did, however, appeal successfully to the Court of Appeal in Versailles.<sup>40</sup> Importantly, by this stage, the reasoned judgment from England was available and the Court of Appeal in Versailles could see that

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33. Translations of the French and German first-instance judgments are on file with the author. See also the Versailles Court of Appeal judgment, by which stage the reasoned judgment of the English court was available. Cour d'appel [CA] [regional court of appeal] Versailles, Sept. 4, 2003, [2003] B.C.C. 984 (Fr.) (Klempka v. ISA Daisytek SA).

34. See, e.g., Skeleton Argument on Behalf of the Petitioner, *In re Enron Directo Sociedad Limitada*, High Court (Chancery).

35. Translation of the French first-instance judgment (on file with the author).

36. *Id.*

37. *Id.*

38. *Id.*

39. Cour d'appel [CA] [regional court of appeal] Versailles, Sept. 4, 2003, [2003] B.C.C. 984, 987 (Fr.) (Klempka v. ISA Daisytek SA).

40. *Id.*

the English judge had gone through a proper process of reasoning in order to hold that the presumption based on the location of the registered office had been rebutted by the facts pointing to the center of main interests being in England. The French Court of Appeal thus recognized the opening of proceedings in England and voided the French opening.<sup>41</sup> The French public prosecutor, who is a party to such proceedings in France, was still dissatisfied and appealed the matter to the French Supreme Court (*Cour de Cassation*), which eventually dismissed the appeal.<sup>42</sup>

One point that troubled the French was that under French law the employees of a company have important rights to be consulted about the opening of insolvency proceedings.<sup>43</sup> Such rights do not exist under English law, which under Article 4 of the EC Regulation governs the criteria for opening proceedings.<sup>44</sup>

The German courts were, in principle, much more cooperative. In the case of one of the German subsidiaries, there was a mistake as to the facts and it was thought that proper notice had not been given to the relevant director of the company.<sup>45</sup> Once this factual mistake was cleared up, recognition was given in Germany.<sup>46</sup>

The *Daisytek* case caused something of a storm of protest in Europe which has not entirely died down. While attending a conference organized by INSOL Europe in the City of Cork in Ireland, the distinguished Professor Paulus, a leading German authority in this area, denounced the British courts as “imperialists.” Subsequently, however, at the second-annual German Insolvency Congress in Berlin, the author explained in his presence that the English courts were pragmatists rather than imperialists, and peace has been declared sufficiently to enable us to write an Article together calling for various urgent reforms to the EC Regulation.<sup>47</sup>

The good practical sense of the approach in *Enron Directo* and *Daisytek* has meant that it has been followed in other countries. In *Hettlage*

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41. *Id.* at 992.

42. Cass. com., June 27, 2006, [2006] B.C.C. 841 (Fr.) (French Republic v. Klempka).

43. Cour d'appel [CA] [regional court of appeal] Versailles, Sept. 4, 2003, [2003] B.C.C. 984 (Fr.) (Klempka v. ISA Daisytek SA).

44. Council Regulation 1346/2000, art. 4, 2000 O.J. (L 160) 1.

45. The history is set out in the first instance court judgment of March 12, 2004 (Amtsgericht Düsseldorf) (translation on file with author).

46. *Id.*

47. Gabriel Moss & Christoph Paulus, *The European Insolvency Regulation—The Case for Urgent Reform*, 19 INSOLVENCY INTELLIGENCE 1 (2006).

*AG* (a.k.a. *Hettlage Austria*),<sup>48</sup> the German insolvency court in Munich applied a similar approach in relation to an Austrian-registered company in a German group.<sup>49</sup> In the Hungarian case of the *Parmalat Group*,<sup>50</sup> a particular company (Mliekotej, a.k.a. Parmalat Slovakia) was incorporated in Slovakia, which has a particularly business-friendly approach in respect of, inter alia, taxes, but was run from Hungary.<sup>51</sup> Main proceedings were opened by the Hungarian local court.<sup>52</sup> In France, after the French had reconciled themselves to the approach of “Perfidious Albion,”<sup>53</sup> they very efficiently adopted it themselves in the case of *MPOTEC GmbH*, a German-registered company run as part of a French group.<sup>54</sup> It was only a matter of time before they got a chance to do it to the English themselves. This occurred as recently as August 2, 2006 in the case of *Eurotunnel Finance Limited*,<sup>55</sup> an English-registered company which is part of the Eurotunnel group. That case is being appealed.

Interestingly, whereas the English, German, and Hungarian courts had focused mainly on the need to fulfill the statutory criteria of Article 3 of the EC Regulation by having resort to “the head office functions” approach to rebut the presumption of place of incorporation, the French seemed quite happy to give as an additional rationalization, in their cases, the pragmatic usefulness of running insolvency proceedings from the same place from which the group itself had been run. There is no better statement of English pragmatism than in the French judgments. For example, in the *MPOTEC* case, the relevant case law is summarized as follows:

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48. Amtsgericht München [AG] May 4, 2004, ZIP 20/2004, 962 (F.R.G.) (unofficial translation on file with author).

49. *Id.*

50. Municipal Court of Fejer/Szekesfehervar (Hung.) (unreported; unofficial translation on file with author).

51. *Id.*

52. *Id.*

53. A translation of the mid-nineteenth century French expression “*la perfide Albion*,” referring to the French view that the British are treacherous in their dealings with foreigners. See “Albion,” OXFORD ENGLISH DICTIONARY (2d ed. 1989).

54. Tribunal de grande instance [T.G.I.] [ordinary court of original jurisdiction] Nanterre, Feb. 15, 2006 [2006] B.C.C. 681 (Fr.). Interestingly, this was a decision of the Tribunal de Commerce of Nanterre, whose district includes the area outside Paris where the corporate head office towers banned from the center of Paris, France, are located—in other words the location of many head office functions!

55. Tribunal de commerce Paris, Aug. 2, 2006 (Fr.) (unreported) (unofficial translation on file with the author).

The analysis of the case law of the various Member States shows that courts adopt a pragmatic approach tending to allow streamlining of strongly integrated groups of companies.

In this respect, the centralisation of proceedings permits the avoidance of the partitioning effects linked to the opening of several main proceedings in different Member States. It is indeed desirable that the management of different companies continues thanks to a centralisation of different main proceedings under the supervision of just one court in order to allow the implementation of a global administration plan.

This pragmatic approach preserves the legal personality of the subsidiary which is not considered as a branch of the parent company within the meaning of Regulation 1346/2000. Above all, this approach allows the opening of secondary proceedings, independently of the location of the registered office, in order to better take into account of the interests of employees and local creditors. This interpretation was retained by the German and Austrian case law in the *Daisytek . . . Automold, Hettlage and Rover* cases and, more recently, by the judgment of December 15, 2005, by the Court of Appeal of Versailles.<sup>56</sup>

#### V. THE "HEAD OFFICE FUNCTIONS" TEST IN THE EUROPEAN COURT OF JUSTICE

For technical reasons, which the author will not deal with in detail here, but which were explained in *The EC Regulation on Insolvency Proceedings*,<sup>57</sup> a reference seeking guidance on questions of European law cannot be sought in respect of the EC Regulation except when one has reached the final appellate court in one's own system. Note, however, that this is not like an appeal to the U.S. Supreme Court, since the procedure involves not an appeal but rather the reference of particular issues of European law, designed to enable the national final appellate court to make its decision in the light of the rulings as to European law on those issues. Ultimately, getting the right answers depends on asking the right questions.

In terms of getting such rulings, the Irish have a great advantage: they only have one level of appeal, which is from the High Court to the Supreme Court.

The insolvency of the Parmalat Group in Italy has led to great deal of interesting legal work in the United States, the Caribbean, and Europe. One of the Parmalat subsidiaries was an Irish-registered company called Eurofood, registered in Ireland in order to take advantage of the favor-

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56. Tribunal de grande instance [T.G.I.] [ordinary court of original jurisdiction] Nanterre, Feb. 15, 2006 [2006] BCC 681, 687-88 (Fr.) (MPOTEC GmbH).

57. MOSS ET AL., *supra* note 1, para. 2.34.

able tax climate in the Dublin docks. The entity itself had no employees and was run by Bank of America,<sup>58</sup> a close business associate of Parmalat before its insolvency.

Although Eurofood had a board consisting of Irish and Italian directors, since Eurofood had no business other than the raising of money for the Parmalat Group it can be inferred that the steps that Eurofood took were under the ultimate direction of the Parmalat parent in Italy. In any event, Eurofood only carried out three transactions—two transactions raising money guaranteed by the Italian parent and one swap.<sup>59</sup> Fearing that the Italians were (from Bank of America's point of view) going to move the center of main interests to Italy, Bank of America swooped by filing a petition to wind up in Ireland and applying successfully for the appointment of a provisional liquidator in order to prevent the center of main interests' moving.<sup>60</sup> When the matter subsequently came before the Italian court in Parma, that court held that the appointment of a provisional liquidator had not opened proceedings in Ireland and that the center of main interests was in Italy.<sup>61</sup> Accordingly, the court opened main proceedings in respect of the company.<sup>62</sup>

However, when the winding-up petition was heard in Ireland, the Irish court held that the appointment of the provisional liquidator had opened a proceeding and, amongst other things, the Irish court also declined to recognize the Italian opening because it believed that the provisional liquidator had not been fairly treated in the Italian proceedings.<sup>63</sup> Subsequently, the opening of main proceedings in Ireland was appealed by the Italian administrator to the Irish Supreme Court.<sup>64</sup> The Irish Supreme Court made it clear that they thought the Irish courts were correct, but nevertheless put a series of rather loaded questions to the European Court of Justice designed to elicit answers which would confirm the Irish courts' approach.<sup>65</sup> The Irish Supreme Court was not, generally speaking, disappointed. For present purposes, the author will only deal with the ruling in relation to "centre of main interests."

In such proceedings before the European Court of Justice, detailed written arguments are submitted and a brief oral argument takes place,

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58. *See Re Eurofood IFSC, Ltd.*, [2005] B.C.C. 999, 1003 (S.C.) (Ir.).

59. *Id.* at 1004.

60. *Id.* at 1005.

61. *Id.* at 1005–06. A translation of the judgment of the Italian court is on file with the author.

62. *Re Eurofood IFSC, Ltd.*, [2005] B.C.C. 999, 1003 (S.C.) (Ir.).

63. *Id.* (citing *Re Eurofood IFSC, Ltd.*, [2004] B.C.C. 383 (H. Ct.) (Ir.)).

64. *Id.*

65. *Id.* at 1013; *see* Case C-341/04, *Eurofood IFSC, Ltd.*, Opinion of Mr. Advocate General Jacobs, 2006 E.C.R. I-3813.

after which the Advocate General, who is part of the court, gives his opinion. This is then considered by the judges of the court. In most cases the opinion is accepted and the court itself gives a brief judgment. In a minority of cases the opinion is rejected and acquires the status of a minority opinion. In cases where the opinion is accepted, since the eventual judgment is usually much more concise, the opinion can be looked to for further reasoning.

In the *Eurofood* case, the judgment of the court says nothing at all about the “head office functions” test.<sup>66</sup> This is due to the form of the question, which gave the European Court of Justice the choice of locating the center of main interests either in the place of the registered office, being also the place described by Recital (13) of the Regulation as the center of main interests,<sup>67</sup> or in the place where the parent, by virtue of its shareholding and its power to appoint directors, controls the policy of the subsidiary.<sup>68</sup> Given that choice, the European Court of Justice obviously had to vote for the description of the center of main interests appearing in Recital (13). This, of course, said nothing whatsoever about situations where the registered office was in one place and the head-office functions were conducted in another.

In order to see what has been said in the European Court of Justice about the “head office functions” test, one therefore needs to refer to the Advocate General’s Opinion, which the court generally followed in the case:

Dr Bondi and the Italian Government submit that if it is to be demonstrated that the centre of main interests is somewhere other than the State where a company’s registered office is located, it consequently needs to be shown that the head office’ type of functions are performed elsewhere. The focus must be on the head office functions rather than simply on the location of the head office because a ‘head office’ can be just as nominal as a registered office if head office functions are not carried out there. In transnational business the registered office is often chosen for tax or regulatory reasons and has no real connection with the place where head office functions are actually carried out. That is particularly so in the case of groups of companies, where the head office functions for the subsidiary are often carried out at the place where the head office functions of the parent of the group are carried out.

. . . I find those submissions sensible and convincing. They do not, however, seem to me very helpful in answering the question. They do

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66. Case C-341/04, *Eurofood IFSC, Ltd.*, Judgment, 2006 E.C.R. I-3813.

67. Council Regulation 1346/2000, Recital (13), 2000 O.J. (L 160) 1.

68. Case C-341/04, *Eurofood IFSC, Ltd.*, Opinion of Mr. Advocate General Jacobs, 2006 E.C.R. I-3813.

not in particular demonstrate that a parent company's control of the subsidiary's policy determines that subsidiary's 'centre of main interests' within the meaning of the Regulation.<sup>69</sup>

Thus, one can see an express endorsement of the "head office functions" approach to rebutting the place of registration as the center of main interests. Accordingly, all those in Europe who appear to have the impression that the European Court of Justice has somehow overturned or disapproved of the previous case law have a mistaken impression.

Indeed, the *MPOTEC* case cited above was decided after the Advocate General's Opinion had come out and with express reference to it,<sup>70</sup> and the *Eurotunnel* case was decided after the European Court of Justice Judgment came out, although it does not expressly refer to it. Each of these two cases follows the pre-*Eurofood* line of cases, using the "head office functions" approach.<sup>71</sup>

What the European Court of Justice Judgment does do is emphasize that the facts rebutting the presumption of registered office must be "objective and ascertainable by third parties."<sup>72</sup> There is nothing surprising or novel in that.

## VI. HOW TO AVOID SECONDARIES

Even if one has succeeded in opening main proceedings for all the companies in a group in one location, the smooth process of rescue, reconstruction, or beneficial sale can be disrupted by the opening of a secondary proceeding which would then apply local law to local assets. This was the type of potential difficulty encountered in the European operations of the Collins and Aikman Group, another U.S.-led group.

A good start was made by opening main proceedings for companies in a number of differently registered subsidiaries in England.<sup>73</sup> However, the filing of secondary proceedings by local creditors would have disrupted the process of trying to sell the group business by the U.K. administrators in charge of all the main proceedings. The legitimate concerns of local creditors were that if only main proceedings were opened the choice of law dictated by Article 4 of the EC Regulation would mean

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69. *Id.*, paras. 111–12. The author was lead Counsel for Dr. Bondi, the special administrator appointed by the Italian government.

70. Tribunal de grande instance [T.G.I.] [ordinary court of original jurisdiction] Nanterre, Feb. 15, 2006 [2006] B.C.C. 681 (Fr.) (*MPOTEC GmbH*).

71. *Id.* at 687; see Tribunal de commerce Paris, Aug. 2, 2006 (Fr.) (*Eurotunnel*) (unreported) (unofficial translation on file with the author).

72. Case C-341/04, *Eurofood IFSC, Ltd.*, Judgment, 2006 E.C.R. I-3813, para. 34.

73. *Re Collins & Aikman Corp. Group* (Application for Administration Orders), [2005] EWHC (Ch) 1754, [2006] B.C.C. 606 (Eng.).

that local priorities would not apply.<sup>74</sup> These included equitable subordination provisions in Germany and Spain, the application of which would have had a considerable beneficial effect for local trade creditors.<sup>75</sup>

The administrators met with committees of local creditors and in order to prevent them from opening secondaries gave them assurances to the effect that local priorities would be respected.<sup>76</sup> As a result, a very good sale of the group business (with some exceptions) without the opening of secondaries (again with some exceptions) took place, achieving a considerably higher return than had been forecast.<sup>77</sup> The remaining legal problem was the ability of the administrators to keep their promises, given that the mandatory terms of Article 4 of the EC Regulation required the application of English law and English law priorities. Fortunately for the administrators, we<sup>78</sup> were able to find no less than three grounds, accepted by the judge, for justifying the giving of assurances and their fulfillment.<sup>79</sup>

If sufficient flexibility can be found in other European laws where main proceedings are opened, *Collins & Aikman* will be an obvious model for the way to harmonize the need for centralization and simplicity, on the one hand, and the respecting of local priorities, on the other. The indirect application of local priorities through the provisions of English statute and case law also neatly balances the charges of imperialism and demonstrates that the application of the “head office functions” test has in fact been a triumph of pragmatism.

For the sake of completeness, it is important to mention that there are some limited situations in which the opening of secondary proceedings is either necessary or beneficial. Examples include situations where the local law is more helpful in terms of the transfer of employees to a purchaser or where the application of local law is necessary to restrain enforcement of a security interest, since the enforcement of security interests in other Member States forms an exception from the general applicability of the law of the main proceedings.<sup>80</sup>

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74. Council Regulation 1346/2000, art. 4, 2000 O.J. (L 160) 1.

75. See *Re Collins & Aikman Europe SA*, [2006] EWHC (Ch) 1343, [2006] B.C.C. 861

76. *Id.*

77. *Id.*

78. The author acted as Lead Counsel for the administrators on this application.

79. *Re Collins & Aikman Europe SA*, [2006] EWHC (Ch) 1343, [2006] B.C.C. 861.

80. Council Regulation 1346/2000, art. 5, 2000 O.J. (L 160) 1.

# LOCATING THE EYE OF THE FINANCIAL STORM

*Jay Lawrence Westbrook\**

Bankruptcy law has become a prominent part of the effort to bring coherence to the management of a global economic system that operates through multinational enterprises but must function in a world of sovereign states.<sup>1</sup> The very nature of bankruptcy law requires a unified legal response to a debtor's general default.<sup>2</sup> In the case of a multinational enterprise, that response requires identification of a single jurisdiction that will control, or at least coordinate, the task. Any standards chosen for specifying the primary jurisdiction will necessarily be approximate and imperfect, given the fundamental mismatch between the broad scope of our economic institutions and the narrower reach of our political organizations. This Article addresses recent efforts to develop workable standards for that purpose.

## I. CHOICE OF LAW AND COMI

Together, the establishment of the European Union Insolvency Regulation (E.U. Regulation)<sup>3</sup> and the widening adoption of the Model Law on Cross Border Insolvency (Model Law)<sup>4</sup> represent a powerful trend to-

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1. See generally Christoph Paulus, *The Global Insolvency Law And The Role Of Multinational Institutions*, 32 BROOK. J. INT'L L. 755 (2007).

2. Jay Lawrence Westbrook, *A Global Solution to Multinational Default*, 98 MICH. L. REV. 2276 (2000). In an interesting Article in this symposium, Professor Rasmussen suggests that creditor control of bankruptcy proceedings may lead to a market solution to coordination of multinational bankruptcies. Robert K. Rasmussen, *Where are all the Transnational Bankruptcies?: The Puzzling Case for Universalism*, 32 BROOK. J. INT'L L. 983 (2007). He points to the absence of multiple proceedings in some major bankruptcies as evidence. His thesis deserves serious attention. While this Article is not a suitable vehicle for this discussion, I can point out that it seems equally interesting that so many practicing lawyers of great experience in multinational bankruptcies, including some distinguished contributors to this symposium, seem to believe the legal issues that we are discussing—and the choice between universalism and territorialism—are important.

3. Council Regulation 1346/2000, Council Regulation on Insolvency Proceedings, 2000 O.J. (L 160) 1 (EC).

4. U.N. Comm'n on Int'l Trade Law [UNCITRAL], *Model Law on Cross-Border Insolvency with Guide to Enactment*, U.N. Sales No. E.99.V.3 (1999). The United States version of the Model Law was adopted as Chapter 15 by the 2005 amendments to the Bankruptcy Code. 11 U.S.C. § 1501 *et seq.* (2007). The language of Chapter 15 is very

ward universalism in the management of multinational bankruptcies.<sup>5</sup> Both regulations require deference to a “main” proceeding, so identification of that jurisdiction is central to their proper application. Both laws place the main proceeding at the “the center of [the debtor’s] main interests” (COMI). The choice of principal forum in turn will have important implications for the choice of the bankruptcy rules to be applied and therefore the substantive outcomes for stakeholders.

COMI is similar to standards like “principal place of business,” “chief executive offices,” or “real seat”<sup>6</sup> that one finds in many statutes in the United States and elsewhere. It is not hopelessly vague, but it is clearly subject to various interpretations. This Article addresses a fundamental question about the interpretation of the COMI standard: what policy factors should influence the interpretation of that standard? I will argue that the two primary factors are predictability and the likelihood of selection of an acceptable substantive law. I will also argue that we should not necessarily apply the same COMI standard under the Model Law and the E.U. Regulation. Finally, I will conclude that in the current, evolving state of the management of multinational bankruptcies, a “Dual COMI” standard<sup>7</sup> is an acceptable, if imperfect, basis for the application of modified universalism.

Central to universalism in bankruptcy matters is the ideal of a single worldwide proceeding in which one court or administrative body administers the default of a multinational corporation with the assistance of other courts as necessary.<sup>8</sup> It is conceded that this ideal will not be reached in the near future, so the notion of modified universalism has

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close to that of the Model Law. H.R.REP. No. 109–31, pt. 1, at 105 (2005). Virtually everything I have to say about the Model Law is meant to apply to Chapter 15 as well.

5. I use the term “bankruptcy” in the North American way given Brooklyn’s present location, but I mean to refer to a bankruptcy or insolvency proceeding involving a business corporation.

6. See Gabriel Moss, *Group Insolvency—Choice Of Forum And Law: The European Experience Under The Influence Of English Pragmatism*, 32 BROOK. J. INT’L L. 1005, 1008 (2007). An excellent discussion in English of the real seat doctrine is found in Tobias Caspary, *The Freedom of Establishment and the Real Seat Doctrine after the Überseering Decision of the ECJ 2003* (unpublished Article, on file with the author).

7. See *infra* notes 71–72 and accompanying text.

8. See *Cambridge Gas Transp. Corp. v. Official Comm. of Unsecured Creditors*, [2006] UKPC 26, [2006] 3 W.L.R. 689, para. 16 (appeal taken from the Isle of Man) (U.K.); see also American Law Institute, *Principles of Cooperation Among the NAFTA Countries* 8 (2003) [hereinafter ALI Principles]. (I had the privilege of serving as the U.S. Reporter for the project.) For the current state of the debate between territorialism and universalism and some interesting suggestions of a middle way, see Edward Janger, *Universal Proceduralism*, 32 BROOK. J. INT’L L. 819 (2007).

been advanced to describe an approach that seeks to achieve pragmatic results as close to the universalist ideal as possible.<sup>9</sup>

I have long believed that in multinational bankruptcies choice of bankruptcy law and choice of bankruptcy forum are intimately related—and should be.<sup>10</sup> Every aspect of any national bankruptcy law is part of an integrated set of decisions about the policies to be served and the stakeholders to be benefited. Thus, for example, the point of the avoiding powers found in virtually every bankruptcy law is to recover value that was misallocated pre-bankruptcy and to redistribute it. The avoiding powers vindicate the desire for orderly and fair distributions to the favored stakeholders in a bankruptcy proceeding. That benefit must be balanced against the cost of the disruption to markets inherent in avoidance of transactions that are ordinarily unexceptionable. Each jurisdiction draws that balance differently and also has different priorities in management and distribution of bankruptcy assets.<sup>11</sup> Thus it would rarely make sense to void a pre-bankruptcy transaction under the bankruptcy policies of Country A in a proceeding in which the distribution of any avoidance recovery would be vindicating the policies of Country B.<sup>12</sup> That result would ill-serve the policies of both countries. B would not avoid because of market disruption concerns, while A would give the avoidance recovery to a different set of beneficiaries. The avoidance and the distribution are mismatched like brown shoes with a black suit.

The close integration among bankruptcy rules and policies in each jurisdiction applies to the big four of bankruptcy policy: control, priority, avoidance, and reorganization policy. In a system of universalism each of

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9. ALI Principles, *supra* note 8, at 8; Janger, *supra* note 8.

10. See generally Janger, *supra* note 8, at 831; Jay Lawrence Westbrook, *Theory and Pragmatism in Global Insolvencies: Choice of Law and Choice of Forum*, 65 AM. BANKR. L.J. 457 (1991); Jay Lawrence Westbrook, *Choice of Avoidance Law in Global Insolvencies*, 17 BROOK. J. INT'L L. 499 (1991). Cf. *In re Board of Directors of Telecom Argentina, S.A.*, No. 06 Civ. 2352NRB, 2006 WL 3378687, at \*6 (S.D.N.Y. Nov. 20, 2006) (Trust Indenture Act satisfied by Argentinean bankruptcy procedures).

11. See, e.g., Nick Segal, *The Effect of Reorganisation Proceedings on Security Interests—The Position under English and U.S. Law*, 32 BROOK. J. INT'L L. 927 (2007); see generally Jay Lawrence Westbrook, *Universal Participation in Transnational Bankruptcies*, in MAKING COMMERCIAL LAW, ESSAYS IN HONOUR OF ROY GOODE 419 (Ross Cranston ed., 1997); Jay Lawrence Westbrook, *Universal Priorities*, 33 TEX. INT'L L.J. 27, 30 (1998).

12. See Jay Lawrence Westbrook, *Avoidance of Pre-Bankruptcy Transactions in Multinational Cases*, \_\_ TEX. INT. L.J. \_\_ (forthcoming 2007) [hereinafter Westbrook, *Pre-Bankruptcy*] [on file with *Brooklyn Journal of International Law*]. But see *Al Sabah v. Grupo Torras S.A.* [2005] 2 W.L.R. 904, [2005] UKPC 1. Avoidance under a nonbankruptcy avoiding power may require a different analysis. Westbrook, *Pre-Bankruptcy*, *supra*.

these four elements should be governed by the law of the main proceeding.<sup>13</sup> Under modified universalism, such centralization should be the goal, although not always the result. I will leave the argument thus stated without further elaboration for the purposes of this Article, but I have spelled it out in other Articles, including one currently pending publication.<sup>14</sup>

The immediate consequence of linking choice-of-law decisions to COMI is to increase greatly the stakes for choosing the correct COMI. It therefore increases the willingness of parties to litigate the COMI issue, because the choice of forum will come ever closer to determining substantive outcomes in a Model Law-EU Regulation world. The larger implication is that this link makes it inevitable that we should be concerned about the substantive law likely to be applied by the adoption of various interpretations of COMI.

## II. FACTORS THAT SHOULD INFLUENCE INTERPRETATION OF THE COMI STANDARD

Two policy factors may be important in determining the best standard for interpreting the COMI requirement: predictability and the likely quality of the substantive law of the chosen jurisdiction. Neither should be overemphasized and no one should imagine a perfect fit from any possible rule, a goal that is as elusive in this area of the law as in all the others. Both predictability and substantive law are important in interpreting COMI, but they may differ in importance between the Model Law and the E.U. Regulation, producing defensible differences in interpretation of COMI under the two texts. I will work through the analysis of the two factors and then discuss the Model Law-E.U. Regulation distinction.

### *A. Predictability*

To one degree or another, creditors may rely upon the laws of a corporation's state of incorporation or principal place of business to regulate the management of a general default by the corporation, a point recognized in the United States as long ago as 1883.<sup>15</sup> It seems hard to argue that this reliance—or potential reliance—is not important to the interpre-

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13. *Cambridge Gas Transp. Corp. v. Official Comm. of Unsecured Creditors*, [2006] UKPC 26, [2006] 3 W.L.R. 689, para. 16 (appeal taken from the Isle of Man) (U.K.); *In re Collins & Aikman Europe SA*, [2006] EWHC (Ch) 1343 (English liquidators may distribute under foreign priority schemes as part of a worldwide settlement). *But see* *HIH Cas. & Gen. Ins. Ltd.*, [2005] EWHC (Ch) 2125, [2006] All E.R. 672 (English priority scheme must control for distributions from English assets).

14. Westbrook, *Pre-Bankruptcy*, *supra* note 12.

15. *Canada S. Ry. Co. v. Gebhard*, 109 U.S. 527, 537–38 (1883).

tation of COMI, if only in a negative sense. As the United States Supreme Court said in *Gebhard*:

Such being the law, it follows that every person who deals with a foreign corporation impliedly subjects himself to such laws of the foreign government, affecting the powers and obligations of the corporation with which he voluntarily contracts, as the known and established policy of that government authorizes. To all intents and purposes, he submits his contract with the corporation to such a policy of the foreign government, and whatever is done by that government in furtherance of that policy, which binds those in like situation with himself, who are subjects of the government, in respect to the operation and effect of their contracts with the corporation, will necessarily bind him.<sup>16</sup>

However, while it seems likely that creditors rely upon the bright-line distinction between domestic and foreign laws, it is much less clear whether that reliance goes farther to a reliance on a specific foreign law governing bankruptcy. Do creditors just note that some strange law may apply or do they focus on the specific law that might govern a bankruptcy of their debtor? That question should be the subject of serious empirical study.<sup>17</sup> An interim position may be more plausible: that creditors may go one step beyond the domestic-foreign distinction to rely upon the difference between corporations organized in jurisdictions with which the creditors are “legally comfortable” and those organized in other jurisdictions.<sup>18</sup> To that extent predictability may be important. If so, then predictability of that sort should be a major concern in identifying a COMI.

Predictability is always in tension with correctness of result. The world offers endless variations of the clash between competing values and policies, leaving the judge torn between the predictable result and the one that is correct in this case or that establishes a correct rule for the future. So, we may expect that a balance between predictability and flexibility must be drawn with regard to COMI as well. The question remains as to where the balance should be struck. Two recent cases mark the ends of the spectrum—the *SPhinX* case establishing maximum discretion and the *Eurofood* case focusing on maximum predictability.

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16. *Id.*

17. See Part IV *infra*.

18. They might be legally comfortable based on fact or on prejudice, of course. In large transactions, they might inquire closely, through lawyers, and develop real knowledge.

### 1. Discretion and the Right Result Today

Maximum discretion, ignoring predictability, permits a judge to achieve what seems to the court to be the right result, but often at a considerable cost to commercial tranquility and efficiency. A central point of the Model Law was meant to be adoption of a structure less amorphous than comity and a procedure more suited to bankruptcy than the ancient machinery of judgment recognition. It was also designed quite specifically to replace the *structure* of U.S. Bankruptcy Code section 304, in which section 304(c) imposed sometimes tight restrictions on cooperation based on the substance of the foreign law,<sup>19</sup> while drawing no distinction between primary and secondary bankruptcy proceedings in other countries.

The new structure in the Model Law would serve several important purposes. First, it would guide the court, while giving assurance to other jurisdictions that decisions were not arbitrary or based on local favoritism. The uniformity of structure would serve the latter purpose by increasing the transparency of the process. The Model Law grants great discretion as to specific relief, but imposes a fairly rigid procedural structure for recognition of foreign proceedings. It also establishes a hierarchy of main and non-main proceedings that draws a sharp distinction between the two. COMI is a central organizing element in that hierarchical structure. It would be a mistake to adopt an approach that adds a further layer of discretion and that blurs even the limited amount of structure the Model Law is able to impose.

The *SPhinX* case in New York carries the flexible interpretation of COMI to an extreme.<sup>20</sup> The analysis in the court's opinion offers much to admire as to specific points, but overall it seems to virtually eliminate predictability in determining COMI, consigning each case to the unrestrained discretion of the judge. *SPhinX* was incorporated in the Cayman Islands, but had no other substantial connection with that jurisdiction—no employees, operations, or assets. All of its directors and most, if not all, of its creditors and investors were located elsewhere. The court found that both objective and pragmatic considerations would locate the debtor's COMI outside the islands and therefore make the Caymans case a non-main proceeding under Chapter 15. Yet the court went on to state that in a different case it would have ignored all those factors on the sole

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19. See *In re Treco*, 240 F.3d 148 (2d Cir. 2001).

20. *In re SPhinX*, 351 B.R. 103 (Bankr. S.D.N.Y. 2006), *aff'd*, 2007 WL 1965597 (S.D.N.Y. July 3, 2007) (The district court affirmance was published just before this Article went to press. The opinion simply approved the bankruptcy court analysis.).

ground that the parties in interest had not objected to the Cayman proceeding and had not initiated a bankruptcy anywhere else.<sup>21</sup>

The implicit rule seems to be that creditors and other parties in interest may simply agree about the COMI and may be deemed to have done so if they have not affirmatively objected, even where there is virtually no other basis for the COMI finding. In the end, however, the court refused main status on the ground of *the bad faith motives* of those who brought the case in the Cayman Islands.<sup>22</sup> The court, in effect, found that its discretion as to the COMI is so complete that any good reason to deny relief permits a finding that the foreign proceeding is non-main and the debtor's COMI located somewhere else.

The court's central concern was that the Cayman proceeding was a ploy to delay, and perhaps derail, the settlement of a claim against the debtor in a U.S. lawsuit.<sup>23</sup> Recognition of the foreign proceeding as a main proceeding would have triggered the automatic stay of section 1520 of the Bankruptcy Code. The opinion does not explain why the court could not have avoided this difficulty simply by finding a U.S. COMI for the company. That finding would have made the Cayman proceeding non-main and any injunction would have been discretionary. Instead, for reasons that are not apparent, the court went out of its way to state in dictum that a COMI could be based purely on creditor consent. It, then, refused to do so in this case on a ground wholly unrelated to the location of the company's main interests.<sup>24</sup> Even had the court held that the debtor's COMI was in the Cayman Islands based on creditor consent, it could still have foiled the attempt to block the settlement simply by recognizing the

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21. *Id.* at 120. The court noted that no other proceeding involving the debtor has been brought and "someone needs to manage the Debtors' winding up." *Id.*

22. *Id.* at 121–22. Unfortunately, the district court seemed to approve specifically the jurisdiction-by-consent holding of the bankruptcy court. 2007 WL 1965597, at \*8–9.

23. The debtor had been sued for the return of an alleged preference in another bankruptcy case.

24. *Cf. In re Aerovias Nacionales de Columbia S.A. (Avianca)*, 303 B.R. 1 (Bankr. S.D.N.Y. 2003). In *Avianca*, the New York bankruptcy court permitted a Colombian company to conduct what amounted to a main proceeding in the United States while there was no proceeding pending in Columbia. The result rested primarily on creditor consent and some connections with the United States. The larger question of bankruptcy jurisdiction by consent must be left to discussion on another occasion, but it seems to me that the result is hard to square with the Model Law or Chapter 15 of the U.S. Bankruptcy Code. The Model Law COMI provision on its face does not allow consent to determine if a foreign proceeding is a main proceeding. If that is true, it is hard to see how an adopting state (like the United States) can justify permitting consent to make a proceeding in a U.S. court a main proceeding when it would deny that status to a foreign proceeding in equivalent circumstances.

Cayman proceeding as a main proceeding and then lifting the automatic stay on bad-faith grounds.<sup>25</sup>

These holdings in *SPhinX* were the culmination of pages of analysis that reduced the carefully crafted structure of Chapter 15 to nothing more than a broad grant of judicial discretion. Now freed of the section 304(c) limitations, the court's interpretation effectively eliminates the new structure that replaces it under the Model Law. The result is that the court may do pretty much as it thinks best. There is no doubt that the Model Law and Chapter 15 give the court great discretion to *grant or deny relief* of various sorts, but a recognition of a proceeding and finding it to be main or non-main also invokes provisions that must be given effect.

The *SPhinX* court was unwilling to accept the restraints imposed by that structure, even though Chapter 15 has abolished the more specific restraints previously imposed by section 304.<sup>26</sup> The lesson for courts in other adopting jurisdictions will be clear: the local court may do exactly as it pleases, thus undoing the effort to create a procedure that would make good faith cooperation or its absence more certain and more transparent.<sup>27</sup> Predictability and transparency have considerable importance and decisions such as *SPhinX* essentially eliminate them.

The central mechanisms of Chapter 15 are recognition of the foreign proceeding and characterization of that proceeding as main or non-main. The *SPhinX* court essentially ignores the first mechanism, yet one of the most important changes brought by the Model Law is to centralize recognition in the bankruptcy courts using the Chapter 15 proceedings.<sup>28</sup> No court is entitled to grant comity or otherwise react to a foreign bank-

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25. See 11 U.S.C. §§ 362(d), 1520(a). These sections make section 362 applicable to the debtor and its property and therefore incorporate the grounds for lifting the stay under section 362(d), including "cause." H.R.REP. No. 109-31, at 114-15; United Nations Commission on International Trade Law (UNCITRAL), *Legislative Guide on Insolvency*, ¶ 33 (rev. 2005), available at [www.uncitral.org/pdf/english/texts/insolven/05-80722\\_Ebook.pdf](http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf).

26. See *In re Treco*, 240 F.3d 148, 154-55 (2d Cir. 2001) (requirements of section 304(c)).

27. The court relied fairly heavily on *Hoffman v. Bullmore (In re Nat'l Warranty Ins. Risk Retention Group)*, 306 B.R. 614 (B.A.P. 8th Cir.), *aff'd* 384 F.3d 959 (8th Cir. 2004), apparently because it also involved an offshore incorporation of a company whose objective COMI was undoubtedly in the United States. It did not note, however, that the decision preceded the adoption of Chapter 15, and involved vigorously objecting creditors (one of them represented by the current author). The then-applicable language of the Bankruptcy Code was much broader in identifying the debtor's location than is COMI under the 2005 Amendments that added Chapter 15. § 101(23) (amended) ("domicile, residence, principal place of business, or principal assets").

28. See Jay Lawrence Westbrook, *Chapter 15 At Last*, 79 AM. BANKR. L.J. 713, 726-27 (2005); see also H.R.REP. No. 109-31 (2005), at 111-12.

ruptcy proceeding unless Chapter 15 recognition is obtained from a bankruptcy court.<sup>29</sup> Conversely, every American court must grant comity to a foreign bankruptcy proceeding once it has received Chapter 15 recognition. These provisions highlight the importance of Chapter 15 recognition as such, aside from the grant of specific relief. They are entirely new and quite different from section 304.

The *SPhinX* opinion rests largely on the suggestion that Chapter 15 makes little real distinction between main and non-main proceedings.<sup>30</sup> With respect, that suggestion is clearly incorrect on the face of the statute. In fact, there are a number of important distinctions. For example:

1. Under section 1520, recognition of a main proceeding leads automatically to imposition of the usual stay under section 362(a). The stay can be lifted for the usual reasons, but it springs into place as soon as the relatively simple and relatively mechanical requirements of section 1517 have been satisfied.

2. Sections 1521(c) and 1523(b) sharply limit the relief that can be granted to a non-main proceeding, confining it to assets that the court specifically finds should be administered in that secondary jurisdiction.

3. Perhaps most important, recognition of a main proceeding limits any subsequent full American bankruptcy proceeding to those assets located in the territory of the United States, in sharp contrast to the usual worldwide effect of a United States bankruptcy. A non-main proceeding has no such effect.

The *SPhinX* opinion hinted that a main/non-main finding could be skipped altogether in an appropriate case, because cooperation between courts is what really matters, a proposition that fails to account for the clear language of section 1517(b)(1) that requires that the foreign proceeding be recognized as either main or non-main.

It is especially striking that the *SPhinX* court made almost no reference to the legislative history of this brand new statute. By contrast, the court in *Tri-Continental* discussed in detail both the U.S. legislative history and the background legislative history contained in the UNCITRAL Legislative Guide that accompanies the Model Law (Legislative Guide).<sup>31</sup> Instead, the *SPhinX* court cited U.S. Bankruptcy Code section 304 cases

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29. 11 U.S.C. § 1509(c)–(d) (2005).

30. *In re SPhinX*, 351 B.R. 103, 114–15 (Bankr. S.D.N.Y. 2006), *aff'd*, 2007 WL 1965597 (S.D.N.Y. July 3, 2007). Under prior law, ancillary relief was limited to foreign proceedings that were in some sense “main” by the definition of “foreign proceeding,” but the definition provided a broad menu of choices for the primary proceeding, including the state of incorporation if that were understood to be within the term “domicile.” See *In re Nat’l Warranty*, 306 B.R. at 620.

31. *In re Tri-Continental Exchange Ltd.*, 349 B.R. 627 (Bankr. E.D. Cal. 2006).

extensively, along with the EU Regulation and *Eurofood*.<sup>32</sup> Thus a key point of Chapter 15, the introduction of structure and uniformity, was ignored.

## 2. Predictability Over All

On the other hand, too exclusive a focus on predictability is also a mistake, especially if it leads to a rule that would choose legal “havens” as COMIs. One reading of *Eurofood*<sup>33</sup> would do just that if applied under the Model Law. Its emphasis on the jurisdiction of incorporation might threaten to award the COMI prize to that jurisdiction in almost every case.<sup>34</sup>

*Eurofood* has been much discussed,<sup>35</sup> so I will just sketch it briefly here. Eurofood was a subsidiary of the spectacularly fallen Parmalat group. It was incorporated in Ireland and was apparently a shell used by Bank of America in structuring financing transactions for the Parmalat group, having no actual employees, business, or operations.<sup>36</sup> The COMI question before the European Court of Justice (ECJ)<sup>37</sup> was whether, under the E.U. Regulation, the company’s center was its jurisdiction of incorporation, Ireland, or its alleged jurisdiction of administration, Italy.<sup>38</sup> The court chose the jurisdiction of incorporation with a strong emphasis on the presumption in favor of that jurisdiction.<sup>39</sup> In this section of the Article, I will discuss that sort of rule as it might be applied under the COMI provision of the Model Law. It creates two problems in that it both overemphasizes predictability and it too often chooses laws that are not in fact predictable in their results.

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32. *In re SPhinX*, 351 B.R. 103, 116–20 (Bankr. S.D.N.Y. 2006), *aff'd*, 2007 WL 1965597 (S.D.N.Y. July 3, 2007).

33. Case C-341/04, *Eurofood IFCS Ltd. v. Bank of America, N.A.*, 1999 E.C.R. I-3813 (2006).

34. *Id.* paras. 34–36.

35. Samuel L. Bufford, *Center of Main Interests, International Solvency Case Venue, and Equality of Arms: The Eurofood Decision at the European Court of Justice*, 27 NW. J. INT'L L. & BUS. 351 (2007); see also Gabriel Moss & Christoph Paulus, *The European Insolvency Regulation—The Case for Urgent Reform*, 19 INSOLVENCY INTELLIGENCE 1, 2 (2006); Christoph Paulus, *Two Comments on Advocate General Jacobs’ Opinion in the Eurofood Case*, GLOBAL TURNAROUND, Nov. 2005, available at <http://www.globalturnaround.com>.

36. In Star Trek terms, it was Crewman Number Six. See GALAXY QUEST (Dreamworks SKG 1999).

37. There were five questions all told.

38. Case C-341/04, *Eurofood IFCS Ltd. v. Bank of America, N.A.*, 1999 E.C.R. I-3813 (2006).

39. *Id.*

The first problem with a strong incorporation presumption is that we have little data about the extent or the mechanisms of reliance by creditors.<sup>40</sup> We risk giving the reliance factor much more weight than reality justifies, thus incurring too few benefits at considerable cost. One reason to be skeptical about creditor reliance is that we have weak laws about disclosure of jurisdiction of incorporation. A law requiring a corporation to disclose prominently its jurisdiction of incorporation on every piece of paper it emitted (stationery, invoices, checks, EFT documentation, etc.) would substantially increase the plausibility of such reliance, but I do not believe that such a legal regime exists today in most countries.<sup>41</sup> I have not seen a profile of Eurofood's creditors, but it would be interesting to know how many of them knew it was an Irish company.<sup>42</sup> Even if its status as a financing shell meant it had no unknowledgeable creditors, the same would not be true of cases like *National Warranty* in the United States, discussed below.<sup>43</sup> The claimed importance of creditor reliance rests on a shaky and undemonstrated premise of creditor knowledge and reliance without even a strong intuition that it is true.<sup>44</sup>

Even if creditors do know about a debtor's jurisdiction of incorporation, companies are often incorporated in legal havens—tax havens, bank secrecy havens, and the rest. Because I have many good friends who are prosperous professionals living on various enchanting islands, I will discuss a fictional island called “Outlier” where the laws are attractive to the management of corporations that are “external” or “exempted” so that they do no real business in Outlier.<sup>45</sup> A strong presumption of jurisdiction of incorporation as COMI would often choose Outlier as the COMI.

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40. Professor Paulus has offered a further insight into the reliance problem. He wants to know whose reliance is relevant. See Christoph G. Paulus, *Group Insolvency—Some Thoughts About New Approaches*, 42 TEX. INT'L L. J. (forthcoming 2007).

41. Better still would be an additional disclosure of the state of incorporation of the ultimate legal-entity parent of the corporation's corporate group.

42. Admittedly, it was a finance subsidiary, so it may not have had many non-lender creditors.

43. *Hoffman v. Bullmore (In re Nat'l Warranty Ins. Risk Retention Group)*, 306 B.R. 614 (B.A.P. 8th Cir.), *aff'd* 384 F.3d 959 (8th Cir. 2004).

44. A few creditors, primarily lenders, will engage in sufficiently large transactions with debtors that they will make it a point to learn as much as possible about the debtor's legal location, will demand representations about the relevant facts from its officers and principals, and will obtain covenants and even security interests that protect them against manipulation of the location. I believe those creditors will be able to predict COMI with a high degree of certainty in most cases under the Dual COMI approach discussed below.

45. See, e.g., *In re SPhinX*, 351 B.R. 103, 107, n.2 (Bankr. S.D.N.Y. 2006), *aff'd*, 2007 WL 1965597 (S.D.N.Y. July 3, 2007).

Outlier may have laws that are hard to find and recent enactments may not be published. The complex statutory analysis in the recent *Al Sabah* case in the Privy Council illustrates difficulties of interpretation found in the often untidy statutory residue left behind by the ebb of the colonial tide.<sup>46</sup> The law in action in Outlier may be untransparent, except to a limited bar of local lawyers and certain elite international practitioners. Thus, a creditor's knowledge that a corporation is organized in Outlier may not, in fact, produce much outcome predictability unless the creditor is engaged in a large transaction that justifies substantial expenditures on top-drawer legal assistance. That is, a rule that makes Outlier's law predictably applicable may not do much to serve the ultimate purposes of predictability. By contrast, the predictable application of British or Japanese law may be of real value. Even a creditor who does not know the details of those laws may feel comfortable that those jurisdictions would apply sensible and transparent bankruptcy laws to govern their commercial communities. A creditor who is sufficiently concerned can ascertain their substance relatively easily.

#### *B. Acceptability of the Substantive Law*

The second factor that should inform interpretation of the COMI standard is the likelihood that acceptable substantive law will be chosen. I previously summarized the arguments for application of a choice-of-law rule that would generally select the law of the main proceeding with regard to control of assets, priorities, avoidance, and reorganization policy. That connection makes the substantive law of the COMI important. It seems to me that even one who does not wholly accept that argument must concede that the substantive law of the main jurisdiction will have an important impact on outcomes under the Model Law.

On that basis, I think it is hard to resist the proposition that the interpretation of COMI under the Model Law should, to some extent, take account of the likely quality of the substantive law of the COMI jurisdiction. The argument in support of that proposition is similar to the case *against* "contractualism," the academic idea that parties should be allowed to adopt a binding bankruptcy law by contract.<sup>47</sup> A COMI that

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46. *Al Sabah v. Grupo Torras S.A.* [2005] 2 W.L.R. 904, [2005] UKPC 1.

47. See, e.g., Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 319–24 (1993); Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 776–77 (1988); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 117 (1992); Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1850–51 (1998). These theories have been roundly criticized. See, e.g., Elizabeth Warren & Jay Lawrence Westbrook, *Contracting Out of Bank-*

permits a choice of haven law is much the same as one that permits a corporation to adopt a provision in its articles setting forth a default management system that would override an otherwise applicable bankruptcy law, one of the leading contractualist approaches.<sup>48</sup> Outlier and other havens would no doubt make available just about any form of bankruptcy that managements and certain key creditors might find attractive. One great source of abuse with havens, of course, is that they regulate conduct that has no effect on the regulating jurisdiction or its citizens, so they are free to accept results that no polity would be likely to permit as applied to its own citizens or its own economy.

Bankruptcy involves many externalities not fairly or efficiently governed by contract or by a haven law. Creditors often include involuntary creditors, like tort victims and taxing authorities, as well as maladjusting creditors, like employees, small suppliers, and warranty-purchasing customers.<sup>49</sup> These creditors have little or no opportunity to understand or make credit judgments about the substantive effects of Outlier's laws, including distribution priorities and protection of creditors via monitors or creditors committees. These sorts of creditors often have no meaningful opportunity to participate in the control of the haven proceeding. The jurisdictions where these creditors reside will bear the resulting costs. Perhaps the most important difficulty is that Outlier is unlikely to have a robust, fair, and transparent reorganization process designed to save jobs and preserve communities through a financial restructuring or a sale of assets. The lack of these opportunities will create externalities that other jurisdictions must bear, while Outlier enjoys the professional fees associated with liquidation.<sup>50</sup>

The point is not that we cannot tolerate differences in laws. For some time to come, a system of modified universalism must accept differences in policy judgments and, therefore, substantive outcomes. For example, a U.S. court may be right to acquiesce in the nonrecovery of \$100 million in pre-bankruptcy payments, even though U.S. creditors would have

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*ruptcy: An Empirical Intervention*, 118 HARV. L. REV. 1197 (2005); Susan Block-Lieb, *The Logic and Limits of Contract Bankruptcy*, 2001 U. ILL. L. REV. 503, 504–508; Lynn M. LoPucki, *Contract Bankruptcy: A Reply to Alan Schwartz*, 109 YALE L.J. 317 (1999).

48. Robert K. Rasmussen, *A New Approach to Transnational Insolvencies*, 19 MICH. J. INT'L L. 1 (1997).

49. See Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 864, 881 (1996); Warren & Westbrook, *supra* note 47 (empirical study of various types of creditors).

50. See, e.g., *In re Treco*, 240 F.3d 148, 159 (2d Cir. 2001) (professional fees in Bahamas \$8 million of \$10 million estate in uncompleted case).

benefited quite substantially from a recovery.<sup>51</sup> Yet, these examples produce results that fall within a range of reasonable commercial regulation that courts and creditors in most countries can accept, given the benefits of modified universalism and assuming a growing reciprocity.<sup>52</sup> The difficulty with the application of haven law is that, both formally and in action, it is too likely to fall outside that range of acceptable outcomes. It may also lack essential procedural characteristics, such as sufficient transparency and an acceptable judicial system.

It seems to me unlikely that modified universalism could long survive a COMI rule that chose *Outlier* and its sisters to manage a worldwide default. It seems much more likely that courts would use public policy to apply local law to evade the worst results, drifting back toward territorialism. If they did not, surely legislatures would do just that soon after the first major economic downturn revealed the effects of permitting the havens to serve the dominating role. Thus, I believe that we must not adopt a COMI rule that is likely to permit havens to serve often as the COMI of a corporation whose headquarters and operations are elsewhere. Yet a strong presumption in favor of jurisdiction of incorporation might have just that effect. Thus, the most predictable rule may not be the best one under the Model Law.

It is instructive in this regard to consider the *National Warranty*<sup>53</sup> case in the United States.<sup>54</sup> *National Warranty* sold “extended” automobile warranties to thousands of people across the United States. Everything about it, except its Cayman Islands incorporation, was located in the United States. Its principal place of business was in Nebraska, a fact prominently stated on its contracts with American consumers.<sup>55</sup> It transferred all of its assets (mostly cash) to the Cayman Islands on the eve of filing bankruptcy there. It had no other assets, operations, headquarters personnel, or significant creditors in that jurisdiction. Yet it was permitted to obtain a section 304 injunction blocking all U.S. proceedings in deference to a Cayman proceeding in which there was little chance for consumers to participate.<sup>56</sup> The courts in that case held that the statutory criterion of “domicile” was sufficient to require deference to a foreign

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51. *In re Maxwell Communication Corp.*, 170 B.R. 800, 818 (Bankr. S.D.N.Y. 1994), *aff'd* 186 B.R. 807, 822 (S.D.N.Y. 1995), *aff'd*, 93 F.3d 1036, 1051 (2d Cir. 1996).

52. See Theory and Pragmatism, *supra* note 10 at 467-68.

53. *Hoffman v. Bullmore (In re Nat'l Warranty Ins. Risk Retention Group)*, 306 B.R. 614 (B.A.P. 8th Cir.), *aff'd* 384 F.3d 959 (8th Cir. 2004).

54. *Id.* I represented one of the objecting creditors in that case and therefore I am subject to the advocate's discount.

55. *Id.* at 617.

56. *Id.* at 622-23.

jurisdiction based on incorporation, without more.<sup>57</sup> They rejected the argument that they should interpret the statute otherwise because of the looming adoption of Chapter 15, under which the COMI standard would have barred recognition of the foreign proceeding as main, thus permitting a U.S. bankruptcy court to take charge of the case.<sup>58</sup> It is my belief that had Chapter 15 not arrived and had there been a few more decisions like *National Warranty*, a public outcry would have led to amendment of the Bankruptcy Code to bar such results.

Finally, I can speak with some confidence about the views of those of us who labored for some years at UNCITRAL and then worked with our legislatures to adopt the Model Law. For the purposes of the Model Law, the U.S. House Report is exactly correct in saying “[t]he presumption that the place of the registered office is also the center of the debtor’s main interest is included for speed and convenience of proof where there is no serious controversy.”<sup>59</sup> Along with the other presumptions in article 1516 of the Model Law, this one permits and encourages fast action in cases where speed may be essential, while leaving the debtor’s true “center” open to dispute in cases where the facts are more doubtful.<sup>60</sup> This presumption was never discussed as a preferred alternative where there was a separation between a corporation’s jurisdiction of incorporation and its “real seat.” The UNCITRAL Legislative Guide and the House Report on Chapter 15 make that clear.<sup>61</sup>

Judge Klein in *Tri-Continental* notes that Chapter 15 changed the Model Law standard for overcoming the presumption in favor of the jurisdiction of incorporation.<sup>62</sup> The Model Law established that presumption “[i]n the absence of *proof* to the contrary,” but the U.S. version states “[i]n the absence of *evidence* to the contrary.” The legislative history explains, “[t]he word ‘proof’ in subsection (3) has been changed to ‘evidence’ to make it clearer using United States terminology that the ultimate burden is on the foreign representative.”<sup>63</sup> Whatever may be the proper interpretation of the E.U. Regulation, the Model Law and Chapter

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57. *Id.* at 620.

58. *Id.* The argument appeared to have some bite given that Chapter 15 was unanimously recommended by an otherwise riven National Bankruptcy Review Commission and supported by the leadership on both sides of the aisle in both houses. It also faced very little opposition outside of Congress.

59. H.R. REP. NO. 109-31, at 113 (2005), reprinted in 2005 U.S.C.C.A.N. 88.

60. See *In re Tri-Continental Exchange Ltd.*, 349 B.R. at 635.

61. See *id.*; see also *In re SPhinX*, 351 B.R. 103, 120, n.22 (Bankr. S.D.N.Y. 2006), *aff'd*, 2007 WL 1965597 (S.D.N.Y. July 3, 2007).

62. See *In re Tri-Continental Exchange Ltd.*, 349 B.R. at 635.

63. H.R. REP. NO. 109-31 (2005), at 112-13 (emphasis added).

15 give limited weight to the presumption of the jurisdiction of incorporation as the COMI.

### 3. E.U. Regulation Versus Model Law

As noted earlier, the *Eurofood* case can be read to create a substantial presumption in favor of the state of incorporation.<sup>64</sup> The argument against such a strong presumption may not have as much force under the E.U. Regulation as it does under the COMI provision of the Model Law, despite their almost identical wording. The reason is that the ECJ in *Eurofood* emphasized the trust necessary for the functioning of the Union:

39. As is shown by the 22nd recital of the Regulation, the rule of priority laid down in Article 16(1) of the Regulation, which provides that insolvency proceedings opened in one Member State are to be recognized in all the Member States from the time that they produce their effects in the State of the opening of proceedings, is based on the principle of mutual trust.

40. It is that mutual trust which has enabled a compulsory system of jurisdiction to be established, which all the courts within the purview of the Convention are required to respect, and as a corollary the waiver by those States of the right to apply their internal rules on recognition and enforcement of foreign judgments in favour of a simplified mechanism for the recognition and enforcement of decisions handed down in the context of insolvency proceedings . . .<sup>65</sup>

To an American ear, this rule sounds similar to the sort of trust and deference among states dictated by the “full faith and credit” clause for the enforcement of sister state judgments in the United States.<sup>66</sup> If an E.U. court must assume that the bankruptcy laws of every other E.U. country are reasonably transparent and within the zone of reasonable commercial expectations, both formally and as applied, then much of the objection to a strong incorporation presumption falls away, especially with the ECJ’s safety-valve excluding a country of incorporation that was merely a “letter-box” headquarters. Whether these assumptions are justified is for others to say. But if there are no Outliers within the Union

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64. See *Eurofood* paras. 34–36. Other cases in that court, like the *Überseering* decision, may suggest a movement toward jurisdiction of incorporation as an acceptable location for an E.U. corporation. See Caspary, *supra* note 6.

65. *Eurofood* paras. 39–40.

66. U.S. Const. art. IV, §1. Much the same assumption of mutual trust must underlie the new domestic choice-of-law rule for secured transactions under Article 9 of the Uniform Commercial Code: state of incorporation is the debtor’s “location” and its laws apply for many purposes. U.C.C. §§ 9-307.

and if there is comfort about every possibly applicable law, then state of incorporation might provide a highly predictable COMI without much of the cost that might be incurred if a similar rule were applied under the Model Law.<sup>67</sup>

My concern is to point out that there are important differences between insolvency cooperation among member states under the E.U. Regulation and cooperation among countries under the Model Law. Thus, interpretations of the same COMI phrase may legitimately diverge in the two contexts, because the cost of predictability may be significantly smaller in intra-Union insolvency cases.

### III. THE DUAL COMI

Having discussed the key policy considerations in developing an interpretation of the COMI standard, we can now turn to the specific possibilities. I have a sense that in most countries, the standard for locating a corporation on a basis other than its place of incorporation is likely to be built on one of two concepts: the corporation's headquarters (e.g., "chief executive offices" or "real seat") or its operations (e.g., "principal assets"). Each has advantages and disadvantages as a COMI standard. I will discuss them briefly below, but the important point is that either will usually be workable. I call the pair of them the Dual COMI.<sup>68</sup>

If both of these standards are workable, then the Dual COMI rule can work a marvelous result. It can reduce the possible governing bankruptcy

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67. It must be acknowledged that such a rule might provoke a "race to the bottom" in which jurisdictions attract incorporations with lax, management-favoring rules, a charge often leveled at Delaware in the United States. *See, e.g.*, Lynn M. LoPucki, *COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS* 236–43 (2005) (venue shopping for Delaware jurisdiction); Lynn M. LoPucki & Sara D. Kalin, *The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a "Race to the Bottom"*, 54 *VAND. L. REV.* 231; Jason M. Quintana, *Going Private Transactions: Delaware's Race to the Bottom?*, *COLUM. BUS. L. REV.* 547 (2004).

68. The Federal Court of Justice has held that the COMI for an individual business person is the place of his principal revenue generation, not his family residence. BGH IX 8/06 (June 13, 2006). The court's guideline of the judgment, translated by Schultze & Braun, states:

The economic activity is a certifiable criterion that guarantees legal certainty and foreseeability of the identification of the court that is responsible for the opening of the main insolvency proceeding for merchants, tradesman and self employed persons. It is not significant that the debtor has his residence in Sweden and that, according to him, his wife lives there.

Email from Schultze & Braun to Jay Lawrence Westbrook (Jun. 18, 2007) (on file with author).

law for a multinational company from 191 countries to two. That result should be within an acceptable range of solutions given the policies discussed above, predictability and substantive acceptability.

The first point, of course, is that often the two standards will point to the same jurisdiction, especially for smaller corporations. Because nowadays more medium-sized companies are engaged in worldwide operations, many of these cases will be easily resolved under the Dual COMI. *National Warranty* is a classic instance.<sup>69</sup> Under either standard, its COMI was the United States and could not have been the Cayman Islands. The location of a COMI under the Dual COMI rule will frequently be easy for much larger companies as well. For example, it would be hard to argue that a Chapter 11 proceeding of the Ford Corporation in the United States would not be the main proceeding for that company under either standard.<sup>70</sup> Nonetheless there will be cases where it is plausible that the two standards point to different jurisdictions and we must consider how the relevant policy considerations might or might not be served by the Dual COMI.

In Part II, I discussed ignorance about the benefits of predictability. Empirical data is needed before we adopt rules that may create serious costs. Our lack of data is especially serious with regard to corporate groups, because creditors in all but the largest transactions are likely to be routinely confused about which member of the group with whom they are dealing. Until we have more data, any solution will be problematic with respect to corporate groups. In the meantime, it will be important to remember that we must hold two inconsistent thoughts in our heads at all times: we must respect the corporate form by focusing carefully on each corporation separately, yet we must also keep one eye on the effects of a rule on corporate groups.

To the extent that we intuit an importance to predictability, the Dual COMI will likely yield workable results even where two jurisdictions would qualify, because creditors are likely to have predicted that either might be home to the corporation's default. That will be especially true if, as I suggest below, predictability is enhanced by placing a thumb on the scales in favor of the headquarters standard.<sup>71</sup> The *Maxwell* case offers a good example, where the parent company's headquarters were beyond doubt in England, but its principal assets were American subsidiar-

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69. *Hoffman v. Bullmore (In re Nat'l Warranty Ins. Risk Retention Group)*, 306 B.R. 614 (B.A.P. 8th Cir.), *aff'd* 384 F.3d 959 (8th Cir. 2004).

70. Admittedly, if the corporation's North American operations collapsed while its foreign activities continued to flourish, the two COMI indicators could diverge.

71. See Jacob Ziegel, *Canada-United States Crossborder Insolvency Relations And The Uncitral Model Law*, 32 BROOK. J. INT'L L. 1041, 1072 (2007).

ies.<sup>72</sup> A creditor would have been likely to predict England as the focus of the management of any default by the parent, and would have been correct in the end, but a creditor would have been foolish to ignore the possibility that U.S. law might have an important and even dominating effect.<sup>73</sup>

Application of either side of the Dual COMI is likely to satisfy the acceptability criterion as well. It will be an unusual case where a plausible argument can be made that Outlier satisfies either branch of the test, so it will generally be true that the law to be applied in the main proceeding will be within the range of acceptable commercial regulation. Taking *Maxwell* as our example once again, the application of the legal systems of either the United Kingdom or the United States should have been both predictable and acceptable, even while we admit that greater certainty is a long-term goal to be pursued.

Judge Klein's opinion in *Tri-Continental* illustrates these points.<sup>74</sup> It is a model application of Chapter 15 that I would commend to every judge facing a COMI problem for the first time. The caveat is that it was a case apparently riddled with fraud from the very inception of the business,<sup>75</sup> so it may not be fully applicable in the more usual case.<sup>76</sup> In that case, the insurance company debtors were incorporated in St. Vincent and the Grenadines (SVG).<sup>77</sup> All of their customers and creditors were in the United States, but they had no presence in this country.<sup>78</sup> All of their twenty employees were in SVG. Fraud was the business, and it was done entirely in the islands.<sup>79</sup> All of their sales appear to have been through independent distributors in the United States or on the Internet.<sup>80</sup>

In the end, the court recognized the SVG liquidation as the main proceeding in the face of opposition from one substantial U.S. creditor that

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72. *In re Maxwell Communication Corp.*, 170 B.R. 800, 818 (Bankr. S.D.N.Y. 1994), *aff'd* 186 B.R. 807, 822 (S.D.N.Y. 1995), *aff'd*, 93 F.3d 1036, 1051 (2d Cir. 1996); see Jay Lawrence Westbrook, *The Duty to Seek Cooperation in Multinational Insolvency Cases*, in *THE CHALLENGES OF INSOLVENCY LAW REFORM IN THE 21ST CENTURY*, (Peter, et al. eds., 2006), *reprinted in* ANN. REV. OF INSOLVENCY LAW 2004 (Janis Sarra ed., 2005).

73. Presumably, the European banks would have taken their \$100 million pre-bankruptcy payment anyhow and hoped for the best in any preference litigation.

74. *In re Tri-Continental Exchange Ltd.*, 349 B.R. 627 (Bankr. E.D. Cal. 2006).

75. *See id.* at 630–31.

76. Enron, for example, was a legitimate company for many years before lapsing into fraud.

77. *In re Tri-Continental Exchange Ltd.*, 349 B.R. 627 (Bankr. E.D. Cal. 2006).

78. *Id.*

79. *Id.*

80. *Id.* Their U.S. activities seem to reflect a complete breakdown of regulation.

claimed a lien on certain funds in the United States.<sup>81</sup> Rather than yielding to the temptation to find the COMI in the United States, the court reacted to the interests of that creditor by recognizing the foreign proceeding as main, but then carefully examining the relief to be granted to ensure that the creditor was “sufficiently protected.”<sup>82</sup> The court noted that, because that the SVG liquidators were not seeking turnover, the creditor would have an opportunity to show the validity of its lien and demand section 363(c)(2) protections if the lien was upheld.<sup>83</sup> Thus, it could protect its interests, while the liquidators would have access to cash necessary to finance a plausible search for assets.

Although this case may look like a victory for the Outlier-type of jurisdiction, in fact the business of this company was carried out in SVG, unlike the business of *National Warranty* or *SPhinX*, a point not unrelated to the fraudulent nature of the business and the lack of proper U.S. regulation. In that regard, it is a bit of a sport.<sup>84</sup> However, even under these unusual circumstances, the foreign proceeding was in fact the main proceeding. The choice of SVG for that role would have been highly predictable, if the facts were known, and if anything can be said to be predictable to the victims of fraud. The case also illustrates the flexibility of Chapter 15: permitting the court to allow the case to be administered in another jurisdiction, while taking care to protect creditors if necessary. Thus, if the law of SVG should prove to create results outside of a broad range of commercial acceptability (not merely a result different from U.S. law), the court makes it clear that it is amply empowered to act protectively.

This discussion leaves open the question which of the Dual COMI should be applied, headquarters or operations? I am inclined to prefer the headquarters, but not exclusively. While I will not attempt to develop the analysis fully in this Article, I will note a few of the considerations that might be thought important pending the development of the necessary data.

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81. *Id.*

82. See *In re Tri-Continental Exchange Ltd.*, 349 B.R. at 639–40; see also 11 U.S.C. § 1522(a) (“The court may grant relief . . . only if the interests of the creditors and other interested entities, including the debtor, are sufficiently protected.”). The House Report explains that the term in Chapter 15 was changed from the Model Law’s “adequately protected” to avoid confusion with the well-established, narrower use of the latter term in American law. H.R. REP. NO. 109-31(Part I) (2005), reprinted in 2005 U.S.C.C.A.N. 88.

83. *In re Tri-Continental Exchange Ltd.*, 349 B.R. at 639; Bankruptcy Code §363(c)(2).

84. As pointed out earlier, most often an Outlier-type of jurisdiction requires that the company do no business within its borders. See *supra* text accompanying notes 45–46.

The headquarters choice of COMI will often be fairly predictable, especially for the benefit of lenders and other large creditors, and particularly when operations of a multinational are located in a number of jurisdictions. That will be true when the corporation in question is not part of a corporate group, is the parent of a corporate group, or is the only active member of a corporate group. As Gabriel Moss' insightful Article points out, in any of those circumstances, the headquarters rule offers a further advantage in permitting centralization of a corporate group in one court.<sup>85</sup> Given that some method of centralization seems essential to developing a coherent response to the default of a multinational group, that advantage to the headquarters rule is an important one.<sup>86</sup>

On the other hand, a headquarters rule will often be more manipulable than an operations rule. Some courts may feel free to disregard such manipulation, but others will not. Having an operations rule available will protect against manipulation and reduce the incentive to manipulate. This rule will also allow for the less common case where the operational center of a debtor company will actually have been much more visible to creditors than its headquarters. For these reasons, there is a case to be made for having a Dual COMI. As long as a headquarters rule is preferred, the loss of predictability arising from a dual standard will be greatly mitigated, especially since the operations standard is most likely to be applied in the unusual case when the headquarters rule is less predictable.

An independent ground of concern about a headquarters rule is that it will often prefer a developed country to a developing one, creating a risk of resistance by the latter to the creation of a universalist system. Although the problem should not be ignored, the COMI rule is just one of a hundred legal issues that create this policy tension. On balance, application of a Dual COMI rule with a preference for the headquarters standard is a good pragmatic choice for a court committed to modified universalism.

#### IV. AN EMPIRICAL AGENDA

The legal academy is leaving behind the tradition of making policy arguments that rest largely on intuition and anecdote. Increasingly, we are

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85. Moss, *supra* note 6.

86. A Working Group of the United Nations Commission on International Trade Law is currently addressing the problem of corporate groups in the context of insolvency. UNCITRAL Working Group V, [http://www.uncitral.org/uncitral/en/commission/working\\_groups/5Insolvency.html](http://www.uncitral.org/uncitral/en/commission/working_groups/5Insolvency.html) (last visited June 6, 2007). Centralization is to be sharply distinguished from "consolidation," where the corporations in the group are treated as one debtor. That is a much more serious and rare phenomenon.

demanding evidence, which, as lawyers, we should have thought to do all along. If we argue that a certain rule is more advantageous because of buyers' expectations and because sellers rely on certain facts to price their goods, we want to know that those factual assumptions have some basis. Of course, judgments have to be made pending empirical study, but we are disciplining ourselves to be tentative and unsatisfied until we have more confidence in our facts. One corollary is that an Article like this one ought to, at a minimum, set for an agenda for empirical research.

The central requirement is for more information about the degree to which creditors take into account the legal impact of a counterparty's home country in an international transaction. Do they attempt to ascertain that fact and even to try to protect against a change of COMI? Do they ignore it and hope to win a battle of forms? Do they use security interests or corporate structures to protect themselves against the risk of a bad choice of forum and choice of law? Or is insolvency such a low-probability event that they ignore it or lump it into their pricing along with hurricanes and expropriations? Do their present practices suggest methods by which a predictable and acceptable COMI could be fashioned from some pre-default system of registration or notice? What are the circumstances of different sorts of creditors (large companies, SAMI companies, consumers, involuntary creditors) in all these regards?

#### V. CONCLUSION

The two factors that should inform our understanding of the proper interpretation of the COMI standard in the EU Regulation and the Model Law are predictability and the likely quality of the chosen substantive law. In both respects, we can be content for now with a standard that is reasonably predictable and that produces reasonably acceptable substantive outcomes. The Dual COMI standard—with a preference for the headquarters alternative—does both. Additionally, despite having the same standard in both the EU Regulation and the Model Law, it is plausible that it will be permissible to interpret them somewhat differently. The reason is the predictability can safely be given more weight in the EU on the assumption that all member states have laws and procedures within the acceptable range and none of them are havens.

The traditional idea was that a journey of a thousand miles begins with a single step. We are several miles into our thousand-mile endeavor to unify and improve one important aspect of globalization, the management of the general default of a multinational corporation. It is a trip well-begun and the prospects for adventure are enticing.

# CANADA-UNITED STATES CROSS-BORDER INSOLVENCY RELATIONS AND THE UNCITRAL MODEL LAW\*

*Jacob Ziegel\*\**

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\* In preparing this Article I have drawn extensively on earlier writings by me in this area and in particular on a chapter on "Crossborder Insolvencies, the Model Law and Bill C-55" prepared by me for inclusion in a forthcoming book of essays on Bill C- 55. CANADIAN BANKRUPTCY AND INSOLVENCY LAW: BILL C-55, STATUTE C.47 AND BEYOND (Stephanie Ben-Ishai & A.J. Duggan eds., 2007).

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## I. INTRODUCTION

Until recently, Canada, and the United States were each other's closest trading partners. Doing business with a neighboring country often implies that one of the parties has a place of business in that country, especially when setting up business is as easy as it is in both these countries, and given the fact that their citizens speak a common language and share a largely common culture, including a common-law-based legal system. It is therefore safe to assume that large numbers of Canadian companies of all sizes have U.S. subsidiaries or other affiliates of some description. The same applies to U.S. companies doing business in Canada. The significance of this close business connection is that when a Canadian-based company runs into serious financial difficulties, the ramifications are also likely to be felt in the United States. The same observation applies in the reverse situation when a U.S. parent company with a Canadian subsidiary faces insolvency.

The number of reported Canadian and U.S. cross-border insolvencies appears to have been very modest before the 1970s. It has grown substantially since then, both in number and in the size of companies involved. Before 1997, Canada's insolvency legislation<sup>1</sup> contained no conflict of laws provisions and Canadian courts had to resolve cross-border issues by invoking common law conflict rules.

The situation changed in 1997. The amendments adopted that year to the Canadian Bankruptcy and Insolvency Act (BIA)<sup>2</sup> and the Companies' Creditors Arrangement Act (CCAA)<sup>3</sup> included a modest number of conflict of laws provisions. As I explain later, the 1997 amendments have had only a modest impact and Canadian courts largely continue to apply the common law rules.

In June 2005, the Canadian government introduced Bill C-55, a 147-page bill that comprised the proposed new Wage Earner Protection Program Act (WEPPA) and a massive number of amendments to the BIA and the CCAA. Among these amendments was a Canadian version of the UNCITRAL Model Cross-border Insolvency Law. Bill C-55 was enacted by the Canadian Parliament on November 25, 2005, after a House of Commons debate and House of Commons Committee hearings that were cut short by the dissolution of Parliament and the calling of a general

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1. In Canada, the federal government has exclusive jurisdiction in the matter of bankruptcy and insolvency. Constitution Act 1867, 30 & 31 Vict. Ch. 3 (U.K.), as reprinted in R.S.C., No. 5 (Appendix 1985).

2. The Bankruptcy and Insolvency Act, 1997 S.C., ch. 27 (Can.) [hereinafter BIA].

3. *Id.* The CCAA amendments are reproduced in the Appendix to this Article. See *infra* Appendix 1.

election for the members of the House of Commons. The enacted Bill C-55<sup>4</sup> provides that the Act does not come into effect until proclamation by Order in Council.<sup>5</sup>

That event has not yet occurred. The Martin government was defeated in the elections and was replaced by the Conservative government of Stephen Harper. The new administration has not so far disclosed its intentions with respect to Bill C-55, but there are many—sometimes conflicting—rumors. The common assumption is (unless new elections are forced on the government in the meantime) that Bill C-55 will be proclaimed sometime over the coming year, although probably with a substantial number of amendments.

Reactions in Canada to the Model Law provisions in Bill C-55 have been mixed. There are those who support adoption of the Model Law in principle but are concerned about the changes to the Model Law made in Bill C-55.<sup>6</sup> Another group of lawyers would have preferred to retain the status quo. However, they have reluctantly accepted the fact that Canada has no option but to follow the U.S. lead given the fact that the Model Law was approved by the U.S. Congress in 2005, as part of the Bankruptcy Abuse Prevention and Consumer Protection Act 2005 (BAPCPA). A third group of Canadian insolvency lawyers worry that some of the key concepts in the Model Law may affect the balance of power between Canadian and U.S. courts and the ability of Canadian courts to effectively protect Canadian interests vis-à-vis other states that have adopted the Model Law.

To make these concerns intelligible to a non-Canadian audience, I need to describe the pre-2005 Canadian treatment of cross-border insolvencies as well as the changes to the Model Law appearing in Bill C-55. The balance of this Article proceeds as follows. Part II describes the common

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4. Bill C-55, S.C., ch. 47 (Can.).

5. This compromise was hammered out between the then Liberal government and the Canadian Senate in return for the Senate approving the bill without studying it in committee. See also Jacob Ziegel, *The Travails of Bill C-55*, 42 CAN. BUS. L.J. 440 (2005) [hereinafter Ziegel, *Bill C-55*]. The federal elections were held in January 2006 and a Conservative government under the leadership of Stephen Harper was elected into office. The new government did not follow up on its predecessor's promise to refer the Act to the Senate for detailed study. Instead, the government gave Notice of a Ways and Means Motion on December 8, 2006 of its intention to introduce a large batch of amendments to the 2006 Act. The draft amendments were attached to the Notice. However, only two of them are relevant to the topic of this Article and they are referred to hereafter. Since the 2006 Act has not been proclaimed and will almost certainly not be proclaimed before Parliament has approved the 2007 amendments, the 2006 Act will continue to be referred to in this Article as "Bill C-55."

6. The author is a member of this group.

law position before the Supreme Court of Canada's decision in *Morguard Investments Ltd. v. De Savoye*<sup>7</sup> and the impact of that case on the recognition of foreign insolvency orders in Canada. Part III summarizes the principal features of the 1997 conflict of laws provisions in the amending legislation, and Part IV describes the treatment of corporate groups under the 1997 amendments as interpreted by Justice Farley in *Re Babcock & Wilcox Canada Ltd.*<sup>8</sup> Part V explains the techniques adopted by Canadian and U.S. courts to promote judicial cooperation in cross-border insolvencies involving Canada and the United States, and also draws attention to some cross-border cases that have caused irritation because of insufficient consultation between the U.S. and Canadian judges. Part VI explains the many differences that exist between the Model Law and Bill C-55's version of the Model Law. Finally, Part VII describes Canadian insolvency practitioners' concerns over the impact of the Model Law on the protection of Canadian interests and seeks to evaluate their merits.

## II. COMMON LAW ANTECEDENTS

Nineteenth-century English courts were already quite familiar with the types of problems thrown up by cross-border insolvency cases and had established the following principles:<sup>9</sup>

1. The initiation of domestic insolvency proceedings involving foreign debtors was governed by statutory jurisdictional rules and, where there were none, by common law jurisdictional rules. Generally speaking, those rules did not discriminate between English and foreign debtors.
2. Foreign insolvency proceedings were recognized if they were initiated in the courts of the debtor's domicile and recognition was accorded foreign insolvency administrators appointed under the domiciliary law.
3. With the exception of real estate assets, foreign insolvency administrators were also granted access to the insolvent's assets situated in England. However, and importantly:

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7. [1990] 3 S.C.R. 1077.

8. See *infra* Part IV. For a moderately detailed treatment of the corporate group insolvency problems in a comparative setting, see Jacob S. Ziegel, *Corporate Groups and Crossborder Insolvencies: A Canada-United States Perspective*, 7 *FORDHAM J. CORP. & FIN. LAW* 367 (2002) [hereinafter Ziegel, *Corporate Groups*].

9. See American Law Institute, *Transnational Insolvency: Cooperation Among the NAFTA Countries. International Statement of Canadian Bankruptcy Law* 65-69 (2003) [hereinafter *Canadian Statement*]. A shorter treatment appears in Jacob S. Ziegel, *Canadian Perspectives on Transborder Insolvencies*, 17 *BROOK. J. INT'L LAW* 539 (1991) [hereinafter Ziegel, *Transborder Insolvencies*].

4. The opening of insolvency proceedings in the foreign domiciliary jurisdiction did not preclude continuance or initiation of insolvency proceedings against the debtor in England, although it was said the English insolvency order would generally be restricted to assets of the debtor located in England.

5. Generally speaking, the English courts drew a clear distinction between jurisdictional and procedural issues involving cross-border insolvency issues (which were governed by English law) and substantive issues arising out of the administration of insolvent estates. The latter questions were governed by other choice of law principles.

This framework of rules identified England with those other jurisdictions that also adopted what has come to be known as a modified universalist approach to cross-border insolvencies.<sup>10</sup> This is in contrast with the territorialist position of other countries that did not recognize foreign insolvency orders or only recognized them if they satisfied onerous and time consuming procedural requirements in the recognizing country.<sup>11</sup> The importance of this cursory exposition of nineteenth-century and early-twentieth-century English insolvency principles is that the same precedents were generally followed in Canada.<sup>12</sup>

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10. University of Texas Law School Professor Jay Westbrook has established himself as the foremost and most articulate expositor of the modified universalist approach. *See, e.g.,* Jay Lawrence Westbrook, *A Global Solution to Multinational Default*, 98 MICH. L. REV. 2276 (2000). Professor Westbrook also served as general reporter for the American Law Institute's *Principles of Cooperation Among the NAFTA Countries* (2003).

11. There was however (and there may still be) a major exception to the generally liberal English approach and this was that a discharge of the bankrupt's debts recognized by the domiciliary law would not be recognized in England unless the discharge was also recognized by the proper law of the debt. Ziegel, *Transborder Insolvencies*, *supra* note 9, at 550; *Canadian Statement*, *supra* note 9, at 101–03. The exception generally only applied to personal insolvencies since most insolvency systems restrict discharge orders to personal insolvencies. The issue of the recognition and enforceability of foreign reorganization orders, which usually also involve at least a partial discharge of unsecured debts, is also unsettled in England. *See id.* at 103–05. *Cf.* Jay Lawrence Westbrook, *Chapter 15 and Discharge*, 13 AM. BANKR. INST. L. REV. 503 (2005). The Canadian position appears to be that the foreign reorganization order will be recognized in Canada if the appropriate jurisdiction and procedural requirements of notice, etc. are satisfied unless there are concurrent reorganizational proceedings in Canada. *See Re Cavell Insurance Co.*, [2005] O.J. No. 645, (aff'd 2006) (O.C.A.) (involving recognition of the reorganization of a solvent English insurance companies vis-à-vis Canadian policyholders). *Cf.* *Menegon v. Philip Services Corp.*, [1999] 11 C.B.R. (4th) 262 (Ont.).

12. Note however the refusal by early Maritime courts to enjoin Canadian creditors from levying execution against the Canadian based assets of foreign (usually U.S.) bankrupts. *See Canadian Statement*, *supra* note 9, at 98, n.323. This preferential treatment of local creditors, which had no source in English precedents, may have been influenced by the territorialist philosophy adopted before 1978 by many American state courts.

The early English and Canadian cases mainly involved individual bankrupts, partnerships and closely held companies. Problems engendered by the appearance of large multinational corporations did not seriously manifest themselves until the widespread economic recessions that struck Western Europe and North America in the 1980s and early 1990s. It was during this period that the British and American courts had to wrestle, among other mega cases, with the fallout from the collapse of the Maxwell Communications empire.<sup>13</sup> Similarly, courts around the globe in several dozen countries had to address the problems generated by the multibillion dollar collapse of the Bank of Credit and Commerce International (BCCI) and its many subsidiaries.<sup>14</sup> Canada too had its own multinational corporate group failures to grapple with, of which some of the most prominent were Olympia & York Developments, Bramalea Limited, Cadillac Fairview Inc., and Unitel Communications Inc.<sup>15</sup>

A striking feature of the British and Canadian approaches at this period was that there were no statutory rules to guide the courts in fashioning solutions to the cross-border aspects of the companies' operations. Nevertheless, on both sides of the Atlantic, the British, Canadian, and U.S. insolvency administrators generally managed to work out the problems harmoniously. At this time, Justice (later Lord) Hoffmann in England and U.S. Bankruptcy Judge Brozan in New York agreed on the appointment of joint administrators to direct the liquidation of the Maxwell conglomerate's assets and distribution of the proceeds. These judges also instituted the concept of direct court-to-court communication to address common problems that came to serve as an important precedent in later cases and strongly influenced provisions in the UNCITRAL Model Law.<sup>16</sup> In a similar vein, Justice Blair in Toronto agreed with Bankruptcy

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13. See Evan D. Flaschen & Ronald J. Silverman, *The Role of the Examiner as Facilitator and Harmonizer in the Maxwell Communication Corporation International Insolvency*, in CURRENT DEVELOPMENTS IN INTERNATIONAL AND COMPARATIVE CORPORATE INSOLVENCY LAW 621 (Jacob S. Ziegel, ed., 1994); see also Christopher K. Grierson, *Issues in Concurrent Insolvency Jurisdiction: English Perspectives*, in CURRENT DEVELOPMENTS IN INTERNATIONAL AND COMPARATIVE CORPORATE INSOLVENCY LAW 577, 592-93 (Jacob S. Ziegel, ed., 1994).

14. See Hal S. Scott, *Multinational Bank Insolvencies: The United States and BCCI*, in CURRENT DEVELOPMENTS IN INTERNATIONAL AND COMPARATIVE CORPORATE INSOLVENCY LAW 733 (Jacob S. Ziegel, ed., 1994); see also Grierson, *supra* note 13.

15. CASE STUDIES IN RECENT CANADIAN INSOLVENCY REORGANIZATIONS: IN HONOUR OF THE HONOURABLE LLOYD WILLIAM HOULDEN 11, 41, 151, 605 (J.S. Ziegel, & D.E. Baird eds. 1997) [hereinafter CASE STUDIES].

16. See UNCITRAL Model Law on Cross-Border Insolvency, G.A. Res. 52/158, arts. 25-27, U.N. Doc. A/RES/52/158 (Jan. 30, 1998) [hereinafter Model Law]; see also UNCITRAL, Guide to Enactment of the UNCITRAL Model Law on Cross-Border Insol-

Judge Garrity in New York on a Protocol for communication between the judges and on Principles of Cooperation between the Canadian and U.S. representatives with respect to the corporate governance of Olympia & York's U.S. subsidiaries and the Canadian parent companies.<sup>17</sup>

#### *A. The Morguard Factor*

One surprising development in Canada over the past decade has been the use Canadian courts have made of the Supreme Court of Canada's decision in *Morguard Investments Ltd. v. De Savoye*<sup>18</sup> to justify the recognition of U.S. bankruptcy proceedings in Canada, and the issuance of stay orders to protect the U.S. debtor's assets and to stay proceedings against the debtor in Canada. In *Morguard*, the Supreme Court reversed a century of Canadian precedents and held that personal presence of the defendant in the province at the time proceedings were initiated was not necessary to give the provincial court jurisdiction over the defendant.<sup>19</sup> Instead, the Supreme Court substituted the test of a "substantial connection" between the province and the defendant as the appropriate basis for the provincial court's jurisdiction.<sup>20</sup> Lower courts subsequently extended the substantial connection test to the recognition of foreign judgments in Canada. In *Beals v. Saldanha*,<sup>21</sup> decided in 2003, the Supreme Court confirmed the correctness of this interpretation of the ratio of the substantial connection test in the enforcement of a Florida money judgment.<sup>22</sup>

*Morguard* did not involve an insolvency case and, historically, Anglo-Canadian courts always applied different jurisdictional tests for the recognition of foreign insolvency orders from the tests applicable to the recognition of foreign judgments. Nevertheless, starting with Justice Lederman's judgment in *Microbiz Corp. v. Classic Software Systems Inc.*,<sup>23</sup> Canadian courts have regularly applied the *Morguard* test in recognizing foreign bankruptcy proceedings in Canada.<sup>24</sup> Not only did these courts

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veny, pt. 2, sec. V, ch. IV, U.N. Doc. A/CN.9/442 (1999) [hereinafter Guide to Enactment].

17. CASE STUDIES, *supra*, note 15, at 177.

18. [1990] 3 S.C.R. 1077, 1990 CanLII 29 (S.C.C.).

19. *Id.*

20. *Id.* (citing *Moran v. Pyle Nat'l (Can.) Ltd.*, [1975] 1 S.C.R. 393).

21. *Saldanha v. Beals*, [2003] 3 S.C.R. 416, 2003 S.C.C. 72.

22. *Id.*

23. *Microbiz Corp. v. Classic Software Sys., Inc.*, [1996] 45 C.B.R. (3d) 40 (Ont. Ct. J. (Gen. Div.)).

24. For the details, see Jacob S. Ziegel, *Corporate Groups and Canada-U.S. Cross-border Insolvencies: Contrasting Judicial Visions*, 35 CAN. BUS. L.J. 459, 477 (2002) [hereinafter Ziegel, *Judicial Visions*]. Importantly, a strikingly different approach to the recognition and enforcement of foreign insolvency orders was adopted in another Su-

change the traditional jurisdictional factor but, following the Supreme Court's lead in *Morguard*, they also emphasized the role of comity between trading nations to justify *enforcing* as well as recognizing U.S. bankruptcy proceedings in Canada.

### III. PRINCIPAL FEATURES OF 1997 AMENDMENTS

Part XIII of the 1997 BIA amendments, introducing the new statutory conflict of law rules, comprises eight sections; section 18.6 of the CCAA amendments only contains five subsections. The dominant motifs of the drafters were to encourage dual insolvency proceedings in Canada and the United States where the debtor had assets in both jurisdictions and to say nothing explicitly that would encourage Canadian courts to authorize removal of Canadian based assets by a foreign representative. This cautious approach was urged upon the drafting committee by the banking representatives who were worried that the long arm of U.S. bankruptcy courts would attempt to reach out to Canadian assets pledged as security to Canadian banks and to have them removed or realized in accordance with United States rather than Canadian bankruptcy law principles.

The focus of this partiality for cooperative proceedings appears in BIA section 268(3) and CCAA section 18.6(3).<sup>25</sup> Further emphasis on the protection of Canadian sovereignty appears in section 268(6) (Canadian courts not obliged to give effect to foreign court orders) and in section 269 (no automatic enforcement of foreign stay of proceedings orders in Canada not endorsed by a Canadian court).<sup>26</sup>

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preme Court of Canada decision, *Holt Cargo Systems v. Containerline N.V. (Trustees of)*, [2001] S.C.R. 907. In particular, see Justice Binnie's judgment for the Court, at paragraph 80, in which he describes the Canadian position as a "middle position" or "plurality approach" in contrast to the universalist approach favored by scholars such as Professor Westbrook. Justice Binnie refers to *Morguard* in his judgment, but in a different context, and he emphasizes that the traditional Canadian approach has favored coordination of Canadian and foreign insolvency proceedings rather than subordination by Canadian courts to the foreign proceedings. *Id.* para. 80. Subsequent lower court Canadian judgments have overlooked Justice Binnie's important judgment in *Holt Cargo*, partly because the facts and issues were complex in that case and, more likely, because the post-*Holt Cargo* cases involved ex parte judgments in which no one opposed recognition of the foreign insolvency order in Canada and the relief sought by the debtor.

25. CCAA section 18.6(3) reads: "An order of the court under this section may be made on such terms and conditions as the court considers appropriate in the circumstances." Companies' Creditors Arrangement Act (CCAA), R.S.C. 1985, c. C-36, s. 18.6(3).

26. These aspects of Part XIII are also emphasized in Justice Binnie's judgment in *Holt Cargo*, [2001] S.C.R. 907, paras. 82-84.

On the other hand, section 270 authorizes a foreign representative to initiate straight bankruptcy and commercial proposal proceedings in Canada, but this is not much of a concession to a foreign representative who wants to avoid the expense and delay of full-fledged Canadian proceedings. Section 271(3) is somewhat friendlier to the foreign representative. This section empowers the Canadian court, where it is satisfied that it is necessary for the protection of the debtor's estate or the interests of a creditor or creditors, to appoint a trustee as interim receiver of all or part of the debtor's Canadian property and to direct the interim receiver, *inter alia*, to take possession of that property and to exercise such control over the property and over the debtor's business in Canada as the court considers appropriate. Unlike section 268(3), section 271(3) is not predicated on the existence of concurrent insolvency proceedings in Canada and the foreign jurisdiction. Nevertheless, the section does require the appointment of a Canadian trustee if the foreign representative wants to assert any kind of control over the Canadian based assets even if the costs of doing so exceeds the value of the assets.

Given the cautious character of these provisions, it is not surprising that Canadian courts applying the *Morguard* doctrine to the recognition of foreign insolvency proceedings in Canada after 1997 often make no reference to Part XIII of the BIA or section 18.6 of the CCAA. Rightly or wrongly, they seem to have preferred the flexibility of the *Morguard* doctrine to the circumlocution of the 1997 amendments. In fact, there are few reported decisions altogether based on the 1997 amendments.

#### IV. CORPORATE GROUPS AND *RE BABCOCK & WILCOX CANADA LTD.*<sup>27</sup>

It is safe to claim that the treatment of corporate groups in cross-border insolvencies is among the most challenging issues in contemporary insolvency law. This is particularly true given that the issues are not addressed in the 1997 Canadian amendments, were not dealt with in section 304 of the U.S. Bankruptcy Code, and are not addressed in the UNCITRAL Model Law. Large multinational corporations are almost invariably organized in group form, and this for a variety of reasons—to facilitate compliance with national laws, for tax reasons, to shelter the parent company against liabilities incurred by its subsidiaries, and for administrative reasons. The degree of control exercised by the parent company over its subsidiaries will also vary considerably. It may be so complete that outsiders may not even realize that they are dealing with a separately incorporated entity. At the other end of the spectrum, the sub-

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27. For a detailed discussion of *Babcock & Wilcock*, see Ziegel, *Judicial Visions*, *supra* note 24.

sidiary may enjoy almost complete autonomy and be subject to few restraints by the parent company.

Common law and civil law jurisdictions differ in their treatment of corporate groups. In common law countries, corporate groups are often treated for tax purposes as a single entity. In the insolvency context, it is customary to distinguish between procedural and substantive consolidation of members of the group. Procedural consolidation occurs where one or more members of the group are joined in the same insolvency proceedings for administrative convenience while maintaining the separate identity of the members of the group for other purposes. Common law courts will authorize or recognize a substantive consolidation where the judge is satisfied that the affairs of the group have been conducted as if its members constituted a single entity and that creditors of individual subsidiaries will not be prejudiced by ignoring the corporate veils separating the members of the group from each other.

In Canadian and U.S. insolvency proceedings, procedural consolidations are very common. Substantive consolidations, on the other hand, are rare. Much more common are *partial* substantive consolidations involving pooling of the group's assets and similar or identical treatment of unsecured creditors' claims. Such de facto consolidations usually occur because of the existence of cross-guarantees among members of the group or the difficulty of disentangling complex financial dealings among the group members. In such cases, it will be practical considerations, not legal theory, that will determine how much de facto consolidation will occur in addressing the group's insolvency problems.

There is no explicit language in Part XIII of the BIA or section 18.6 of the CCAA that endorses this practice in cross-border insolvencies. There is no doubt however that it occurs frequently in practice.<sup>28</sup> Seen from this perspective, Justice Farley's decision in *Re Babcock & Wilcox Canada (BW Canada)*<sup>29</sup> was atypical for a number of reasons. The issue before the court was whether to extend recognition in Ontario to a stay of proceedings order<sup>30</sup> issued by bankruptcy Judge Brown in Louisiana against asbestos tort claimants against BW Canada in Canada. Judge Brown's order was made in response to a Chapter 11 petition filed by BW Canada's U.S. parent company and its U.S.-based affiliates.<sup>31</sup> The stay was

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28. See Ziegel, *Corporate Groups*, *supra* note 8, at 386–87.

29. [2000] 18 C.B.R. (4th) 157, [2000] 5 B.L.R. (3d) 75 (Ont. S.C.J. [Commercial]).

30. The order did not arise automatically under section 362 of the U.S. Bankruptcy Code, but apparently was a separate order made by Judge Brown under section 105 of the Code. Section 105 authorizes U.S. bankruptcy courts to issue such additional orders as may be necessary to carry out the provisions of the Code.

31. *Re Babcock & Wilcox Canada Ltd.*, [2000] 18 C.B.R. (4th) 157.

sought even though BW Canada, a Canadian incorporated entity, was not a party to the U.S. proceedings and was not involved in any Canadian bankruptcy proceedings.<sup>32</sup> Justice Farley recognized the chapter 11 proceedings and issued the requested stay order against potential Canadian tort claimants.<sup>33</sup>

Justice Farley followed his BW Canada judgment in two later cases, *Re Grace Canada Inc.*<sup>34</sup> and *Re Matlack Inc.*<sup>35</sup> On the other hand, Justice Molloy refused to apply the U.S. stay of proceedings order in *Braycon International Inc. v. Everest & Jennings Canadian Ltd.*<sup>36</sup> Similarly, in *Re Singer Sewing Machine Co. of Canada*,<sup>37</sup> Registrar Funduk, applying well established Anglo-Canadian precedents, expressed himself forcibly in declining to enforce the US stay order against Singer Sewing Co.'s subsidiary in Canada.<sup>38</sup>

In reaching the conclusion that he did in *BW Canada*, Justice Farley had to overcome a number of hurdles. One was that CCAA section 18.6 does not explicitly authorize the enforcement in Canada of foreign stay of proceedings orders.<sup>39</sup> Justice Farley resolved this difficulty by invoking (probably correctly) section 18.6(4) of the CCAA, which allows Canadian courts to continue to apply common law and equitable principles in cross-border insolvency proceedings.<sup>40</sup> Using this approach, Justice Farley was able to invoke the *Morguard* doctrine discussed earlier in this article. However, *Morguard* was a dubious precedent since it involved the enforcement of a money judgment in a private law setting involving two parties, not a collective insolvency proceeding with many ramifications. Furthermore, *Morguard* provides even less support for the notion that a foreign insolvency order (assuming it enjoyed equal status with a

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32. *Id.*

33. *Id.*

34. [2001] CarswellOnt 2886 (Ont. S.C.J. [Commercial]).

35. [2001] 26 C.B.R. (4th) 45, 2001 CarswellOnt 1830 (Ont. S.C.J. [Commercial]).

36. [2001] 26 C.B.R. (4th) 154, 2001 CarswellOnt 396 (Ont. S.C.J.).

37. [2000] 6 W.W.R. 598, (2000), 79 Alta. L.R. (3d) 95, [2000] 18 C.B.R. (4th) 127, 2000 CarswellAlta 155, 259 A.R. 364 (Alta. Q.B.).

38. "Comity does not require me to recognize a chapter 11 order over a Canadian company carrying on business only in Canada and whose assets are all in Canada. Who the shareholders are is irrelevant and who the creditors are is irrelevant. Under Alberta law neither gives an American bankruptcy court jurisdiction over Singer Canada." *Id.* at para. 26. In Canada's bankruptcy system, registrars in bankruptcy exercise limited judicial powers and have considerable jurisdiction in procedural matters. By agreement, registrars may also acquire jurisdiction they would not otherwise enjoy. See BIA s. 192(1).

39. CCAA section 18.6 contains no counterpart to BIA section 269.

40. The provenance of this provision is discussed in Ziegel, *Judicial Visions*, *supra* note 24, at 470-71.

foreign judgment for recognitional and enforcement purposes) was binding on a corporation that was not even a party to the foreign proceedings.

The other difficulty Justice Farley had to confront was that Part XIII of the BIA only applies to the recognition of foreign proceedings involving an insolvent debtor. The applicants in *BW Canada* did not claim that the Canadian subsidiary was insolvent. Justice Farley's answer was that "debtor" is not defined in the CCAA, only "debtor company" is, and that the section 18.6 drafters had drawn a conscious distinction between a debtor company and a debtor for the section 18.6 purposes. This author has explained elsewhere<sup>41</sup> why Justice Farley's distinction is incompatible with the drafting history of Part XIII and section 18.6.

Even if Justice Farley's distinction had been on solid ground, it would still have left unresolved the difficulty that the Canadian government's insolvency power under section 91(21) of the Constitution Act has long been held to be confined to insolvent debtors. One could make the argument that in the modern commercial environment the federal insolvency power should be construed flexibly to at least cover the members of a corporate group if the group as a whole is clearly insolvent even if there may be doubts about the solvency of individual members of the group. Justice Farley did not make the argument. If the argument had been made, the answer would not have been a foregone conclusion.

The foregoing critique of *BW Canada* may seem academic given Bill C-55's adoption of a modified version of the Model Law. The answer is that the discussion is far from academic because of important recent decisions of English and French courts and the European Court of Justice (ECJ)<sup>42</sup> addressing comparable corporate group problems under the EC Insolvency Regulation 2000.<sup>43</sup>

#### V. JUDICIAL COOPERATION IN CROSS-BORDER INSOLVENCIES

As noted above, the 1997 BIA and CCAA amendments strongly endorsed cooperative cross-border insolvency proceedings between Canadian and foreign insolvency representatives. The cooperation had long preceded adoption of the amendments and continues to occur, usually

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41. Ziegel, *Judicial Visions*, *supra* note 24, at 471–72.

42. See *Re Daisytek-ISA Ltd.* [2003] B.C.C. 562, [2004] BPIR 30 (Ch.); *Chambre commerciale et financière* [Cass. com.] [Commercial and Financial Chamber], Jun. 27, 2006, Ref. No. 03-19.683; *Case C-341/04, Eurofood IFCS Ltd. v. Bank of America, N.A.*, 1999 E.C.R. I-3813 (2006).

43. Council Regulation 1346/2000, 2000 O.J. (L 160) (EC). The Regulation replaced the EEC Draft Bankruptcy Convention of 1995, which failed to secure the support, first, of the United Kingdom and, later of Spain, for reasons unrelated to the merits of the Convention.

without even a reference to the 1987 amendments. In the larger cases, the cooperation has often been accompanied by Memoranda of Understanding on Court to Court Communication and protocols on cooperation between the Canadian and (almost invariably) U.S. administrators in the management of the joint estates.<sup>44</sup>

There is no hard data on how often Canadian and U.S. bankruptcy judges actually communicate with one another. Given the formalities and expense involved in making the arrangements and the need to notify the parties before the judges do the talking, one suspects it is not very often.<sup>45</sup> There is clear evidence, however, that the protocols have proved very useful, and are perhaps indispensable, in dealing with such common issues as the setting of dates to bar claims, the sale of assets and the distribution of proceeds from such dispositions, the classification of creditor claims, and the structure of chapter 11 and CCAA plans of reorganization for approval by the creditors and the courts. An economist would predict that the level and frequency of cooperation will depend on the efficiency gains both parties anticipate from the cooperation, which will in turn depend on the parties' bargaining strengths. If the assets are fairly evenly divided between the two jurisdictions (almost invariably Canada and the United States), one would expect the insolvency administrators to cooperate closely with each other. If, as is often the case, the Canadian operations are small in relation to the size of the U.S. operations, there will probably be great pressure on the Canadian administrator to fall into line with the U.S. proceedings. There may even be a temptation for the U.S. administrator to bypass consultation with his Canadian counterpart altogether.<sup>46</sup>

This no doubt explains the occasional friction that has arisen between Canadian and U.S. courts or between Canadian and U.S. insolvency administrators. The following are some examples:<sup>47</sup>

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44. For recent examples, see the Cross-Border Insolvency Protocols adopted in *In Re Laidlaw, Inc.*, Order, August 10, 2001, *Livent Inc.*, June 11, 1999, *Philip Service Corp.*, June 1999, *Psinet Limited*, July 10, 2001 (unpublished decisions, on file with author).

45. *But see* Jay Lawrence Westbrook, *The Duty to Seek Cooperation in Multinational Insolvency Cases*, in ANNUAL REVIEW OF INSOLVENCY LAW 2004 (Janis Sarra ed., 2005) [*hereinafter* Westbrook, *Multinational Insolvency Cases*]. Professor Westbrook emphasizes the value of court to court communication to enable the judges to acquire a better understanding of each other's bankruptcy laws and the treatment of foreign creditors' claims.

46. For such examples, see *infra* notes 47–48.

47. The examples are drawn from the outline of an unpublished presentation titled "Striving for a Level Playing Field in Canada-U.S. Cross-border Insolvency Proceedings" at an ABI Panel Discussion held in Toronto on February 11, 2005 (on file with author).

1. *Section 363 Sales.* Canadian courts have complained on a number of occasions over the past five years that U.S. bankruptcy courts have approved auction sales of assets, partly located in Canada and involving the interests of Canadian creditors, without prior notice to Canadian creditors and without the prior approval of the Canadian court.<sup>48</sup> There is no suggestion that U.S. counsel intended to slight Canadian counsel in such cases, although there may have been a lack of sensitivity about Canadian interests and Canadian sovereign rights. It has also been suggested to the author by U.S. counsel that some of the difficulties may have arise because of reluctance by U.S. creditors' committees to approve Canadian proceedings where this would involve additional costs.<sup>49</sup>

2. *Classification of Claims.* A recurring challenge is the reconciliation of conflicting treatment of creditor claims in concurrent insolvency proceedings. The classic case in Canada is *Menegon v. Philip Services Corp.*<sup>50</sup> Here, Justice Blair in Toronto (then a member of the Ontario Superior Court of Justice and now a member of the Ontario Court of Appeal) refused to approve a Chapter 11 plan.<sup>51</sup> He did so because the plan would have demoted Canadian creditors' claims to section 510(b) status without the creditors having a right to vote on the plan in the Canadian plenary proceedings as provided for in the CCAA.<sup>52</sup> The issue of conflicting characterization of securities claims is also addressed in the Third Circuit's important judgment in *Stonington Partners Inc. v. Lerner Speech Products NV.*<sup>53</sup> A striking example of a U.S. court bending over backwards in section 304 proceedings to assist in the sale of Canadian assets occurred in *Starcom Services Corp.*<sup>54</sup> In *Starcom*, the Seattle-based bankruptcy court ordered that U.S. creditors' rights be determined

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48. See, e.g., *Corporate Restructuring*, THE UPDATE (Goodmans LLP, Toronto, Ont.), Sept. 25, 2003, at 2-3, available at <http://www.goodmans.ca/pdfs%5CCorporateRestructuringUpdate.pdf> (discussing *Divine Corp./Delano Technology Corp.* proceedings and *Heller Financial Inc. v. Recoton Can. Ltd.*).

49. These difficulties would not arise in the reverse situation because Canadian creditors' committees—where they exist—exercise much less control over the administration of Canadian estates than do their counterparts in the United States in chapter 11 proceedings.

50. [1999] 11 C.B.R. (4th) 262 (Ont. S.C.J. [Commercial List]). For further discussion, see Pamela L.J. Huff & Lisa S. Corne, *Recent Developments in Cross-border Insolvencies: Application of the Proper Law in the Sale of Assets and the Claims Process* 17 NAT'L INSOLV. REV. 6, 71-75 (2000).

51. *Id.*

52. *Id.*

53. 310 F. 3d 118 (3d Cir. 2002). For further discussion, see Westbrook, *Multinational Insolvency Cases*, *supra* note 45, at 187.

54. See Huff & Corne, *supra* note 50, at 70-71; see also *US Creditors Ordered to Have Rights Determined in Canada*, OSLER UPDATE, Jan. 20, 1999 (on file with author).

in accordance with Canadian law because it would promote the just and expeditious disposition of proceedings in Canada.

3. *Denial of Section 304 Status to Canadian Corporate Group Proceedings.* This denial occurred in the *Teleglobe Inc.* case because, on the intervention of the U.S. Trustee, the U.S. bankruptcy court held that the definition of “foreign proceeding” in the U.S. Code, section 101(23), was not satisfied with respect to the U.S.-based subsidiaries.<sup>55</sup>

These examples are not intended to throw any doubt on the importance of cooperation between cross-border representatives to maximize gains in the realization of assets and to deal fairly with the various classes of creditors. They do, however, signal the need for realism in evaluating the amount of cooperation that can be expected in particular circumstances, and particularly in those cases where little cash remains for distribution among unsecured creditors after the claims of secured and preferred claimants have been satisfied.

#### IV. BILL C-55’S TREATMENT OF THE MODEL LAW<sup>56</sup>

For analytical purposes, the Part XIII provisions in Bill C-55 fall under three headings: (1) provisions that substantially replicate those in the Model Law; (2) Model Law provisions that have no counterpart in Part XIII; and (3) Part XIII provisions that depart substantially from the Model Law provisions.

##### *A. Replicated Provisions*

The replicated provisions are the following and, with one possible exception, appear to be uncontroversial: section 269, Application for recognition of Foreign Main Proceedings (FMP) and Foreign Non-Main Proceedings (FNMP); section 270, Order recognizing FMP and FNMP; section 278, Coordination of domestic and foreign proceedings and concurrent foreign proceeding; section 279, Appointment of person by Ca-

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55. J.A. Carfagnini & Melaney J. Wagner, *Insolvency in the Telecommunications Industry: A Canadian Perspective*, (Goodmans LLP, Toronto, Ont.), Feb. 23, 2003, at 14–15, available at [http://www.goodmans.ca/pdfs/Insolvency\\_in\\_the\\_Telecommunications\\_Industry.pdf](http://www.goodmans.ca/pdfs/Insolvency_in_the_Telecommunications_Industry.pdf) (comparing *Re Teleglobe Inc.* in which the corporate was denied section 304 status because its “U.S. subsidiaries did not have a domicile, residence, principle location or business or location of principle assets in a ‘foreign’ country” with *GT Group Telecom*, where the court granted section 304 relief despite the absence of any “officers or employees” in the United States).

56. For the text of revised Part XIII of the BIA as adopted in Bill C-55, see *infra* Appendix 1. As previously noted, the provisions in Bill C-55 replacing Part XIII of the BIA and Part IV of the CCAA are substantially identical. For this reason, the following analysis in the text is confined to a comparison of the Model Law and the Part XIII provisions.

nadian court to represent Canadian proceedings outside Canada for recognition purposes; and section 283, Adoption of Hotchpot rule in cross-border proceedings.

The exception involves article 16(3) of the Model Law, which is reproduced in section 268(2) of Bill C-55. Article 16(3) provides that, in the absence of proof to the contrary, the debtor's registered office, or habitual residence in the case of an individual, is presumed to be the center of the debtor's main interests, or COMI. It is arguable that the presumptions are fictitious given the ease, in the case of companies, with which a company can be incorporated or reincorporated in a jurisdiction without ever doing any business there.<sup>57</sup> Similarly, in the case of individuals, it is unlikely that an individual engaged in international trade or commerce will be conducting the business from the individual's home.<sup>58</sup>

#### *B. Model Law Provisions Not Replicated in Part XIII*

There are twelve such Model Law provisions which have no counterpart in Part XIII and they are as follows: article 3 (Conflicting treaty obligations); article 4 (Court or other authority competent to deal with recognition of foreign proceedings); article 6: (Public policy exceptions); Article 8 (Interpretation of Model Law); article 9 (Foreign representative's right of direct access to courts of forum state); article 11 (Application by foreign representative to commence proceedings under law of enacting state); article 12 (Participation of foreign representative in proceedings under law of enacting state); article 13 (Access by foreign creditors to proceedings under law of enacting state); article 14 (Notification to foreign creditors of proceedings under law of enacting state); article 22 (Protection of Interests of Creditors and Other Interested Parties); article 23 (Avoidance of acts detrimental to estate); and article 24 (Inter-

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57. A recent, but far from uncommon example, is *Re BRAC Rent-A-Car International Inc.*, [2003] 1 W.L.R. 1421, 1422. Professor Lynn LoPucki, a critic of universalist theories of recognition of cross-border insolvencies, is particularly critical of the COMI test in the EU Regulation and the Model Law, and argues that an astute lawyer looking for an hospitable insolvency climate for his client can easily cobble together the COMI ingredients to satisfy the EU Regulation and Model Law tests. *See* LYNN LOPUCKI, *COURTING FAILURE*, ch. 8 (2005). Professor LoPucki may have underestimated the value of the COMI test but he is surely right in criticizing the retention of the place of incorporation or registration test even as a first approximation.

58. To be sure, in the Internet age, it is easy enough for an entrepreneur to conduct international trade from home and, in North America, an increasing number of individual enterprises are being run from the proprietor's residence. To recognize this changing pattern is not the same, however, as suggesting that, in the absence of contrary evidence, the debtor's residence should be presumed to be the center of the debtor's main interests.

vention by foreign representative in domestic proceedings in forum state.)

Unhappily, the federal government provided no published explanation for these omissions and I can only speculate what the reasons were. Assuming my surmises are correct, I find the explanations unconvincing in several cases and antithetical to the spirit of the Model Law in a number of others. Articles 3 and 4 were presumably omitted because they are not relevant in the Canadian context. However, in my view, the exclusion of article 6 was a bad mistake. Public policy plays an important role in insolvency law and particularly so with respect to the enforcement of foreign insolvency judgments.<sup>59</sup> The same observation applies to the exclusion of article 8. Article 8 reflects a standard provision in UNCITRAL Conventions and Model Laws and is designed to promote uniform interpretation of international texts among adopting states.

Articles 11, 12, and 13 may have been omitted because the drafters perceived them to be redundant in the Canadian context, but this is sheer surmise on the author's part. Even if the Bill C-55 drafters were correct in assuming that Canadian courts would confer the rights mentioned in these articles without the rights being spelled out, there was surely no harm in making explicit what the drafters deemed to be implicit.

The omission of article 22 is even more puzzling. Article 22(1) provides that in granting relief under articles 19 or 21, the court must be satisfied that the interests of creditors and other interested parties, including the debtor's interests, are adequately protected. The omission of this article flies in the face of the long-established mantra of Canadian courts that the interests of Canadian creditors must be protected as a condition

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59. See, e.g., *Re Teleglobe Inc.* [2005] 17 C.B.R. (5th) 256. In *Teleglobe*, Justice Farley refused to enforce an order by the Superintendent of Corporations in Columbia requiring Teleglobe Inc. (T Can), the Canadian parent company of Teleglobe Columbia (T Col), to return the sum of US\$700,000 paid to it by T Col in satisfaction of a debt on the eve of T Col's insolvency proceedings on the grounds that it would be contrary to Canadian public policy to make such an order. The evidence was that the Columbian Superintendent had issued the order at the request of a major creditor of T Col. Justice Farley was of the view that an order requiring the parent company to return the money would result in a distorted distribution of the estate assets and therefore violate the basic rule of equal treatment of creditors.

It seems, moreover, that the drafters of the proposed 2007 amendments may have had second thoughts about the exclusion of article 6. See Ziegel, *Bill C-55*, *supra* note 5. The proposed amendments to section 248(2) of the 2005 BIA amendments and section 61(2) of the CCAA amendments would insert the following subsection in place of the 2005 amendments: "Nothing in this Part prevents the court from refusing to do something that would be contrary to public policy."

of the recognition of foreign insolvency orders in Canada, particularly where the debtor has Canadian-based assets.<sup>60</sup>

Just as troubling is the omission of article 23, authorizing the foreign representative to initiate proceedings in the enacting state to set aside pre-bankruptcy transactions between the debtor and a third party that violate the rule of equal treatment of creditors. Conceivably, the Canadian drafters were concerned that conferring standing on the foreign representative might be construed by a Canadian court as an invitation to apply foreign avoidance rules (particularly the U.S. Bankruptcy Code rules) that are much more draconian than are the Canadian avoidance rules. If this surmise is correct, the drafters' fears were ill founded since it is well established that standing to bring an avoidance suit and the law to be applied to determine the voidability of the transaction are quite separate issues.<sup>61</sup>

*C. Provisions that Deviate From or Have No Model Law Counterparts*

There are eleven such provisions, several of them of considerable significance. The deviating provisions are the following:

(a) Section 268(1)—the definition of FNMP in this subsection differs substantially from the definition in the Model Law. Article 2(c) of the Model Law requires the debtor to have an “establishment” in the place of the foreign proceedings. “Establishment” is defined in article 2(f) as any place of operations where the debtor carries out a non-transitory economic activity with human means and involving goods or services. Section 268(1) does not require the debtor to have an “establishment” in the foreign jurisdiction. Instead, it defines FNMP as “a foreign proceeding *other than* a foreign main proceeding.”<sup>62</sup> This suggests that a Canadian court will or may be obliged to cooperate with or recognize a foreign proceeding even if the debtor has no place of business in the foreign jurisdiction. This open-ended provision is at odds with the standard *Morguard* test adopted by Canadian courts in many recent cross-border proceedings<sup>63</sup> that there must be a substantial connection between the debtor and the foreign jurisdiction before the Canadian court will extend its assistance to the foreign order.

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60. As noted earlier, protection of Canadian creditor interests was a dominant concern of the drafters of Part XIII of the BIA in 1995.

61. *Cf. Canadian Statement, supra* note 9, at 91–92.

62. Emphasis added.

63. *See* discussion *supra* Part II.A.

(b) Section 270 deals with an order recognizing a foreign proceeding. Section 270 is more concise than Model Law article 17, but appears to impose the same essential requirements as the Model Law provision.

(c) Section 271 deals with the effect of recognition of an FMP. Section 271(2) has no counterpart in article 20 of the Model Law.<sup>64</sup> It excludes subsection (1) of article 20 entirely if BIA proceedings are in progress in Canada at the time of the foreign representative's application. Subsection (3) also has no Model Law counterpart. It makes the recognition of an FMP subject to exceptions that would apply if the foreign proceedings had taken place in Canada under the BIA. It is not clear what types of exclusions the Bill C-55 drafters had in mind. Section 271(4) also has no Model Law counterpart and may conflict with article 28 of the Model Law, which deals with proceedings in the enacting state after recognition of an FMP. Section 271(4) retains the right of parties to commence or continue proceedings under the BIA, the CCAA, or the WURA. Subsection 271(4) conflicts with the Model Law philosophy that the locus of the debtor's main interests should govern all proceedings against the debtor and that non-main proceedings against the foreign debtor in the enacting state should be confined to proceedings involving locally situated assets. Section 271(4) may need to be amended to reflect the same policy.

(d) Section 272 deals with the orders a Canadian court can make on recognition of the foreign proceedings. Section 272 has no counterpart to article 21(2) of the Model Law authorizing the forum court to approve "distribution"<sup>65</sup> of all or part of local assets to the foreign representative if the court is satisfied that the assets [sic] of local creditors are adequately protected. Presumably, the Canadian drafters were concerned that the Model Law power might be abused, but this could be said of all discretionary powers under the Model Law or the BIA. There appears to be no good reason to exclude article 21(2) of the Model Law.

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64. Section 271(2) of the Bankruptcy and Insolvency Act reads:

On application by a foreign representative in respect of a foreign proceeding commenced for the purpose of effecting a composition, an extension of time or a scheme of arrangement in respect of a debtor or in respect of the bankruptcy of a debtor, the court may grant a stay of proceedings against the debtor or the debtor's property in Canada on such terms and for such period as is consistent with the relief provided for under sections 69 to 69.5 in respect of a debtor in Canada who files a notice of intention or a proposal or who becomes bankrupt in Canada, as the case may be.

Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3, s. 271(2).

65. Query whether "distribution" should read "release" of the debtor's assets in the enacting state?

(e) Section 274 has no Model Law counterpart and provides that if a recognitional order is made respecting the foreign representative, the foreign representative may commence or continue proceedings under BIA sections 43, 46–47.1, 49, 50(1), and 50.4(1) as if the foreign representative were a creditor of the debtor. These provisions seem unobjectionable and reflect the partiality shown in existing Part XIII for Canadian initiated proceedings over recognition of foreign proceedings and foreign insolvency orders. However, section 274 *would* be objectionable if the courts used these provisions as an excuse not to recognize the foreign proceedings or for refusing the court's assistance to the foreign representative.

(f) Section 275 deals with forms of cooperation between Canadian and foreign courts. Section 275 is not as explicit as are articles 25–27 of the Model Law in spelling out the forms of cooperation between Canadian and foreign courts. It is not obvious what objections the Canadian drafters found in the more detailed Model Law provisions. It is suggested that the fuller Model Law provisions should have been retained in the interests of uniformity of the Model Law provisions among enacting countries.<sup>66</sup>

(g) Section 281 has no counterpart in the Model Law provisions. Section 281 provides that the foreign representative may make an application to the Canadian court under Part XIII, even though an appeal is pending in a foreign court. Section 281 does not state what type of appeal the drafters had in mind. Presumably it must implicate the foreign representative's standing in the Canadian proceedings since otherwise there would be no reason why the Canadian court should be concerned about the foreign representative's entitlement to bring the proceedings.

(h) Section 284(1) is another troubling provision in Bill C-55 which has no counterpart in the Model Law. Subsection 1 provides that nothing in Part XIII prevents the court on the application of a foreign representative or other interested person from applying any legal or equitable rules governing the recognition of foreign insolvency orders and assistance to foreign representatives "that are not inconsistent with the provisions of this Act." Section 284(1) is a reincarnation of existing BIA section 268(5), the CCAA counterpart of which was invoked by Justice Farley in *BW Canada*<sup>67</sup> to recognize the Chapter 11 order in Canada without requiring the US debtor to initiate new insolvency proceedings under the

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66. Happily the drafters of the proposed 2007 amendments to the BIA and the CCAA, Ziegel, *Bill C-55*, *supra* note 5, appears to have reached the same conclusion. See Proposed Draft § 59 (amending section 275(3) of the BIA) and Draft § 80 (amending section 52 of the CCAA) (on file with author).

67. *Re Babcock & Wilcox Canada Ltd.*, [2000] 18 C.B.R. (4th) 157, paras. 16–17.

BIA. The author has explained the origin of section 268(5) elsewhere and its weakening effect on sections 268(2) and (3) of the BIA.<sup>68</sup> Will section 284(1) have a similar diluting effect in new Part XIII? Can it be used to undermine the careful structure of the Model Law provisions? We cannot be sure because everything will depend on whether the court will perceive the requested order to be inconsistent with the other provisions in new Part XIII.

(i) Section 284(2) is also a carry-over from existing Part XIII, in this case, section 268(6). Section 284(2) provides that nothing in new Part XIII requires the court to make any order that is not in compliance with the laws of Canada or to enforce any order made by a foreign court. Section 268(6) was designed to prevent giving per se effect to foreign insolvency orders in Canada and to require the Canadian court's imprimatur before a foreign insolvency order could be implemented in Canada. Is there a conflict between section 284(2) and the other new Part XIII provisions? One hopes not, though one cannot be sure. The drafters of Bill C-55 would surely have done better to leave this relic of an earlier age behind them and to have shown sufficient confidence in the capacity of the new Part XIII provisions to stand on their own feet and to strike a fair balance between the interests of Canadian-based creditors and the interests of the foreign-based debtor and its foreign creditors.

#### VII. THE MODEL LAW AND CANADIAN INSOLVENCY PRACTITIONERS' REACTIONS

As noted in Part I of this Article, Canadian practitioners' reactions to the prospect of Canada adopting the Model Law have been mixed, with only a very small minority supporting the move strongly. The lack of enthusiasm by the others should be viewed not as hostility to the Model Law per se nor as disinterest in UNCITRAL's work in the international trade area. The contrary is true. Canada has been a keen supporter of UNCITRAL's goals for many years and has adopted a substantial number of the Conventions and Model Laws sponsored by UNCITRAL.<sup>69</sup>

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68. See Ziegel, *Judicial Visions*, *supra* note 24, at 470–71.

69. Some examples of these are the UNCITRAL Convention on Contracts for the International Sale of Goods, the Model Law on International Commercial Arbitrations, and the Model Law on Electronic Commerce. See, e.g., Status 1980—United States Convention on Contracts for the International Sale of Goods, [http://www.uncitral.org/uncitral/en/uncitral\\_texts/sale\\_goods/1980CISG\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/sale_goods/1980CISG_status.html) (the treaty entered into force in Canada on May 1, 1992). Canada has also signed and is in the course of ratifying the Capetown Convention on International Interests in Mobile Equipment, although the Convention was the brainchild of UNIDROIT and not UNCITRAL.

Rather, the coolness is due to two main factors. The first is that Canadian practitioners believe that Canadian and U.S. insolvency courts have established a good working relationship to resolve common cross-border insolvency problems and that the Model Law will complicate rather than simplify this rapport in the future. The second factor is that Canada is not in the same position as the United States in seeking to promote a friendlier environment world wide for the recognition of foreign insolvency orders and cooperation with foreign insolvency administrators. The United States is a global power and has many world-class companies that operate in many overseas jurisdictions. The United States therefore has strong economic and legal incentives to ensure that U.S. insolvency orders are recognized and enforced in other jurisdictions. In contrast, Canada has a very small number of world-class business enterprises and, up to now, most of its cross-border insolvency relations have been with the United States. This scenario is unlikely to change in the foreseeable future. What matters most, therefore, to Canadian insolvency practitioners is the treatment that Canadian bankruptcies and business reorganizations receive in the United States.

Among Canadian commentators on the Model Law, the critique offered by Andrew Kent, Stephanie Donaher, and Adam Maerov<sup>70</sup> is probably the most perceptive and trenchant, and is likely also to reflect the consensus of many Canadian insolvency practitioners with active experience in cross-border insolvencies. These authors could have noted that the Model Law is much longer (32 articles) than both the eight sections in BIA Part XIII and the five sections in the CCAA. However, this is not the gravamen of their complaint. Rather, their principal concerns rest on two pillars. The first is that since the 1990s, Canadian and U.S. insolvency practitioners and bankruptcy courts have established a generally very amicable and successful rapport in resolving cross-border insolvency issues and have been able to do so with skeletal or no statutory provisions to assist or guide them. The authors are concerned<sup>71</sup> that Canada's adoption of the Model Law, with its own concepts and terminol-

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70. Andrew J.F. Kent, Stephanie Donaher & Adam Maerov, *UNCITRAL, eh? The Model Law and Its Implications for Canadian Stakeholders*, in ANNUAL REVIEW OF INSOLVENCY LAW 187 (Janis Sarra ed., 2005). Mr. Kent is a senior partner at McMillan Binch Mendelsohn in Toronto and has been actively involved in many of the large cross-border insolvencies occurring in Canada over the past fifteen years. Stephanie Donaher and Adam Maerov are associates at the firm.

71. *Id.* at 196–200. For a later insightful Article, published after this Article was presented at the Brooklyn Law School symposium, see Kevin P. McElcheran & Karen S. Park, *Canadian Cross-Border Corporate Group Insolvencies: Lessons to be Learned from Europe*, in ANNUAL REVIEW OF INSOLVENCY LAW 145 (Janis Sarra ed., 2006).

ogy, will usher in a new era of uncertainty and they are not sure about the outcome. They concede that the Model Law may make little difference in the end but argue that it may take the courts some time to reach this conclusion. In the meantime, uncertainty will prevail. Given the fact that most major cross-border insolvencies involve corporate groups, the authors express particular concerns that the Model Law fails altogether to acknowledge this fact or to provide guidance as to how the Model Law provisions are to be adapted to corporate groups.

In a similar vein, the authors lament the fact that the Model Law provides no guidance as to how a company's main center of interests is to be determined when there is a dispute over whether the proceedings which the Canadian court is asked to recognize is a foreign main proceeding or a foreign non-main proceeding. In the end, however, the authors resign themselves to the likelihood of Canada adopting the Model Law because the United States has done so, and that this will make it necessary in any event for Canadian judges and insolvency practitioners to familiarize themselves with the Model Law concepts and provisions.

I agree with the authors' conclusions. I also believe, however, that the authors' concerns about the Model Law's failure to address the needs of corporate groups and the uncertainty concerning a company's center of main interests are exaggerated and are unlikely to engender the great uncertainty they fear. It is true that adoption of the Model Law will require Canadian courts and insolvency practitioners to master a new set of rules and procedures, but this should not be difficult. Procedurally and substantively, the Model Law rules are quite consistent with the cross-border practices developed between Canadian and U.S. courts and between Canadian and U.S. insolvency practitioners. There is no reason why that cooperation cannot proceed as effectively under the Model Law as it has proceeded up to now outside the Model Law; on the contrary, articles 25–30 of the Model Law place great emphasis on the importance of close cooperation between courts, administrators, and insolvency practitioners in cross-border insolvencies.

Canadian creditors should also feel reassured that article 28 makes it clear that Canada will not have to surrender its own insolvency jurisdiction with respect to Canadian-based assets even if an FMP is in progress in the United States or elsewhere.<sup>72</sup> Equally important is the fact that the

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72. Model Law, *supra* note 16, article 28 reads:

After recognition of a foreign main proceeding, a proceeding under [*identify laws of the enacting State relating to insolvency*] may be commenced only if the debtor has assets in this State; the effects of that proceeding shall be restricted to the assets of the debtor that are located in this State and, to the extent

only mandatory consequence flowing from an FMP is that Canadian courts will have to recognize the proceedings, to order a stay of proceedings, and to cooperate with the foreign court and the foreign administrator.<sup>73</sup>

In this author's view, the concerns expressed by Kent, Donaher, and Maerov<sup>74</sup> over the difficulties of establishing an insolvent debtor company's COMI are inflated. The E.U. cases reported so far are consistent with the results Canadian and U.S. courts might have been expected to reach under similar circumstances. Significantly, Justice Farley, a leading and very experienced Canadian insolvency judge, encountered no difficulty in applying the COMI test in one of the last decisions rendered by him in early 2006, before his retirement from the bench.<sup>75</sup>

The Model Law's failure to deal explicitly with the status and treatment of corporate groups is not surprising. Nor is it fatal. Canadian, British, U.S., and many other insolvency laws are equally silent on this question and it would have been surprising if the Model Law had ventured into this complex area. There is no single, simple solution. A procedural consolidation will be appropriate in some cases, a partial consolidation in others, and a complete consolidation in a third set of cases. What is important to note is that the *Daisytek* litigation<sup>76</sup> conducted under the E.U. Insolvency Regulation shows that the COMI concept is capable of addressing an important facet of corporate group problems without the

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necessary to implement cooperation and coordination under articles 25, 26 and 27, to other assets of the debtor that, under the law of this State, should be administered in that proceeding.

73. I believe these Model Law provisions go a long way to answering the concerns of McElcheran & Park, *supra* note 71, that the distinction emphasized in the Model Law between recognition of FMP and NFMP may militate against Canadian and U.S. bankruptcy courts continuing to address cross-border insolvency problems in the same pragmatic way as in the past. Canadian courts will not be obliged to accept the U.S. court's finding with respect to the debtor's COMI, but will be free to make its own determination, and even if the Canadian court accepts the U.S. court's COMI determination, the Canadian courts will still be left with ample Model Law powers to protect the interests of Canadian creditors with respect to Canadian-based assets, to authorize Canadian insolvency proceedings, and to encourage close cooperation between the Canadian and U.S. insolvency administrators.

74. Kent, Donaher & Maerov, *supra* note 70.

75. *Re MuscleTech Research & Development Inc.*, [2006] O.J. No. 167 QUICKLAW, 2006 CarswellOnt 264 (Ont. S.C.J. [Commercial List]). The case involved the granting of an initial CCA order for a Canadian-based corporate group with assets in the United States. Justice Farley anticipated the parties applying to a U.S. bankruptcy court for recognition of the Canadian proceedings as a FMP under Chapter 15 and therefore presumably thought it helpful for him to express his own view about the corporate group's COMI.

76. *Re Daisytek-ISA Ltd.* [2003] B.C.C. 562, [2004] BPIR 30 (Ch.).

Regulation even mentioning the words “corporate group!” There is no reason to think that the definition of FMP in article 2 of the Model Law is not just as amenable to reaching the same result. However, the results will be different. The Model Law contains no choice-of-law rules, as the E.U. Regulation does, for determining substantive issues and priorities among competing creditors in the distribution of debtor’s assets. It may be expected, therefore, that Canadian courts will continue to be as protective as they have been up until now to safeguard the interests of Canadian creditors and to ensure that Canadian-based assets are not liquidated with the proceeds disbursed to the detriment of Canadian creditors.

APPENDIX 1: SECTION 18.6 OF THE COMPANIES' CREDITORS ARRANGEMENT ACT AS ADDED BY THE 1997 AMENDMENTS

**18.6** (1) In this section,

“foreign proceeding”

« *procédures intentées à l'étranger* »

“foreign proceeding” means a judicial or administrative proceeding commenced outside Canada in respect of a debtor under a law relating to bankruptcy or insolvency and dealing with the collective interests of creditors generally;

“foreign representative”

« *représentant étranger* »

“foreign representative” means a person, other than a debtor, holding office under the law of a jurisdiction outside Canada who, irrespective of the person's designation, is assigned, under the laws of the jurisdiction outside Canada, functions in connection with a foreign proceeding that are similar to those performed by a trustee in bankruptcy, liquidator or other administrator appointed by the court.

Powers of court

(2) The court may, in respect of a debtor company, make such orders and grant such relief as it considers appropriate to facilitate, approve or implement arrangements that will result in a co-ordination of proceedings under this Act with any foreign proceeding.

Terms and conditions of orders

(3) An order of the court under this section may be made on such terms and conditions as the court considers appropriate in the circumstances.

Court not prevented from applying certain rules

(4) Nothing in this section prevents the court, on the application of a foreign representative or any other interested person, from applying such legal or equitable rules governing the recognition of foreign insolvency

orders and assistance to foreign representatives as are not inconsistent with the provisions of this Act.

Court not compelled to give effect to certain orders

(5) Nothing in this section requires the court to make any order that is not in compliance with the laws of Canada or to enforce any order made by a foreign court.

Court may seek assistance from foreign tribunal

(6) The court may seek the aid and assistance of a court, tribunal or other authority in a foreign proceeding by order or written request or otherwise as the court considers appropriate.

Foreign representative status

(7) An application to the court by a foreign representative under this section does not submit the foreign representative to the jurisdiction of the court for any other purpose except with regard to the costs of the proceedings, but the court may make any order under this section conditional on the compliance by the foreign representative with any other order of the court.

Claims in foreign currency

(8) Where a compromise or arrangement is proposed in respect of a debtor company, a claim for a debt that is payable in a currency other than Canadian currency shall be converted to Canadian currency as of the date of the first application made in respect of the company under section 10 unless otherwise provided in the proposed compromise or arrangement.

## APPENDIX 2: PART XIII OF THE BIA AS SUBSTITUTED BY BILL \*\*\*

## CROSS-BORDER INSOLVENCIES

## Purpose

**267.** The purpose of this Part is to provide mechanisms for dealing with cases of cross-border insolvencies and to promote

(a) cooperation between the courts and other competent authorities in Canada with those of foreign jurisdictions in cases of cross-border insolvencies;

(b) greater legal certainty for trade and investment;

(c) the fair and efficient administration of cross-border insolvencies that protects the interests of creditors and other interested persons, and those of debtors;

(d) the protection and the maximization of the value of debtors' property; and

(e) the rescue of financially troubled businesses to protect investment and preserve employment.

## Interpretation

**268.** (1) The following definitions apply in this Part.

"foreign court" means a judicial or other authority competent to control or supervise a foreign proceeding.

"foreign main proceeding" means a foreign proceeding in a jurisdiction where the debtor has the centre of the debtor's main interests.

"foreign non-main proceeding" means a foreign proceeding, other than a foreign main proceeding.

"foreign proceeding" means a judicial or an administrative proceeding, including an interim proceeding, in a jurisdiction outside Canada dealing with creditor's collective interests generally under any law relating to bankruptcy or insolvency in which a debtor's property and affairs are subject to control or supervision by a foreign court for the purpose of reorganization or liquidation.

"foreign representative" means a person or body, including one appointed on an interim basis, who is authorized, in a foreign proceeding in respect of a debtor, to

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\*\*\* See also *supra*, notes 59 & 66, with respect to proposed 2007 amendments to these provisions.

- (a) administer the debtor's property or affairs for the purpose of reorganization or liquidation; or
  - (b) act as a representative in respect of the foreign proceeding.
- (2) For the purposes of this Part, in the absence of proof to the contrary, a debtor's registered office and, in the case of a debtor who is an individual, the debtor's ordinary place of residence are deemed to be the centre of the debtor's main interests.

#### Recognition of Foreign Proceeding

**269.** (1) A foreign representative may apply to the court for recognition of the foreign proceeding in respect of which he or she is a foreign representative.

(2) Subject to subsection (3), the application must be accompanied by

(a) a certified copy of the instrument, however designated, that commenced the foreign proceeding or a certificate from the foreign court affirming the existence of the foreign proceeding;

(b) a certified copy of the instrument, however designated, authorizing the foreign representative to act in that capacity or a certificate from the foreign court affirming the foreign representative's authority to act in that capacity; and

(c) a statement identifying all foreign proceedings in respect of the debtor that are known to the foreign representative.

(3) The court may, without further proof, accept the documents referred to in paragraphs (2)(a) and (b) as evidence that the proceeding to which they relate is a foreign proceeding and that the applicant is a foreign representative in respect of the foreign proceeding.

(4) In the absence of the documents referred to in paragraphs (2)(a) and (b), the court may accept any other evidence of the existence of the foreign proceeding and of the foreign representative's authority that it considers appropriate.

(5) The court may require a translation of any document accompanying the application.

**270.** (1) If the court is satisfied that the application for the recognition of a foreign proceeding relates to a foreign proceeding and that the applicant is a foreign representative in respect of that foreign proceeding, the court shall make an order recognizing the foreign proceeding.

(2) The court shall specify in the order whether the foreign proceeding is a foreign main proceeding or a foreign non-main proceeding.

**271.** (1) Subject to subsections (2) to (4), on the making of an order recognizing a foreign proceeding that is specified to be a foreign main proceeding,

(a) no person shall commence or continue any action, execution or other proceedings concerning the debtor's property, debts, liabilities or obligations;

(b) if the debtor carries on a business, the debtor shall not, outside the ordinary course of the business, sell or otherwise dispose of any of the debtor's property in Canada that relates to the business and shall not sell or otherwise dispose of any other property of the debtor in Canada; and

(c) if the debtor is an individual, the debtor shall not sell or otherwise dispose of any property of the debtor in Canada.

(2) Subsection (1) does not apply if any proceedings under this Act have been commenced in respect of the debtor at the time the order recognizing the foreign proceeding is made.

(3) The prohibitions in paragraphs (1)(a) and (b) are subject to the exceptions specified by the court in the order recognizing the foreign proceeding that would apply in Canada had the foreign proceeding taken place in Canada under this Act.

(4) Nothing in subsection (1) precludes the commencement or the continuation of proceedings under this Act, the *Companies' Creditors Arrangement Act* or the *Winding-up and Restructuring Act* in respect of the debtor.

**272.** (1) If an order recognizing a foreign proceeding is made, the court may, on application by the foreign representative who applied for the order, if the court is satisfied that it is necessary for the protection of the debtor's property or the interests of a creditor or creditors, make any order that it considers appropriate, including an order

(a) if the foreign proceeding is a foreign non-main proceeding, imposing the prohibitions referred to in paragraphs 271(1)(a) to (c) and specifying the exceptions to those prohibitions, taking subsection 271(3) into account;

(b) respecting the examination of witnesses, the taking of evidence or the delivery of information concerning the debtor's property, affairs, debts, liabilities and obligations;

(c) entrusting the administration or realization of all or part of the debtor's property located in Canada to the foreign representative or to any other person designated by the court; and

(d) appointing a trustee as receiver of all or any part of the debtor's property in Canada, for any term that the court considers appropriate and directing the receiver to do all or any of the following, namely,

(i) to take possession of all or part of the debtor's property specified in the appointment and to exercise the control over the property and over the debtor's business that the court considers appropriate, and

(ii) to take any other action that the court considers appropriate.

(2) If any proceedings under this Act have been commenced in respect of the debtor at the time an order recognizing the foreign proceeding is made, an order made under subsection (1) must be consistent with any order that may be made in any proceedings under this Act.

(3) The making of an order under paragraph (1)(a) does not preclude the commencement or the continuation of proceedings under this Act, the *Companies' Creditors Arrangement Act* or the *Winding-up and Restructuring Act* in respect of the debtor.

**273.** An order under this Part may be made on any terms and conditions that the court considers appropriate in the circumstances.

**274.** If an order recognizing a foreign proceeding is made, the foreign representative may commence or continue any proceedings under sections 43, 46 to 47.1 and 49 and subsections 50(1) and 50.4(1) in respect of a debtor as if the foreign representative were a creditor of the debtor, or the debtor, as the case may be.

### Obligations

**275.** (1) If an order recognizing a foreign proceeding is made, the court shall cooperate, to the maximum extent possible, with the foreign representative and the foreign court involved in the foreign proceeding.

(2) If any proceedings under this Act have been commenced in respect of a debtor and an order recognizing a foreign proceeding is made in respect of the debtor, every person who exercises any powers or performs duties and functions in any proceedings under this Act shall cooperate, to the maximum extent possible, with the foreign representative and the foreign court involved in the foreign proceeding.

**276.** If an order recognizing a foreign proceeding is made, the foreign representative who applied for the order shall

(a) without delay, inform the court of

(i) any substantial change in the status of the recognized foreign proceeding,

(ii) any substantial change in the status of the foreign representative's authority to act in that capacity, and

(iii) any other foreign proceeding in respect of the same debtor that becomes known to the foreign representative; and

(b) publish, without delay after the order is made, once a week for two consecutive weeks, or as otherwise directed by the court, in one or more newspapers in Canada specified by the court, a notice containing the prescribed information.

#### Multiple Proceedings

**277.** If any proceedings under this Act in respect of a debtor are commenced at any time after an order recognizing the foreign proceeding is made,

(a) the court shall review any order made under section 272 and, if it determines that the order is inconsistent with any orders made in the proceedings under this Act, the court shall amend or revoke the order; and

(b) if the foreign proceeding is a foreign main proceeding, the court shall make an order terminating the application of the prohibitions in paragraphs 271(1)(a) to (c) if the court determines that those prohibitions are inconsistent with any similar prohibitions imposed in the proceedings under this Act.

**278.** (1) If, at any time after an order is made in respect of a foreign non-main proceeding in respect of a debtor, an order recognizing a foreign main proceeding is made in respect of the debtor, the court shall review any order made under section 272 in respect of the foreign non-main proceeding and, if it determines that the order is inconsistent with any orders made under that section in respect of the foreign main proceedings, the court shall amend or revoke the order.

(2) If, at any time after an order is made in respect of a foreign non-main proceeding in respect of the debtor, an order recognizing another foreign non-main proceeding is made in respect of the debtor, the court shall, for the purpose of facilitating the coordination of the foreign non-main proceedings, review any order made under section 272 in respect of the first recognized proceeding and amend or revoke that order if it considers it appropriate.

#### Miscellaneous Provisions

**279.** The court may authorize any person or body to act as a representative in respect of any proceeding under this Act for the purpose of having them recognized in a jurisdiction outside Canada.

**280.** An application by a foreign representative for any order under this Part does not submit the foreign representative to the jurisdiction of the court for any other purpose except with regard to the costs of the proceedings, but the court may make any order under this Part conditional on the compliance by the foreign representative with any other court order.

**281.** A foreign representative is not prevented from making an application to the court under this Part by reason only that proceedings by way of appeal or review have been taken in a foreign proceeding, and the court may, on an application if such proceedings have been taken, grant relief as if the proceedings had not been taken.

**282.** For the purposes of this Part, if a bankruptcy, an insolvency or a reorganization or a similar order has been made in respect of a debtor in a foreign proceeding, a certified copy of the order is, in the absence of evidence to the contrary, proof that the debtor is insolvent and proof of the appointment of the foreign representative made by the order.

**283.** (1) If a bankruptcy order, a proposal or an assignment is made in respect of a debtor under this Act, the following shall be taken into account in the distribution of dividends to the debtor's creditors in Canada as if they were a part of that distribution:

(a) the amount that a creditor receives or is entitled to receive outside Canada by way of a dividend in a foreign proceeding in respect of the debtor; and

(b) the value of any property of the debtor that the creditor acquires outside Canada on account of a provable claim of the creditor or that the creditor acquires outside Canada by way of a transfer that, if the transfer were subject to this Act, would be a preference over other creditors or a transfer at undervalue.

(2) Despite subsection (1), the creditor is not entitled to receive a dividend from the distribution in Canada until every other creditor who has a claim of equal rank in the order of priority established under this Act has received a dividend whose amount is the same percentage of that other creditor's claim as the aggregate of the amount referred to in paragraph (1)(a) and the value referred to in paragraph (1)(b) is of that creditor's claim.

**284.** (1) Nothing in this Part prevents the court, on the application of a foreign representative or any other interested person, from applying any legal or equitable rules governing the recognition of foreign insolvency

orders and assistance to foreign representatives that are not inconsistent with the provisions of this Act.

(2) Nothing in this Part requires the court to make any order that is not in compliance with the laws of Canada or to enforce any order made by a foreign court.

APPENDIX 3. TABLE OF CONCORDANCE OF UNCITRAL MODEL LAW,  
BAPCA CH. XV, AND BILL C-55'S VERSION OF MODEL LAW

Model Law	BAPCPA 2005, ch. 15	Bill C-55	
		<i>BIA</i> , Part XIII	<i>CCAA</i> , Part IV
Preamble	s. 1501(a)	s. 267 Preamble (minor verbal changes)	s. 44 Preamble
CH. I. GENERAL PROVISIONS			
Article 1 Scope of application	s. 1501(b)	—	—
Article 2 Definitions (a) "Foreign proceeding" (b) "Foreign main pro- ceeding" (c) "Foreign non-main proceeding" (d) "Foreign representa- tive" (e) "Foreign court" (f) "Establishment"	s. 1502	s. 268(1) Definitions (definition of "establishment;" Art. 2(f) of ML is omitted)  s. 268(2) Presumption re centre of main interest	s. 45(1) Definitions (definition of "foreign repre- sentative" is different from definition in s. 268(1); ditto. s. 45(2))
Article 3 International obligations of this state	s. 1503	—	—
Article 4 Competent court or au- thority	—	—	—

Article 5 Authorization of <i>[insert the title...]</i> to act in a foreign state	s. 1505	s. 279	s. 56
Article 6 Public policy exceptions	s. 1506	—	No provision in Bill C-55 but see text, <i>supra</i> , note 59.
Article 7 Additional assistance under other laws	s. 1507	—	—
Article 8 Interpretation of Model Law	s. 1508	—	—
CH. II. ACCESS OF FOREIGN REPRESENTATIVES AND CREDITORS TO COURTS IN THIS STATE			
Article 9 Right of direct access	s. 1509	—	—
Article 10 Limited jurisdiction	s. 1510	s. 280 Foreign representative status	s. 57 Foreign representative status
Article 11 Application by a foreign representative to commence a proceeding under <i>[identify laws of enacting state...]</i>	s. 1504	s. 274 Foreign representative may bring proceedings under BIA ss. 43, 46-47.1, 49, 50(1) & 50.4(1)	—
Article 12 Participation of foreign representative	s. 1512	—	—
Article 13 Access of foreign creditors	s. 1513	—	—

to a proceeding under <i>[identify laws of the enacting state relating to insolvency]</i>			
Article 14 Notification to foreign creditors of a proceeding under <i>[identify laws of the enacting state relating to insolvency]</i>	s. 1514	—	—
CH. III. RECOGNITION OF A FOREIGN PROCEEDING AND RELIEF			
Article 15 Recognition of a foreign proceeding and of a foreign representative	s. 1515	ss. 269 & 270 Application for recognition of a foreign proceeding	ss. 46 & 47 Application for recognition of a foreign proceeding
Article 16 Presumptions concerning recognition	s. 1516	—	—
Article 17 Decision to recognize foreign proceedings	s. 1517	—	—
Article 18 Foreign representative's duty to report subsequent information	s. 1518	—	—
Article 19 Relief upon application for recognition of a foreign proceeding	s. 1519	—	—
Article 20 Effects of recognition of a foreign main proceeding	s. 1520	s. 271 Effects of recognition of an FMP	s. 48 Order relating to recognition of an FMP
Article 21 Relief that may be granted upon recognition of a foreign proceeding	s. 1521	s. 272 Orders	s. 49 s. 272(d) is omitted

Article 22 Protection of creditors and other interested persons	s. 1522	—	—
Article 23 Actions to avoid acts detrimental to creditors	s. 1523	—	—
Article 24 Intervention by a foreign representative in actions in this state	s. 1524	—	—
CH. IV. COOPERATION WITH FOREIGN COURTS AND FOREIGN REPRESENTATIVES			
Article 25 Authorization of cooperation and direct communication with foreign courts	s. 1525	s. 275 Cooperation between courts	s. 52 Cooperation between courts
Article 26 Cooperation and Direct communication between . . .	s. 1526 Cooperation between trustee & foreign courts & with foreign representative	s. 276 Obligations of foreign representative	s. 53 Obligations of foreign representative
Article 27 Forms of Cooperation	s. 1527 Forms of cooperation	No details, but see text, <i>supra</i> , note 66	Same
CH V. CONCURRENT PROCEEDINGS			
Article 28 Concurrent proceedings	s. 1528 Commencement of case after recognition of FMP	ss. 277 & 278 Concurrent proceedings	ss. 54 & 55 Concurrent proceedings
Article 29 Coordination of proceedings under...and a foreign proceeding	s. 1529	s. 278	s. 54

Article 30 Coordination of more than one foreign proceeding	s. 1530	s. 278	s. 55
Article 31 Presumption of insolvency based on FMP	s. 1531	s. 282	s. 59
Article 32 Rule of payment of creditors	s. 1532	s. 283	s. 60
—	—	s. 284(1) Preservation of legal/ equitable rules re recognition of FP	s. 61(1)
—	—	s. 284(2) No per se effect of foreign orders in Canada	s. 61(2)

Abbreviations:

ML—Model Law

FR—Foreign Representative

FMP—Foreign Main Proceeding

FP—Foreign Proceedings

# LEGITIMACY, TECHNOLOGY, AND LEVERAGE: THE BUILDING BLOCKS OF INSOLVENCY ARCHITECTURE IN THE DECADE PAST AND THE DECADE AHEAD\*

Terence C. Halliday\*\*

I participate in this conference as a thorn among roses. Since I am a social scientist, and more precisely, a sociologist of law, my concern is less with doctrine and more with institutions. I shall be asking: How did the advances of the past ten years come about? What are the preconditions for “maintaining the momentum,” as Ian Fletcher puts it?<sup>1</sup> And, not least, what are the conditions under which the writing of norms or design of insolvency systems will actually be implemented? The ultimate test of all this diligent construction of an insolvency architecture comes at the moment of practice. In the classic terminology of sociolegal scholarship, under what conditions will “law-on-the-books” become “law-in-action?”<sup>2</sup>

Today I shall sketch the outlines of a theory of institutional development. This draws in part upon my book, *Globalization, Law and Markets*, which I am currently completing with economic sociologist, Bruce Carruthers. In this case the institution is the framework or set of institutional configurations I shall call the global insolvency architecture. By “development” I refer to the process by which disparate, scattered, and ad hoc efforts become integrated into a coherent framework of institutional cooperation that purports to provide a comprehensive set of norms for governing national and cross-national bankruptcy.

I shall develop my argument through four steps. First, I shall look back over the past decade and argue that the development of the insolvency field that we celebrate at this conference can be understood through a political logic of bringing into alignment three elements of an effective

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1. Ian F. Fletcher, *Maintaining the Momentum: The Continuing Quest for Global Standards and Principles to Govern Cross-Border Insolvency*, 32 BROOK. J. INT'L L. 767 (2007).

2. See generally RICHARD LEMPert & JOSEPH SANDERS, AN INVITATION TO LAW AND SOCIAL SCIENCE (1986). See also JOHN R. SUTTON, LAW/SOCIETY: ORIGINS, INTERACTIONS, AND CHANGE 11 (2001).

architecture: legitimacy, technology, and leverage. Second, I shall look forward and point to challenges that the advance of the international bankruptcy field will confront as it seems to build upon the solid foundation already in place. Third, I bring us back to the ultimate test: the likelihood that even the most elegant and seamless of norms and structures will be effective in practice. I shall pose this as the enduring problem of the implementation gap. Finally, I shall raise some questions about the variability of bankruptcy regimes as they confront varieties of capitalism.

These observations derive from a research program I have been undertaking for a number of years. It has three elements: (1) a quantitative, cross-sectional, and time-series analysis of all bankruptcy reforms from 1973 to 1998; (2) an intensive study of bankruptcy initiatives by international organizations; and (3) three case studies of bankruptcy reforms in China, Indonesia, and Korea since the Asian Financial Crisis.<sup>3</sup>

#### I. THE PAST TEN YEARS: AN INSTITUTIONAL THEORY OF LEGITIMATION AND POWER

In 1995 there was no comprehensive, coherent global set of standards for national bankruptcy regimes. As we turned the millennium in 2000 at least four potentially competing sets of standards were in the public domain—the World Bank *Principles for Effective Insolvency and Creditor Rights Systems (Principles)*,<sup>4</sup> the International Monetary Fund's (IMF) *Orderly and Effective Insolvency Procedures*,<sup>5</sup> the Asian Development Bank's (ADB) standards,<sup>6</sup> and the European Bank for Reconstruction and Development's (EBRD) surveys<sup>7</sup>—with others pending. By 2005 these four had essentially been unified in a single global standard represented by the integration of the United Nations Commission on Interna-

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3. See Bruce G. Carruthers & Terence C. Halliday, *Negotiating Globalization: Global Scripts and Intermediation in the Construction of Asian Insolvency Regimes*, 31 LAW & SOC. INQUIRY 521 (2006); Terence C. Halliday & Bruce G. Carruthers, *The Recursivity of Law: Global Norm Making and National Lawmaking in the Globalization of Corporate Insolvency Regimes*, 112 AM. J. SOC. 1135 (2007) [hereinafter Halliday & Carruthers, *Recursivity of Law*].

4. World Bank, *Principles for Effective Insolvency and Creditor Rights Systems* (rev. 2005), available at [http://www.worldbank.org/ifa/rosc\\_ocr.html](http://www.worldbank.org/ifa/rosc_ocr.html).

5. International Monetary Fund (IMF), *Orderly and Effective Insolvency Procedures: Key Issues* (1999), available at <http://www.imf.org/external/pubs/ft/orderly/index.htm>.

6. Asian Development Bank (ADB), *Law and Policy Reform at the Asian Development Bank*, at 10–85 (Apr. 2000), available at [http://www.adb.org/Documents/Others/Law\\_ADB/lpr\\_2000\\_1.pdf](http://www.adb.org/Documents/Others/Law_ADB/lpr_2000_1.pdf).

7. European Bank for Reconstruction and Development (EBRD), *Transition Report 1999: Ten Years of Transition* (1999).

tional Trade Law's (UNCITRAL) *Legislative Guide on Insolvency (Legislative Guide or Guide)*<sup>8</sup> with the World Bank *Principles*. How was it possible for the world's disparate bankruptcy specialists, competing nation-states, and sometimes contending international organizations to get from the inchoate state of 1995 to the global consensus of 2005? That question can be answered at many levels. Let me offer a sociological perspective.

The propagation of an effective global standard by an international organization requires three elements. The organization and its product must be seen as *legitimate*. The organization must select or create a *technology* that is fitted to the task. And the legitimate technology must be disseminated with a *leverage* appropriate for implementation. We interpret the movement towards a single global standard in the bankruptcy area as a series of trial and error steps towards normative models that combined legitimacy, technology, and leverage. Let me explain.

#### A. Legitimacy

If the purpose of global actors is to facilitate the adoption of global norms by nation-states, then they must be seen as legitimate.<sup>9</sup> It is clear that most international organizations (IOs) most of the time either do not wish to rely on force or coercion or do not have the capacity to do so. If the objects of action by international organizations can be persuaded of the rightness of prescribed action, then compliance is more likely and implementation more probable.

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8. United Nations Commission on International Trade Law (UNCITRAL), *Legislative Guide on Insolvency* (rev. 2005), available at [www.uncitral.org/pdf/english/texts/insolven/05-80722\\_Ebook.pdf](http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf).

9. See generally Bruce Cronin & Ian Hurd, *Introduction to THE UNITED NATIONS SECURITY COUNCIL AND THE INSTITUTION OF INTERNATIONAL AUTHORITY* ch. 1 (Bruce Cronin & Ian Hurd eds., forthcoming) (on file with the *Brooklyn Journal of International Law*) [hereinafter Cronin & Hurd, *Introduction*]; Ian Hurd, *Legitimacy*, in *ENCYCLOPEDIA PRINCETONIENSIS: THE PRINCETON ENCYCLOPEDIA OF SELF-DETERMINATION* (Wolfgang F. Danspeckgruber ed., forthcoming) (on file with the *Brooklyn Journal of International Law*); STIJN SMISMANS, *LAW, LEGITIMACY, AND EUROPEAN GOVERNANCE: FUNCTIONAL PARTICIPATION IN SOCIAL REGULATION* (2004); Ian Hurd, *Legitimacy, Power, and the Symbolic Life of the UN Security Council*, 8 *GLOBAL GOVERNANCE* 35 (2002) [hereinafter Hurd, *Legitimacy, Power*]; Elizabeth Heger Boyle & John W. Meyer, *Modern Law as a Secularized and Global Model: Implications for the Sociology of Law*, 49 *SOZIALE WELT* 213 (1998).

Scholars of international organizations identify three such mandates.<sup>10</sup> First, IOs are more legitimate when their membership and decision-making comprises representatives of the entities that are the objects of normmaking. This *representative* basis for legitimacy depends on the activation of criteria, which are quite diverse, for persuading prospective audiences that future products of an organization have been formulated by actors that share their interests or attributes. Second, IOs are seen to be more legitimate when their internal decision-making proceeds by standards of *procedural fairness*. All actors incorporated into the deliberative process in principle should be aware of the rules of deliberation and be treated fairly in their application. Third, in a kind of circular reasoning, IOs are more legitimate when they are seen to be *effective*. If an IO has previously shown itself to be successful in achieving its goals, in production of standards and in their adoption, then the IO is more likely to be considered legitimate in prospective endeavors.

International organizations engage in a kind of internal calculus—they weigh their legitimation warrants against legitimation deficits. Each global actor either has, or may be able to construct, elements of legitimacy that nation-states, and other audiences, will accept as legitimate. These legitimation warrants variously include expertise, representativeness, or prestige. Legitimation warrants adhere not only to attributes of organizations or their deliberative processes. As Susan Block-Lieb and I have argued,<sup>11</sup> a powerful legitimation warrant can be internal to global templates or scripts. Global scripts, such as UNCITRAL's *Legislative Guide*, may vindicate themselves by a rhetoric that impels acceptance by its readers. In this sense IOs employ the scripts to legitimate rhetorically their claim for approval and adoption. They must frame the rhetoric of norms to appeal simultaneously to diverse, and often dissenting, constituencies.

But alongside these potential legitimation warrants exist legitimation deficits. Either by virtue of their goals, or their reputations, or their rela-

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10. The most compelling and theoretically incisive work can be found in IAN HURD, *AFTER ANARCHY: LEGITIMACY AND POWER IN THE UNITED NATIONS SECURITY COUNCIL* (2007); Cronin & Hurd, *Introduction*, *supra* note 9; Ian Hurd, *Breaking and Making Norms: American Revisionism and Crises of Legitimacy*, 44 INT'L POL. 194 (2007), available at [faculty.wcas.northwestern.edu/~ihu355/Home\\_files/breaking%20making.pdf](http://faculty.wcas.northwestern.edu/~ihu355/Home_files/breaking%20making.pdf); Hurd, *Legitimacy, Power*, *supra* note 9; Ian Hurd, *Security Council Expansion and Institutional Legitimacy: Five Hypotheses in Search of a Test*, GLOBAL GOVERNANCE (forthcoming 2008) (manuscript available at [http://faculty.wcas.northwestern.edu/~ihu355/Home\\_files/final%20manuscript.doc](http://faculty.wcas.northwestern.edu/~ihu355/Home_files/final%20manuscript.doc)).

11. See Susan Block-Lieb & Terence C. Halliday, *Legitimacy and Global Lawmaking* (Fordham University School of Law, Legal Studies Research Paper No. 952492, 2006), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=952492](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=952492).

tionship with delegitimizing actors, or disreputable past practices, or their offensive ideologies, or incapacity, among others, international organizations carry delegitimizing attributes that disqualify them or diminish their capacity to exercise influence.

As a result, a central dynamic of reaching a consensus around global norms turns on efforts by international organizations not only to balance their own legitimation warrants and deficits, but also to seek compensatory alliances, coalitions, and cooperation with organizations that are perceived as legitimate.

### *B. Technologies*

For social scientists, a social technology is defined as a systematic social means of achieving a particular outcome. Technologies emerge from organizations and they are expressed in many ways—as codified standards, managerial protocols, regulatory regimes, or regularized practices. International organizations are production centers of technologies. Some they borrow. Others they invent. All are intended to encapsulate a set of understandings or agreements and to package them in a form that will be persuasive to potential audiences or constituencies.

In international lawmaking we observe three aspects of technologies that make a difference in their form and function. First, technologies in law vary by how binding they are. In the terminology of legal scholarship, are they products of hard law or soft law?<sup>12</sup> In UNCITRAL's case, for instance, it has a repertoire of technologies that range from those closer to the hard law end of a continuum, such as conventions, to those that are progressively softer, such as model laws or legislative guides. In the insolvency field we have protocols, model laws from professional associations, principles and best practice, and guidelines, among others. In the drafting of norms for national bankruptcy systems all the products have leaned to the soft rather than hard law end of the continuum in part because consensus on transnational hard law would have been impossible.

Second, legal technologies in global normmaking vary by their level of generality or specificity. A lively debate exists among scholars over the relative merits of technologies that produce standards versus those that produce rules. At one end of a continuum lie scholars and norm-

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12. See Ken Abbott & Duncan Snidal, *Hard and Soft Law in International Governance*, 54 *INT'L GOVERNANCE* 421 (2000).

producers who resist national and global harmonization of law.<sup>13</sup> At the other end of the continuum lie scholars who insist that the great diversity of fast-changing markets with huge economic stakes requires that global regulation be expressed through binding principles that may be implemented by many varieties of non-binding rules.<sup>14</sup> The choice can be highly consequential in practice. In the bankruptcy field, the World Bank, IMF, and ADB took the more abstract route. So, too, did INSOL in its "Statement of Principles" for out-of-court workouts.<sup>15</sup> By contrast, UNCITRAL's *Legislative Guide* combines not only high-level goals and objectives but many recommendations that are quite precise.<sup>16</sup>

Third, legal technologies vary in their relative weighting of diagnosis and prescription.<sup>17</sup> All formulations of norms for national legal systems proceed on some kind of diagnosis. Sometimes that diagnosis is assumed and scarcely articulated (e.g., that a country lacks an independent judiciary). In other cases the diagnosis is systematically conducted and sometimes publicized in full or in part, as we see in the "Legal Transition" surveys of the EBRD<sup>18</sup> or the ADB survey of eleven nations.<sup>19</sup> Legal technologies more often, but not always, include a prescriptive element. The IMF, World Bank, ADB, and UNCITRAL technologies are precisely of this kind. The weighting of diagnosis and prescription vary significantly across technologies. The EBRD instrument was all diagnosis and no prescription. The IMF "Blue Book" kept diagnosis implicit and was mostly prescriptive.<sup>20</sup>

### C. Leverage

The capacity of IOs to influence nation-states and local actors depends on what kinds of leverage they can exercise (i.e., the mixture of mecha-

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13. See Alan Schwartz & Robert E. Scott, *The Political Economy of Private Legislatures* 143 U. PA. L. REV. 595 (1995); Robert E. Scott, *The Politics of Article 9*, VA. L. REV. 1783 (1994).

14. See John Braithwaite, *Rules and Principles: A Theory of Legal Certainty*, 27 AUSTL. J. LEGAL PHIL. 47 (2002).

15. INSOL Int'l, *Statement of Principles for a Global Approach to Multi-Creditor Workouts* (2000), available at <http://www.insol.org/pdf/Lenders.pdf>.

16. See UNCITRAL, *Legislative Guide on Insolvency*, *supra* note 8; Block-Lieb & Halliday, *supra* note 11.

17. See Halliday & Carruthers, *Recursivity of Law*, *supra* note 3.

18. See EBRD, *Transition Report 1999: Ten Years of Transition*, *supra* note 7.

19. See ADB, *Law and Policy Reform at the Asian Development Bank*, *supra* note 6, at 10-85.

20. See IMF, *Orderly and Effective Insolvency Procedures: Key Issues*, *supra* note 5.

nisms and power).<sup>21</sup> Social science scholarship on global business regulation points to various forms of leverage.<sup>22</sup> The most visible is *economic coercion*, notably through the use of conditionalities by international financial institutions which demand legal changes in commercial law and institutions as a condition of financial assistance. More common is *modeling*, when IOs offer nation-states model laws or model bankruptcy systems to which they may adapt their own institutions. Not infrequently, leverage proceeds through *persuasion*, when IOs and professionals in their circle host conferences, write articles, and give speeches in regional meetings about the merits of particular scripts or other national models that adhere to those scripts. Persuasion can be coupled with systems of reward or *incentives*; sometimes financial, as in foreign aid or technical assistance loans, and sometimes moral, when IOs suggest that a country's reputation will be enhanced or diminished by its conformity to global standards. Occasionally *reciprocity* also appears, when one country is persuaded to take a course of action that conforms reciprocally with another; as when two neighbors who share strong trading relationships decide to implement a global norm that ensures their respective courts each treat the other symmetrically. Organizational isomorphism proposes that several processes are in play, such as coercion, imitation, and persuasion.<sup>23</sup> In transnational relationships these must be specified and extended.

International organizations have portfolios of leverage.<sup>24</sup> The IMF has economic coercion and UNCITRAL does not. The United States may employ reciprocity whereas INSOL is reliant on persuasion. Moreover the type of leverage is situation-specific. Conditionality can only be used by the IMF and World Bank when countries need their funds. Reciprocity only works when two countries have strong ties, commercial or otherwise. The availability of instruments for leverage depends also the attributes of nations, whether they want or are willing to accept the conditions of donors. Not all forms of leverage are positive: the powerful economic coercion available to the IMF and World Bank often generates a backlash. Persuasion by UNCITRAL may be friendly but not potent.

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21. See generally Terence C. Halliday & Pavel Osinsky, *Globalization of Law*, 32 ANN. REV. SOC. 447 (2006).

22. See generally JOHN BRAITHWAITE & PETER DRAHOS, *GLOBAL BUSINESS REGULATION* (2000).

23. See Paul J. DiMaggio & Walter W. Powell, *The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields*, 48 AM. SOC. REV. (1983).

24. See generally Halliday & Carruthers, *Recursivity of Law*, *supra* note 3.

Here then are three elements of global institution-building. The development of the insolvency field—and by extension other global fields of law—proceeded in a process of trial and error, competition and negotiation, among organizations as they searched for: (a) strong warrants of legitimacy; (b) a technology that looks likely to work; and (c) forms of leverage that will convert global standards into national laws, and ultimately local practices.

Look again at the development of the bankruptcy field in these terms. The EBRD's legal transition survey, begun in the mid-1990s, was essentially a diagnostic instrument constructed by a very small group of mostly in-house experts.<sup>25</sup> It relied almost entirely on persuasion of nation-states to take it seriously, something it did by ranking countries against each other and effectively shaming them into reforms. But it had several defects. Its legitimation warrants were limited—it relied almost entirely on a few technical experts and its authority was regional—to Central and Eastern Europe and Central Asia. Its technology was primitive and not at all defensible by social science standards. Moreover its technology was not accompanied by an articulated normative standard. Its leverage for enactment was potentially strong—through persuasion and even financial incentives.

The ADB's report of 1999 had relatively narrow legitimation warrants; it relied principally on ADB lawyers, a consultant, and various law firms in eleven countries.<sup>26</sup> Moreover, it was restricted to only a part of the Asian region. Its good practice standards balanced diagnosis—what was right or wrong with a country—with prescription, i.e., the standards themselves. Its leverage was a combination of modeling; it set out a model of a “good” bankruptcy system and persuasion, i.e., encouraging or shaming countries to conform to this model.

The IMF “Blue Book” of 1999 was developed by Legal Department lawyers in consultation with five distinguished international practitioners.<sup>27</sup> Compared to the ADB and EBRD it was stronger on its expert auspices but weak on any pretense of representiveness. Moreover, the IMF's use of conditionality ensured that any norms it produced would be

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25. See, e.g., Anita Ramasastry, *What Local Lawyers Think: A Retrospective on the EBRD's Legal Indicator Surveys*, in EBRD, *LAW IN TRANSITION: TEN YEARS OF LEGAL TRANSITION*, at 14 (Autumn 2002), available at <http://www.ebrd.com/pubs/legal/lit022.pdf>; Anita Ramasastry, Stefka Slavova, & Lieve Vandenhoeck, *EDRB Legal Indicator Survey: Assessing Insolvency Laws After Ten Years of Transition*, in EDRB, *LAW IN TRANSITION: SOUTH-EASTERN EUROPE*, at 34 (Spring 2002), available at <http://www.ebrd.com/pubs/legal/lit021.pdf>.

26. See ADB, *Law and Policy Reform at the Asian Development Bank*, *supra* note 6.

27. See IMF, *Orderly and Effective Insolvency Procedures: Key Issues*, *supra* note 5.

greeted with resistance, manifest or latent, by many developing countries, a deficit the IMF legal staff fully understood. Its technology took the form of a prescriptive standard without any accompanying diagnostic instrument, although the IMF does undertake diagnoses of nation-states, either through Article IV reviews or “Reviews of Standards and Codes.” In neither case did it make public its diagnostic instruments. Its prescriptive norms had the merit of offering alternatives to countries and not demanding that “one-size-fits-all.” The IMF had extraordinary leverage in financial crises, as we saw in Indonesia and Korea, where it compelled far-reaching reforms.<sup>28</sup> It presented a model with variants in a form that might be persuasive, particularly to countries that might anticipate requiring its funds at a later stage. But the IMF realized all too fully that its combination of legitimacy, technology, and leverage would not prevail as a global standard.

The World Bank was rather more equivocal on this score. As with the IMF, its legitimacy rested heavily on expertise, not only pulling in a small group of experts, but in taking its *Principles*, through many iterations, from one forum of specialists and government officials, in one after another region of the world. But to many observers, including key leaders of the global insolvency initiatives, its expert strength was accompanied by weakness on each of the three aspects of legitimacy. Moreover, it had significant legitimation deficits. These included a generalized resistance to the World Bank because of its use of coercive economic leverage and a sense by many that it was unduly close to the United States, that it was, in a word, exporting U.S. approaches to bankruptcy. Its technology—principles—seemed well suited to the diversity of potential adopting nations, but they were subject to criticism on a variety of grounds. The World Bank also had accompanying diagnostic instruments, but it did not and does not make them public, although some of the results of its “Reports on the Observance of Standards and Codes” (ROSCs) are posted publicly.<sup>29</sup>

It was for all these reasons that some countries and some leaders of international professional groups turned to UNCITRAL. It seemed to offer the optimal balance of legitimation, technology, and leverage. Its legitimacy was high on each of the three attributes of representativeness, procedural fairness, and effectiveness. It had a stock of technologies that could be adapted to whatever levels of hard or soft law, principles, or rules, seemed apposite. It could rely on leverage through modeling and

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28. See Halliday & Carruthers, *Recursivity of Law*, *supra* note 3.

29. See World Bank, Reports on the Observance of Standards and Codes (ROSC), <http://www.worldbank.org/ifa/rosc.html> (last visited June 7, 2007).

persuasion. On these bases, all asserted at the outset of the Commission's deliberations, and variously adapted during the Working Group's deliberations, UNCITRAL produced its *Legislative Guide*.

Yet UNCITRAL itself does not have quite the leverage nor technical resources of its less legitimate UN sisters—the IMF and World Bank. This would seem to work against enactment and implementation. But precisely at this point there may be a prospect of an alliance that will balance its legitimacy with the leverage of the International Financial Institutions (IFIs). From 2002 to 2005, friction occurred between the World Bank and UNCITRAL secretariat and many of its delegates. Rather than channeling its efforts through UNCITRAL, as had other international organizations, the Bank proceeded with what appeared to be a rival set of norms. Admittedly these were more expansive than UNCITRAL's mandate, including institutional aspects of insolvency systems not treated by UNCITRAL. But the rivalry over the substantive heart of the *Legislative Guide* and *Principles* respectively aggravated many leaders of the global reform movement. Even the U.S. Treasury and the U.S. State Department fretted that rival standards would confuse adopting nations and impede convergence.

Through negotiations over the past two years an agreement has been reached. UNCITRAL would publish its *Guide* independently. The Bank would publicize its *Principles*, without its accompanying commentary. The two would be substantively reconciled in a document that would show where World Bank *Principles* coincided with UNCITRAL recommendations. In practice, the Bank and IMF agreed on a diagnostic instrument—its insolvency ROSC—that was also reviewed by UNCITRAL. In theory, the Bank would use the *Legislative Guide* as a prescriptive backdrop to countries that were impelled or persuaded to reform their laws.

By 2005, therefore, an inchoate and difficult field of practice had gone from global disorganization to convergence on a single set of global norms. This feat occurred because financial crises had pressed the international and professional communities to push towards an international financial architecture in which insolvency regimes were a constitutive element. The logic of this advance can be seen as a process of trial and error, experimentation and adaptation, to attain a standard promulgated by organizations that could optimize legitimacy, a suitable technology, and appropriate leverage.

## II. THE NEXT TEN YEARS: ELABORATING LEGAL TECHNOLOGIES

In one sense, the UNCITRAL *Legislative Guide* is a signal achievement because it obtained a global consensus from the world's most le-

gitimate transnational organization on a set of norms for national bankruptcy systems. In another sense, the work has just begun. Let me raise several issues that will be critical in maintaining momentum over the next decade.

#### *A. Legitimacy*

In the final analysis, legitimacy is a subjective state. It signifies whether a particular audience believes in the “rightness” of an organization or its actions. It depends upon constituencies accepting that certain norms are authoritative and should be recognized as such. In the case of the *Legislative Guide*, this would manifest itself in efforts by national lawmakers to review their laws against this new standard and to amend them accordingly. In the composition of its Commission and Working Group, its procedures, and its past successes, UNCITRAL has proceeded along a path that will increase the probability that the *Guide* will be greeted as authoritative by national lawmakers and professionals alike. But whether in fact that legitimacy will be recognized remains to be evidenced—and legitimacy alone will not suffice, as we shall see below when we consider implementation. Moreover it will remain unclear for some time whether UNCITRAL’s association with the IMF and World Bank will prove costly from the vantage point of developing nations.

Legitimacy may become an issue in the efforts of the American Law Institute (ALI) and International Insolvency Institute (III) to generalize the cross-border facilities of NAFTA to the rest of the world.<sup>30</sup> This project has significant auspices. The ALI is an established and prestigious institution in U.S. law reform circles, and the III is a young but prestigious organization of insolvency practitioners, scholars, and judges. ALI has a track record in producing normative instruments, some of which have been highly influential. The fact that these principles include the world’s most powerful economy and govern relations among three quite different countries may also add cachet. But to be accepted universally, the product of such an expert enterprise may also run into some of the very legitimation issues that bedeviled the precursors to UNCITRAL’s *Legislative Guide*. For instance, its close proximity to the United States may be a deficit, engendering instinctive resistance from countries that chafe at perceived U.S. efforts to make the world conform to its image. In part its legitimacy will depend on how well it can be shown—for Mexico and for Canada especially—that these principles have worked. I

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30. American Law Institute (ALI), *Transnational Insolvency: Cooperation Among the NAFTA Countries, Principles of Co-operation in NAFTA Cross-Border Insolvency Cases* (2003).

am not yet aware of the evidence on this account. Moreover, ALI's process and products have been criticized by scholars of private legislatures, not least for its work on Article 9 of the UCC.<sup>31</sup>

Yet counting against these reservations it may be that legitimacy's elements play differently in courts than legislatures. In contrast to adoption of global norms by a legislature, in which most divergent interests in a society can be brought into play, courts can proceed without such a democratic mandate and at a lower decibel level. Indeed an ALI/III partnership may be far more persuasive to courts than any other branch of government. Even so, courts are also political institutions, never entirely insulated from local politics, and very much part of local politics in developing countries. Courts also must be seen to be legitimate in their respective contexts. Hence their discretion for adopting rules that affect local creditors and workers, state and community interests, national prestige and political patronage, may not be so great in practice.

### *B. Technology*

UNCITRAL's *Guide* adopts a soft law instrument that combines several levels of norms, ranging from high-level principles to statutory language in many recommendations. By adopting the soft law approach in the highly flexible guide-format, UNCITRAL has been able to take on issues that previously were thought to be intractable.

Furthermore, Susan Block-Lieb and I have shown that UNCITRAL's secretariat adroitly manipulated the formal properties of the *Guide* to cope with wide diversity in the world's legal systems.<sup>32</sup> In its glossary the *Guide* does not identify with any particular legal system. In its commentary the *Guide* frequently presents options that reflect some of the variations across insolvency regimes worldwide. And, when a global consensus was not possible, the *Guide*'s recommendations used combinations of rule-types that constitute a hierarchy of generality or specificity to lower or raise the threshold of recommendation in accordance with the degree of diversity to be managed.

This combination of soft law and a repertoire of rule-types appears highly respectful of national sovereignty. It places before national legislatures the governing principles that animate the law as a whole; it presents alternatives among which legislators may choose; and in cases where legislatures choose to step outside the *Guide*, that choice is framed by reference points towards which legislators can consciously orient

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31. See Alan Schwartz, *The Still Questionable Role of Private Legislatures*, 62 LA. L. REV. 1147 (2002); Schwartz & Scott, *supra* note 13.

32. See Block-Lieb & Halliday, *supra* note 11.

themselves—for or against. Together these attributes of the *Guide* appear conducive to a favorable response by legislators. This certainly will not produce unification. But it may facilitate convergence.

Two problematic features of the *Guide* remain. One is its lack of a diagnostic instrument. The advantage of a diagnostic instrument is plain: it can sharply display to policymakers and officials where and how the country does and does not conform to global standards. If coupled with a prescriptive standard, this provides an impetus for reform. UNCITRAL has compensated for this by linking the *Guide* to the World Bank's ROSC. However, it is not yet clear whether the Bank has tightly coupled its ROSC to the *Guide* in such a way that deficiencies that appear in a country's ROSC can then be remedied in relation to specific recommendations or options in the *Guide*. This is both a technical matter as well as a matter of institutional will: will UNCITRAL and the Bank proceed as partners or in parallel? The theory of legitimacy and technology would predict that both institutions will be better off working together than if either institution defects from their agreement to cooperate.

A second limitation of the *Guide* concerns what it leaves out.<sup>33</sup> The largest gap concerns institutions. Of the six core features of a bankruptcy system—substantive law, procedural law, professions, courts, regulatory agencies, and out-of-court mechanisms—UNCITRAL treats the first three in detail but the last three scarcely at all. Yet all scholars of law-in-action, not to mention practitioners, know that the most pristine law-on-the-books amounts to nothing if institutions are not in place to put it into practice. In this the Bank provides a complementary treatment, particularly of courts. However, at present the World Bank *Principles* on courts, regulatory agencies, and out-of-court mechanisms are at a fairly high level of generality—and with a thrust, it has been said by potential consumers, to be too reminiscent of the United States. As an alternative, some scholars argue<sup>34</sup> that benefits would accrue to the presentation of principles in terms of several operative alternative systems that exist in practice and would which be acceptable under the principles. The *Guide* does this in a number of cases—presenting several options and discussing their relative benefits, an approach also seen in the IMF Blue Book. This suggests that it is timely for a more considered treatment of courts, regulatory agencies, and out-of-court mechanisms with the finesse

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33. UNCITRAL historically has not seen institution-building as part of its mission. Moreover, “limitation” may not be the appropriate term because arguably UNCITRAL could only achieve the production of the *Legislative Guide* by taking some contentious matters off the table.

34. See Katharina Pistor & Chenggang Xu, *Incomplete Law*, 35 N.Y.U. J. INT'L L. & POL. 931 (2003).

UNCITRAL has used in its substantive and procedural provisions, a task that UNCITRAL cannot do itself.

### *C. Leverage*

If UNCITRAL, the IMF, and the World Bank in fact do develop a cooperative relationship, by working back and forth between the *Guide* and the ROSCs, then a gradient of leverage is possible for these global norms. At the soft end, the *Guide* and *Principles* offer a prescriptive model or standard that is available for consideration by national reformers. In the middle of the gradient, technical assistance by international institutions provide an economic and expert incentive to implement the norms; and in emergency situations, such as a financial crisis, the IFIs have available economic levers to compel national lawmakers to take the global norms seriously.

Braithwaite and Drahos maintain that global business regulation is facilitated when webs of expertise are mobilized through webs of influence.<sup>35</sup> What webs are available to propagate these global norms? Historically UNCITRAL has suffered from an incapacity of resources. While it has produced a succession of global standards, it has not been given the resources to disseminate and help implement its products. To correct this problem, in the last two years the Secretariat has created a Technical Assistance section, led by the Senior Legal Officer who drafted the *Guide*, and added a staff lawyer to provide technical assistance to countries that are appraising UNCITRAL products. Even so, resources available to the Secretariat remain far below what would be necessary for it to make a global impact.

For this, UNCITRAL will need to rely on two interconnected webs of influence. A powerful alliance has already been forged between UNCITRAL and international professional associations. INSOL has been a close partner in the first two of UNCITRAL's successful insolvency initiatives and it appears it will continue to play such a role in its third initiative now beginning on corporate groups and inter-court cooperation. The International Bar Association's (IBA) delegates, and those of the American Bar Association (ABA), have been intimately involved in the drafting of the *Guide* and the International Insolvency Institute has maintained a close involvement with the Working Group. UNCITRAL's impact in substantial part will depend on how actively INSOL's national affiliates and the IBA's Committee J on Insolvency and Creditors'

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35. BRAITHWAITE & DRAHOS, *supra* note 22.

Rights<sup>36</sup> energize their members to mobilize domestically on behalf of insolvency reforms. Will these organizations have the same capacity for collective action at the level of the nation-state as they have in global arenas? The answer is probably no. The global influence of these organizations has been possible because a small number of delegates from each have committed themselves over several years to close cooperation with UNCITRAL's Working Group and its informal expert groups. This has required no substantial problem of collective action since they appear to have acted pretty much autonomously, borrowing their organization's prestige but operating independently of it. To mobilize domestically has greater demands of collective action, and requires a strong message to be conveyed within associations from their global normmakers to local prospective lawmakers. Both are demanding and cannot be taken for granted.

A more powerful web of influence is available through the World Bank and regional development banks. Both the World Bank and the EBRD have staffers dedicated to insolvency reforms. They provide diagnoses of insolvency systems, offer technical assistance, and develop further standards. They also have resources. The ADB was an early and major mover in the field of insolvency reforms and continues to lend advice to particular countries, as it recently has at the penultimate moment of China's bankruptcy reforms. Yet the two regional banks were not active parties in the later development of the UNCITRAL *Guide* and it may be that they are less invested in the outcome. The Bank, we have seen, has had an equivocal attitude to the *Guide*. If, then, after all the effort of forging an apparent global consensus on a single standard, the regional development banks and the World Bank are lukewarm about urging the *Guide* on their member countries, then it risks sitting on the shelf. By contrast, the OECD, based in Paris, has had a continuing interest in insolvency since the collapse of the Soviet Empire. Through its Forums on Asian Insolvency Reforms, held each year for Asian countries, it has featured UNCITRAL and the *Guide* with increasing prominence, most notably in its April 2006 conference in Beijing.<sup>37</sup> Some nation-states are similarly mobilizing through their aid programs, most notably Australia.

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36. See Int'l Bar Ass'n (IBA), Section on Insolvency, Restructuring and Creditor's Rights Projects, [http://www.ibanet.org/legalpractice/Insolvency\\_Projects.cfm](http://www.ibanet.org/legalpractice/Insolvency_Projects.cfm) (last visited June 7, 2007).

37. See World Bank, Global Insolvency Law Database, Forum on Asian Insolvency Reform V, Beijing, China (Apr. 27–28, 2006), <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/LAWANDJUSTICE/GILD/0,,contentMDK:21031110~pagePK:64065425~piPK:455253~theSitePK:215006,00.html> (describing meeting held in Beijing, China, jointly sponsored by the OECD, the World Bank, the ADB, the government of

We confront, therefore, two potential scenarios. In one, the flexible and legitimate technology embodied in the *Legislative Guide* gets leveraged through the persuasion, modeling, and even financial incentives of professional associations, international financial institutions, and international governance organizations. Legitimacy, technology, and leverage will conjointly and significantly raise the probability of national convergence around UNCITRAL's norms. In another scenario, the differing priorities of international financial institutions, and problems of mobilization by professional associations, will lead to a dissipation of the effort that brought the *Guide* to fruition. It is a social science problem to explain why one path will be taken rather than another. It is a pragmatic problem to choose whether momentum will be maintained or will falter.

There are two further issues that will be critical in determining the reform trajectory of the next decade. One concerns diagnostic capacities. The other concerns best practices.

#### *D. Diagnostics*

A great deal of law reform proceeds on the basis of diagnosis—of evaluations about what works and what doesn't.<sup>38</sup> In many respects, by the standards of social science scholarship, the quality of diagnosis by international organizations has not kept pace with the quality of global standards and norms.

The reasons are not surprising. Few players in the international insolvency field have any training in social science research methodology. Insolvency reform organizations have had virtually no contact with the networks of social science specialists on law across the world. The results are what might be predicted: the quality of diagnosis too often is at a level comparable to the likely results if social scientists were to draft statutes.

The problems are manifest. These include: lack of precise indicators for evaluation; sampling bias in who gets asked what; too few cases are held to be representative of substantial diversity; entire legal systems are arbitrarily assigned numbers that are statistically meaningless; and cross-sectional and time-series comparisons are thereby highly suspect.

Law Departments of IFIs do have the expertise and capacity to appraise law-on-the-books. But the appraisal of law-in-action, or of practice more broadly, falls far short of this. Conventionally IFIs save costs by variously (a) asking one law or accounting firm with which they do

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Japan, and government of Australia, in cooperation with the Development Research Institute and the government of China).

38. See Halliday & Carruthers, *Recursivity of Law*, *supra* note 3.

business to report on an entire country; (b) asking a single academic or professional to do likewise; (c) conducting ad hoc interviews with a few practitioners and elevating them to a national profile; or (d) engaging outside consultants to undertake (a) through (c) on their behalf. The main exception is the World Bank which conducts its ROSCs by spending one or two weeks of intensive interviewing in a country.

Characteristically, IFIs seldom or never talk to debtors or small creditors or any parties to bankruptcies away from the capital city of a developing country.

Unless this weak hand of IOs is significantly strengthened, then the quality of technical assistance, reform advice, and adaptation by countries to global norms will suffer badly.

#### *E. The Fallacy of "Best Practices."*

A persistent fallacy stalks the world of global law reform and business regulation. It is the notion that there are "best practices" that apply equally well in all situations. The implausibility of this concept becomes more obvious when IOs advocate "one-size-fits-all" formulations for countries worldwide. This is so nonsensical on its face that IFIs now routinely deny that they engage in this practice. Yet it is difficult to see the difference between "best practices" and "one-size-fits-all."

What is wrong with these concepts? Perhaps the point is best made with a metaphor. No self-respecting wine lover would ever admit to the proposition that pinot noir grapes will flourish equally well everywhere. If you plant pinot noir in Provence or upstate New York or Fiji you will get at best an inferior, and at worst, an im potable wine. There are only certain regions of the world where pinot noir flourishes—in Burgundy of course, in parts of California and Oregon, in some regions of New Zealand, but not others. Moreover, even in Burgundy, pinot noir in the bottle will reflect even minor differences in terrain, soils, and exposure to sunlight and wind—that is, the effects of *terroir*. In wine, as in law local context makes a discernible difference—the vine, the winemaker, the soil, the climate, the caves, the barrels, the techniques of winemaking, transport, storage, and exposure to changes in temperature. It is nonsense to expect the universality of taste of a given grape, irrespective of these 1,001 contexts of its growth and cultivation.

Law, too, is implanted in 1,001 different soils: from within a legal culture or from outside it; in contexts where people respect law and those where they don't; in places where law has long-regulated behavior and situations where it is a new basis of social regulation; in locations where it conflicts with other legal systems and those where it complements current legal systems; in cultures where recourse to courts is acceptable and

those where it is shameful; in places where judges are inferior officials from families at the edge of ruling elites to places where judges are honorable, high-status professionals; in political systems where it is laughable to imagine that judges could restrain a powerful ruler to those where it is thought to be their very obligation; in social systems where law is expected to be just and those where it has never been so; in countries where lawmakers intend implementing reforms and those where they have no such intent; and in places where the machinery of government has the capacity to implement reforms and those where it does not.

Exactly the same set of so-called global “best practices” implanted in these radically different situations will produce notably different outcomes. This is so for at least two reasons—the dynamics of law reform in a given country and a failure to match insolvency systems with different forms of markets.

I close by commenting briefly on each.

### III. THE IMPLEMENTATION GAP AND THE RECURSIVITY OF LAW

The ultimate test of the form and content of global norms, such as insolvency standards, depends not only on domestic enactment but on local implementation and usage.<sup>39</sup> This confronts all international agents of reform with the enduring problem of the implementation gap. Two sets of factors contribute to implementation gaps in the insolvency field.

On the one hand, an implementation gap can be predicted from particular configurations of legitimacy, technology, and leverage exercised by international organizations. In cases where international financial institutions use coercive powers to impose rigid global norms on a nation-state it can be expected that implementation will itself become an arena of resistance. Even in cases where a marked asymmetry of power occurs between global institutions and nation-states—for instance, a financially desperate nation-state in financial crisis urgently needs huge loans to forestall economic collapse—and they appear entirely vulnerable to foreign pressure, supposedly weak nations show surprising capacities to foil international organizations.<sup>40</sup> While capital-deprived developing nations

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39. On implementation issues in Asian insolvency reforms, see Terence C. Halliday, Fifth Forum on Asian Insolvency Reform (FAIR), *Lawmaking and Institution-Building in Asian Insolvency Reforms: Between Global Norms and National Circumstances*, (Apr. 2006), available at <http://www.oecd.org/dataoecd/42/47/38184739.pdf>; Terence C. Halliday & Bruce Carruthers, Fourth Forum on Asian Insolvency Reform (FAIR), *Institutional Lessons from Insolvency Reforms in East Asia*, (Nov. 2004), available at <http://www.oecd.org/dataoecd/50/7/33935734.pdf>.

40. Terence C. Halliday & Bruce Carruthers, *Foiling the Hegemons: Limits to the Globalization of Corporate Insolvency Regimes in Indonesia, Korea and China*, in LAW

may be compelled to reform their law-on-the-books, they can effectively retreat to ground where they have all the advantages, viz., implementation or putting law into practice. Through adroit combinations of delay, playing international organizations off against each other, nullifying ostensibly compliant provisions of statutes with obscure regulations, and ignoring the law, these and other weapons of the weak may quash in practice what weak nation-states could not resist in enactment.

This is not only a matter of unwillingness to implement global norms. Ample research shows that a translation process occurs when global norms encounter local situations.<sup>41</sup> The process of translation itself is mediated by professionals and officials with quite different capacities or willingness to capture the underlying principles or spirit of global norms and make them meaningful in another setting. In practice, of course, these intermediaries also face legitimacy problems because, to be effective, they must find ways to present something foreign as domestically acceptable. They are not always willing or able to do this. They also have an array of technologies available to them. Both implementation or resistance can be effected by more or less creative ways of manipulating these technologies in a way that Campbell calls bricolage.<sup>42</sup>

On the other hand, law reform in any country follows a recursive process.<sup>43</sup> The dynamics of recursivity in bankruptcy reforms reveal that several mechanisms widen or narrow the implementation gap in domestic lawmaking.

First, implementation often fails because the law itself is incomplete and indeterminate.<sup>44</sup> Of course, law by its nature is indeterminate. But arguably its determinacy is more in question when new concepts, doctrines, and theories are being imported from foreign sources. Statutory

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AND GLOBALIZATION IN ASIA: FROM THE ASIAN FINANCIAL CRISIS TO SEPTEMBER 11, (Christoph Anton & Volkmar Gessner eds., forthcoming 2007) [hereinafter Halliday & Carruthers, *Foiling the Hegemons*].

41. See JOHN L. CAMPBELL, INSTITUTIONAL CHANGE AND GLOBALIZATION (2004); SALLY ENGLE MERRY, HUMAN RIGHTS AND GENDER VIOLENCE: TRANSLATING INTERNATIONAL LAW INTO LOCAL JUSTICE (2006); Sally Engle Merry, *Transnational Human Rights and Local Activism: Mapping the Middle*, 108 AM. ANTHROPOLOGIST 38 (2006).

42. See CAMPBELL, *supra* note 41.

43. For a detailed account of recursivity in global lawmaking, see Halliday & Carruthers, *Recursivity of Law*, *supra* note 3. For the application of recursivity to domestic lawmaking in the insolvency field, see BRUCE G. CARRUTHERS & TERENCE C. HALLIDAY, RESCUING BUSINESS: THE MAKING OF CORPORATE BANKRUPTCY LAW IN ENGLAND AND THE UNITED STATES (1998) [hereinafter CARRUTHERS & HALLIDAY, RESCUING BUSINESS].

44. See Pistor & Xu, *supra* note 34.

enactment of bankruptcy law itself may be written in ambiguous terms with gaps and inconsistencies. Depending on the sophistication of the judicial system and regulatory agencies, further cycles of reform may render meanings more precise or compound the ambiguity. For instance, China's new Enterprise Bankruptcy Act, which becomes effective on June 1, 2007, has been drafted in a very open format which leaves many issues unresolved.<sup>45</sup> In part this has occurred because political struggles behind the new law were not resolved definitively. Passage of the legislation could only occur if ambiguities and gaps remained. The task of resolving these now moves to "Interpretations" by the Supreme People's Court and rulemaking by various agencies of the State Council. But these may multiply rather than reduce the meanings of the law.<sup>46</sup>

This brings us to a second reason for failed implementation: contradictions contained within the law. In attempts to implement global standards, domestic policymakers not infrequently build in concepts that are in tension with extant concepts, doctrines, and usages. These then confront domestic political struggles which are often handled by building in concessions to conflicting political actors without forging an effective consensus. Such a struggle has been occurring in China's bankruptcy reforms, for instance, between those top leaders who favor a *socialist* market economy versus those who prefer a socialist *market* economy.<sup>47</sup> In the face of such ideological tensions, a vague law that incompletely reconciles foreign and domestic interests may be the only hope of legislative enactment. But by pushing clarification of the ambiguities to competing state agencies—financial regulators or regulators or state-owned enterprises—and courts, the struggle breaks out again, often with inconsistent results.

Third, a mismatch of actors frequently occurs between those who make the law and those who are involved in practice. Creditors and professionals are usually heavily involved in lawmaking but debtors are not—and labor, too, is often missing in bankruptcy law reforms.<sup>48</sup> If debtors are ignored, as they were by the IMF and World Bank in the Indonesian reforms, then they have all the more reason to resist in practice, as they

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45. Terence C. Halliday, *Policy Brief: The Making of China's Corporate Bankruptcy Law* (Foundation for Law, Justice and Society, Oxford University, forthcoming 2007) (on file with the *Brooklyn Journal of International Law*) [hereinafter Halliday, *Policy Brief*].

46. Compare the analysis of reforms in China's criminal procedure law. See Sida Liu & Terence C. Halliday, *Contesting the Limits of State Power: Recursivity in the Peoples' Republic of China Criminal Procedure Law, 1979-2006* (East Asia Workshop, Univ. of Chicago, May 11, 2006) (on file with the *Brooklyn Journal of International Law*).

47. See Halliday, *Policy Brief*, *supra* note 45.

48. See CARRUTHERS & HALLIDAY, *RESCUING BUSINESS*, *supra* note 43.

also effectively did in Indonesia.<sup>49</sup> Talk of creditor rights by international organizations, without a commensurate respect for debtor rights, gets the parties to bankruptcies off on a bad footing. If international organizations care as much about law-in-practice as law-on-the-books, they will need to elicit the cooperation of all parties to bankruptcy proceedings, especially as some of those parties are powerful in local politics, not to mention in practice.

Fourth, implementation problems often occur because there are diagnostic struggles over the nature of the problems to be corrected by law reform. Each party to bankruptcy reforms—international financial institutions and ministries of justice, workers and managers, creditors and debtors, lawyers and judges—has views about what is wrong that needs fixing. I have already said a good deal about the importance of diagnosis. Suffice it here to say that it is not simply a technical matter of defensible evaluation. It is also a political matter. Every party in domestic politics has an interest in defining the bankruptcy problems in ways that their prescriptions are designed to remedy. Hence effective implementation requires some consensus among international organizations and domestic constituencies over the definition of problems and their relative priority. Frequently IFIs and nation-states disagree. Without agreement reforms are likely to be stillborn.

#### IV. VARIETIES OF CAPITALISM, VARIETIES OF LAW

Let me conclude more by assertion than argument. For national bankruptcy regimes, I have proposed that the concept of “best practices” is fallacious. It is extremely rare that a single practice in law will be best in all circumstances. This notion has no validity on its face and cross-national research shows it has no prospect of implementation in practice. This same critique can be made for global norms more generally. The more rule-like those norms and the less flexible the alternatives they provide, the more probable it is that they will fail at the point of implementation. Square pegs cannot be forced into round holes.

I believe it is time that international organizations take more seriously the scholarship of political economists and recognize that there are several varieties of capitalism.<sup>50</sup> They contrast a coordinative form of capitalism that is characteristic of most Continental countries with a liberal

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49. See particularly their methods of resistance to the out-of-court efforts of the Jakarta Initiative Task Force. See Halliday & Carruthers, *Foiling the Hegemons*, *supra* note 40.

50. See, e.g., Peter A. Hall & David Soskice, VARIETIES OF CAPITALISM: THE INSTITUTIONAL FOUNDATIONS OF COMPARATIVE ADVANTAGE ch. 1 (2000).

form of capitalism that is exemplified by Britain and United States. Plausibly this theory can be extended to other regions of the world where we will discover distinctive forms of market organization and distinctive configurations of governance over markets. Much of this variation will turn on the relative maturity of legal institutions in a nation-state and the historical primacy of law as a means of regulating social relationships. In several regions law has never been particularly salient, legal institutions have not been much respected, and lawyers and judges have not been considered prestigious occupations. Commercial transactions have been regulated in a variety of other ways.

It may now be the case that increasing integration of global trade will demand more law-like ordering of commercial relationships. Many developing countries now recognize that they must at least provide the appearance of legalism in their frameworks for commercial transactions. But the extent to which legal certainty is required for expansion of trade is by no means empirically established. In fact there are glaring examples in East Asia to the contrary, China not the least amongst these.<sup>51</sup>

A more sophisticated way forward, I propose, is to develop a contingent set of relationships between types of markets and types of insolvency systems. Put another way, it is now time for scholars and international agencies to begin developing a theory of the conditions under which certain kinds of bankruptcy systems will best fit certain kinds of markets. If we can identify family resemblances of states and markets, then we can also identify clusters of insolvency systems.<sup>52</sup> The task then is to match particular types of insolvency systems with the markets to which they are best adapted. This is no easy matter. That is one reason why it has not already happened. Such a matching would require careful attention to the affinities of legitimacy, technologies, and leverage in global and local arenas. But as we push forward into the next decade I propose that such a refinement of our collective enterprise represents not only an exciting intellectual frontier but a pragmatic necessity.

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51. See John K.M. Ohnesorge, *The Rule of Law, Economic Development, and the Developmental States of Northeast Asia*, in *LAW AND DEVELOPMENT IN EAST AND SOUTHEAST ASIA* (Christoph Antons ed., 2003); Tom Ginsburg, *Does Law Matter for Economic Development? Evidence from East Asia*, 34 *LAW & SOC'Y REV.* 829 (2000).

52. By an insolvency system I refer to the bundle of law and institutions that include: (1) substantive bankruptcy law; (2) procedural bankruptcy law; (3) bankruptcy courts; (4) out-of-court mechanisms; (5) bankruptcy professions; and (6) government bankruptcy agencies.

# THE HAGUE CONVENTION ON CHOICE-OF-COURT AGREEMENTS: IS THE PUBLIC POLICY EXCEPTION HELPING CLICK-AWAY THE SECURITY OF NON-NEGOTIATED AGREEMENTS?

## I. INTRODUCTION

On June 30, 2005, the United States and sixty-three other Member States<sup>1</sup> at the Hague Conference on Private International Law (“HCPIIL”)<sup>2</sup> signed a Convention on Choice of Court Agreements (“Convention”).<sup>3</sup> If ratified by the U.S.,<sup>4</sup> the Convention will control the

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1. In addition to the United States, the current Member States of the Hague Conference are: Albania, Argentina, Australia, Austria, Belarus, Belgium, Bosnia and Herzegovina, Brazil, Bulgaria, Canada, Chile, China, Croatia, Cyprus, Czech Republic, Denmark, Egypt, Estonia, Finland, France, Georgia, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Jordan, Republic of Korea, Latvia, Lithuania, Luxembourg, The former Yugoslav Republic of Macedonia, Malaysia, Malta, Mexico, Monaco, Morocco, Netherlands, New Zealand, Norway, Panama, Peru, Poland, Portugal, Romania, Russian Federation, Serbia and Montenegro, Slovakia, Slovenia, South Africa, Spain, Sri Lanka, Suriname, Sweden, Switzerland, Turkey, Ukraine, United Kingdom of Great Britain and Northern Ireland, Uruguay, Venezuela. Hague Conference on Private International Law Frequently Asked Questions 4[d], [http://www.hcch.net/index\\_en.php?act=faq.details&fid=6](http://www.hcch.net/index_en.php?act=faq.details&fid=6) (last visited May 16, 2007).

2. The “Hague Conference on Private International Law” is not an event, but is an intergovernmental organization whose goal is “to work for the progressive unification of the rules of private international law,” primarily through negotiation and drafting of multilateral treaties, also called “Hague Conventions.” Hague Conference on Private International Law Frequently Asked Questions 2[b], [http://www.hcch.net/index\\_en.php?act=faq.details&fid=32](http://www.hcch.net/index_en.php?act=faq.details&fid=32) (last visited Oct. 2, 2005). The Hague Conventions cover a wide range of topics including: determinations of applicable law, conflicts of jurisdiction, recognition, and administrative and judicial co-operation between authorities. *Id.*

3. Hague Conference on Private International Law, *Convention on Choice of Court Agreements*, June 30, 2005, [http://www.hcch.net/index\\_en.php?act=conventions.pdf&cid=9835](http://www.hcch.net/index_en.php?act=conventions.pdf&cid=9835) (last visited Oct. 2, 2005) [hereinafter *Convention*]. The Convention is the result of negotiations that began in 1992 at the request of the United States that the HCPIIL negotiate a multilateral convention on the recognition and enforcement of judgments. Peter H. Pfund, *The Project of the Hague Conference on Private International Law to Prepare a Convention on Jurisdiction and the Recognition/Enforcement of Judgments in Civil and Commercial Matters*, 24 BROOKLYN J. INT’L L. 7, 8 (1998) (citing letter from Edwin D. Williamson, Legal Advisor, U.S. Department of State, to George Droz, Secretary General, The Hague Conference on Private International Law (May 5, 1992)). In 1999, the HCIL produced a Preliminary Draft Convention on Jurisdiction on Foreign Judgments in Civil and Commercial Matters. Hague Conference on Private International Law, *Prelim. Draft Convention on Jurisdiction on Foreign Judgments in Civil and Com. Matters*, Prel. Doc. No. 11, Aug. 2000, <http://www.hcch.net/upload/wop/jdgmpl11.pdf> (last visited Oct. 2, 2005) [hereinafter *Preliminary Draft*]. However, after

recognition and enforcement of exclusive<sup>5</sup> forum-selection clauses in business-to-business civil and commercial transactions.<sup>6</sup> It will require that legal judgments on cross-border disputes involving contracts containing an exclusive choice-of-court clause be honored and enforced in other signature States.<sup>7</sup> For example, under the Convention, if an American and a Belgian company agreed in a contract that all disputes arising under the contract would be brought in the U.S., then the Belgian company could not file suit or seek an alternative judgment in Belgium. If a U.S. court then ruled in favor of the American company, the courts in

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further revisions, it became apparent that the scope of the draft convention was too broad and that agreement on the draft convention could not be met. Hague Conference on Private Int'l. L., *Draft Report on the Exclusive Choice of Court Agreements*, Prel. Doc. No. 26, Intro., para. 6, Dec. 24, 2004, [http://www.hcch.net/upload/wop/jdgm\\_pd26e.pdf](http://www.hcch.net/upload/wop/jdgm_pd26e.pdf) (last visited Oct. 2, 2005) [hereinafter *Draft Report*]. In 2002, the conference was redirected to focus on narrower bases of jurisdiction. *Id.* By 2003, the focus of the Convention was solely on exclusive choice of court agreements in business-to-business contracts. *See id.*

4. Article 27 of the Convention states that ratification, acceptance, approval, or accession is required for adoption of the Convention and that the instrument used for adoption must be deposited with the Ministry of Foreign Affairs prior to the entry into force of the Convention. *Convention, supra* note 3, art. 27. If the U.S. decides to agree to the Convention then it will have to be ratified by a 2/3 majority of the Senate. U.S. CONST. art. II, § 2, cl. 2. *See also* International News Section, WASH. INTERNET DAILY, Vol. 6, No. 136, (Warren Pub. Inc., D.C.) July 15, 2005.

5. *Convention, supra* note 3, art. 1(1). Under the Convention a choice-of-court clause is "exclusive" where the courts of only one country are designated as the chosen forum for any litigation arising out of the agreement. *See* Ronald A. Brand, *A Global Convention on Choice of Court Agreements*, 10 ILSA J. INT'L & COMP. L. 345, 347 (2004); *See also Convention, supra* note 3, art. 3. This differs from the U.S. common law practice in construing choice-of-court provisions as non-exclusive unless the parties indicate otherwise. Peter D. Trooboff, *Choice-of-Court Clauses*, 27 THE NAT'L L. J. 13 (ALM, New York, N.Y.), Oct. 17, 2005. Under the Convention, choice-of-court clauses are deemed "exclusive unless the parties have expressly provided otherwise." *Convention, supra* note 3, art. 3. Article 22 of the Convention allows States to designate that they will also recognize non-exclusive choice-of-court agreements. *Id.* art. 22.

6. *Convention, supra* note 3, arts. 1–2. The terms "civil" and "commercial" are used in the Convention out of habit; they have been used in Hague Conventions since 1896. *See Preliminary Draft, supra* note 3, at 29–30. The terms have never been defined, but it is agreed that some matters that would be considered civil or commercial in some countries are outside the scope of the convention. *Id.* These include: status and legal capacity of natural persons, family law matters, wills and succession, carriage of passengers or goods by sea, nuclear liability, rights *in rem* in immovable property, certain questions relating to legal persons (corporations), and some issues concerning certain intellectual property rights. *Draft Report, supra* note 3, para. 15.

7. *See Draft Report, supra* note 3. Use of the word "State" in this Note refers to foreign countries rather than a domestic "state."

Belgium would generally be required to recognize and enforce the judgment.<sup>8</sup>

Without the Convention, however, it is unclear whether the Belgian legal system in the example above would recognize and enforce the U.S. judgment. While the U.S. has generally been willing to enforce foreign judgments in international business-to-business contract disputes,<sup>9</sup> many foreign governments are skeptical of the U.S. legal system because they believe U.S. juries award excessive punitive damages.<sup>10</sup> Thus, foreign courts are frequently reluctant to enforce American court judgments, leaving U.S. companies involved in such disputes with few remedies.<sup>11</sup> The adoption of the Convention will greatly benefit U.S. companies by providing clarity and harmonization in international business-to-business transactions by ensuring recognition and enforcement of exclusive choice-of-court agreements and the resulting foreign judgments.

While it may seem that the Convention is a “win-win” situation for the U.S., it is not without controversy among some American companies and organizations.<sup>12</sup> The simplicity of the Convention is made complex because it also covers exclusive choice-of-court agreements in non-negotiated contracts,<sup>13</sup> such as online “click-wrap”<sup>14</sup> agreements and

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8. See *Convention*, *supra* note 3, art. 8. See generally Part II *infra* for discussion of exceptions.

9. The leading precedent on U.S. recognition and enforcement of foreign judgments is *Hilton v. Guyot*, 159 U.S. 113 (1895). There, the United States Supreme Court held that while no state is obligated to give effect to foreign judgments, the U.S. courts should recognize foreign judgments under the notion of comity. See *id.* at 163–64. Comity is the principle “to which the law of one nation, as put in force within its territory ... shall be allowed to operate within the dominion of another nation.” *Id.*

10. See Kristen Hudson Clayton, Comment, The Draft Hague Convention on Jurisdiction and Enforcement of Judgments and the Internet — A New Jurisdictional Framework, 36 J. MARSHALL L. REV. 223, 228 (2002); Andrew C. Schneider, New Treaty Will Help Firms Operate Abroad, KIPLINGER BUS. FORECASTS (Kiplinger Wash. Editors, Inc.), Oct. 10, 2005, available at [http://www.kiplingerforecasts.com/home/stories/new\\_treaty\\_will\\_help\\_firms\\_operate\\_abroad.html](http://www.kiplingerforecasts.com/home/stories/new_treaty_will_help_firms_operate_abroad.html) (last visited Oct. 30, 2005).

11. Schneider, *supra* note 10. A U.S. company has three basic options: (1) accept the breach of contract despite the loss it entails, (2) hire counsel and dispute the matter overseas, or (3) submit the matter to arbitration. *Id.*

12. See *Delegates Sign Convention on Choice of Courts, Await Report*, 19 WORLD INTELL. PROP. REP. (BNA Int’l., D.C.), Aug. 2005, at 17 [hereinafter *Delegates Sign Convention*]; Schneider, *supra* note 10.

13. By not including non-negotiated contracts under the Article 2(2) exclusions, the Convention necessarily includes non-negotiated contracts. See *Convention*, *supra* note 3, art. 2(2). Article 2(2) provides:

This Convention shall not apply to the following matters:

- a) the status and legal capacity of natural persons;

“shrink-wrap”<sup>15</sup> agreements.<sup>16</sup> This is of special concern because of the increased prevalence of non-negotiated contracts for information goods

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- b) maintenance obligations;
  - c) other family law matters, including matrimonial property regimes and other rights or obligations arising out of marriage or similar relationships;
  - d) wills and succession;
  - e) insolvency, composition and analogous matters;
  - f) the carriage of passengers and goods;
  - g) marine pollution, limitation of liability for maritime claims, general average, and emergency towage and salvage;
  - h) anti-trust (competition) matters;
  - i) liability for nuclear damage;
  - j) claims for personal injury brought by or on behalf of natural persons;
  - k) tort or delict claims for damage to tangible property that do not arise from a contractual relationship;
  - l) rights *in rem* in immovable property, and tenancies of immovable property;
  - m) the validity, nullity, or dissolution of legal persons, and the validity of decisions of their organs;
  - n) the validity of intellectual property rights other than copyright and related rights;
  - o) infringement of intellectual property rights other than copyright and related rights, except where infringement proceedings are brought for breach of a contract between the parties relating to such rights, or could have been brought for breach of that contract;
  - p) the validity of entries in public registers.

*Id.* art. 2(2).

14. Click-wrap refers to agreements that appear on a computer screen and require a user to click a “yes” or “I agree” button to assent to the terms and conditions before viewing the website, installing software or purchasing a product from the website. *See* Terry J. Ilardi, *Mass Licensing—Part I: Shrinkwraps, Clickwraps and Browsewraps*, in PAT., & HIGH TECHNOLOGY LICENSING 2005, at 253, 256 (PLI Pat., Copyrights, Trademarks and Literary Prop., Course Handbook Series No. 5939, 2005); *Delegates Sign Convention*, *supra* note 12, at 17. *See also* Part III.B *infra*.

15. Shrink-wrap licenses are license terms that are contained on or inside a software box. Mitchell Waldman, *Enforceability of “Clickwrap” or “Shrinkwrap” Agreements*, NTS AM. JUR. 2D COMPUTERS AND THE INTERNET § 16 (2005). Acceptance of the terms is generally indicated by failure to return the software within a designated period of time. Ilardi, *supra* note 14, at 256.

and services.<sup>17</sup> By including non-negotiated contracts, buyers of online software and other services that use non-negotiated terms will be subject to the seller's choice of forum.

The concern by groups such as libraries, nonprofit organizations, Internet Service Providers, and telecommunications companies who oppose the current Convention<sup>18</sup> is that they will be forced to defend themselves in a foreign jurisdiction or be subject to a default judgment.<sup>19</sup> In either case, should judgment result in favor of the seller, the U.S. could then be obligated to enforce the judgment, regardless of whether the outcome of the case would have been the same in the U.S.<sup>20</sup> Furthermore, these groups believe the inclusion of non-negotiated contracts will enable

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16. *Delegates Sign Convention*, *supra* note 12, at 17; Dugie Standeford, *After 13-Year Odyssey, Hague Judgments Treaty Moves Toward Ratification*, WASH. INTERNET DAILY, Vol. 6, No. 133 (Warren Pub. Inc.), July 12, 2005.

17. *See id.*; *see also*, Letter from Robert Oakley, Wash. Aff. Rep., Am. Ass'n of L. Libraries; Miriam Nisbet, Legis. Couns., Am. Library Ass'n.; and Prudence S. Adler, Assoc. Exec. Dir., Ass'n. of Res. Libraries to Jeffrey Kovar, Assistant Legal Advisor for Private Int'l. L. (April 22, 2005) [hereinafter Robert Oakley Letter] (on file with author), available at <http://www.ala.org/ala/washoff/WOissues/copyright/intlcopyright/HagueCmnts0405.pdf> (last visited Oct 4, 2005). Libraries are one of the groups that have voiced concern over the inclusion of non-negotiated contracts because for many libraries most of their transactions involve non-negotiated contracts. *Id.*

18. Sarah Lai Stirland, *Lobbying: Group Urges Rejection of Treaty on Cross-Border Disputes*, NAT'L J. TECH. DAILY (Nat'l J. Group, Inc.) June 15, 2005. Some organizations that have opposed the inclusion of non-negotiated contracts include: the American Association of Law Libraries, American Library Association, AT&T, BellSouth, the Computer Communications Industry Association, MCI, SBC Communications, the U.S. Internet Industry Association, the US Internet Service Provider Assoc. and Verizon Communications. *Id.* The main fear of libraries is that a non-negotiated contract will prohibit copyright privileges which libraries currently enjoy, such as making copies for preservation and inter-library loan. *See* Robert Oakley Letter, *supra* note 17. A foreign court might permit these terms whereas a U.S. court might find them preempted by the Copyright Act. *Id.*

19. Jason Krause, *Concerns Over Clickwrap*, ABA J. E-REPORT (Am. Bar Assoc.), June 3, 2005. Another concern is that consumers might be considered businesses in some circumstances because the definition of consumer under the Convention is very narrow. *See* International News Section, *supra* note 4. The current definition of consumer under the Convention is: "a natural person acting primarily for personal, family or household purposes." Convention, *supra* note 3, art. 2. A prior report of the draft convention stated that the reason that consumers are not covered is because some legal systems have rules that do not allow proceedings over consumers to be brought in a foreign state. *Draft Report*, *supra* note 3, art. 2, para. 17.

20. *See* Robert Oakley Letter, *supra* note 17. The Convention does not permit a court to refuse to recognize or enforce a foreign court judgment on the basis that the court being requested to recognize or enforce the judgment would have decided the case differently. *Convention*, *supra* note 3, art. 8.

companies to essentially forum shop around the world because the drafter of the forum-selection clause can choose the State with the most favorable laws as the exclusive forum and have confidence that it will be enforced.<sup>21</sup> Moreover, critics are concerned that click-wrap agreements could result in businesses unknowingly<sup>22</sup> contracting away rights that they normally would have had under U.S. copyright law, such as lending or fair use rights.<sup>23</sup>

Software and publishing companies who support the Convention argued during drafting that it was “unprecedented to exclude a contract because of its form”<sup>24</sup> and since no definition of “non-negotiated contract” exists in U.S. law, it would have had to be created from scratch.<sup>25</sup> Jeffrey Kovar, the U.S. Department of State Advisor for Private International Law who is also the U.S. negotiator for the Convention, believes that the Convention is “not a workable forum to create new innovations in American law” and that he hoped to maintain the “status quo” in areas that are “not resolved under U.S. law.”<sup>26</sup> Besides arguing that excluding non-negotiated contracts was unrealistic, supporters also point to the Convention’s so-called “escape clauses,” which allow non-chosen courts to exercise jurisdiction or refuse to recognize or enforce jurisdiction on the grounds of “manifest injustice” or that the agreement is “manifestly contrary to public policy,”<sup>27</sup> as reasons to keep non-negotiated contracts

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21. See Krause, *supra* note 19; Businesses Want Clickwrap Contracts Explicitly Excluded from Convention, WORLD INTELL. PROP. REP., Vol. 19, No. 6 (BNA Int’l., D.C.), June 2005, at 16; Delegates Could Finalize Hague Treaty Next Month, WASH. INTERNET DAILY, Vol. 5, No. 43 (Warren Pub. Inc.), Mar. 4, 2004.

22. The term “unknowingly” is used because it is said that few people actually read click-wrap agreements. See Krause, *supra* note 19.

23. See Drew Clark, E-Commerce: Groups Restate Objections To Treaty For Business; Disputes, NATIONAL J. TECH. DAILY (Nat’l J. Group, Inc.), Mar. 5, 2004; Dugie Standeford, E-Commerce Off Front Burner: Intellectual Property Issues Continue to Roil Treaty Talks, WASH. INTERNET DAILY, Vol. 6, No. 49 (Warren Pub. Inc.), March 14, 2005.

24. *Delegates Sign Convention*, *supra* note 12, at 17. Presumably this is because historically treaties have only excluded contracts based on their subject matter rather than form.

25. Krause, *supra* note 19.

26. *Id.* It seems that there is a fear that if the Convention changes U.S. law then the U.S. would not ratify it, thus negotiators are trying to keep the Convention in line with American law in order to increase the chances of ratification. See *id.*

27. See *Convention*, *supra* note 3, arts. 6(c), 9(e). See *infra* Part III for discussion of the public policy exception. The article 6 “escape clauses” state:

A court of a Contracting State other than that of the chosen court shall suspend or dismiss proceedings to which an exclusive choice of court agreement applies unless – a) the agreement is *null and void* under the law of the cho-

within the scope of the Convention.<sup>28</sup> They feel that the “escape clauses” are enough protection to alleviate the critics concerns.<sup>29</sup>

With the inclusion of non-negotiated contracts in the final draft, the software and publishing industries have accomplished their objective, but in order for them to succeed completely the Convention will have to be adopted by the U.S. and other States. If adopted, U.S. businesses and organizations will have to look elsewhere in order to get relief from enforcement of non-negotiated contracts containing choice-of-court clauses. Part II of this Note provides a summary of the key clauses within the Convention. Part III.A. of this Note examines U.S. public policy jurisprudence to determine whether this exception is likely to be a realistic safe guard for businesses and organizations at-risk by the inclusion of non-negotiated contracts.<sup>30</sup> Part III.B. looks at U.S. jurisprudence in context with domestic click-wrap and shrink-wrap agreements containing forum-selection clauses. Part III.C. concludes that based on prior case law, the public policy exception is unlikely to be a realistic safe guard for libraries, non-profits, and other businesses who are at-risk by the inclusion of non-negotiated contracts in the Convention.<sup>31</sup> Part IV of this Note

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sen court; ... c) giving effect to the agreement would lead to a *manifest injustice* or would be *manifestly contrary to the public policy* of the State of the court seised;

*Id.* art. 6 (emphasis added).

The article 9 “escape clauses” provide that a non-chosen state may refuse to recognize a foreign court judgment if:

- a) the agreement was *null and void* under the law of the State of the chosen court, unless the chosen court has determined that the agreement is valid or ...
- e) recognition or enforcement would be *manifestly incompatible with the public policy* of the requested State, including situations where the specific proceedings leading to the judgment were incompatible with fundamental principles of procedural fairness of that State;

*Id.* art. 9 (emphasis added).

28. Krause, *supra* note 19.

29. *See id.*

30. *See* Part III.C. *infra* (Art. 21 of the Convention provides that a State which “has a strong interest I not applying this Convention to a specific matter” may “declare that is will not apply the Convention to that matter.”).

31. The reason larger companies are not as at-risk by the inclusion of non-negotiated contracts is because if a big company encounters a click-wrap contract for something and does not like the terms, the company can easily contact the seller of the click-wrap item and negotiate a special contract, which could include bargaining for alternative litigation criteria. *See* Jonathan A. Franklin & Roberta Morris, *Int'l Jurisdiction and Enforcement of Judgments in the Era of Global Networks: Irrelevance of, Goals For, and Comments on the Current Proposals*, 77 CHI.-KENT L. REV. 1213, 1285–86 (2002). On the other

suggests other possible solutions for at-risk businesses and organizations, including urging the U.S. to make a declaration<sup>32</sup> upon ratification, signing a supplemental convention, and waiting to see the effects should the U.S. ratify the Convention. Part V concludes that if the U.S. decides to ratify the Convention as is, the best option for those at-risk by the inclusion of non-negotiated contracts is to limit non-negotiated transactions until the Convention is modified or the drafter of the non-negotiated contract modifies the forum-selection clause.

## II. OVERVIEW OF CONVENTION

The basic rules of the Convention lie within Articles 5,<sup>33</sup> 6,<sup>34</sup> and 8.<sup>35</sup>

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hand, like consumers, Universities and libraries are not in the position to negotiate every click-wrap contract, nor are they able to assume the risk of having to go to a foreign forum. *Id.* at 1289.

32. *Convention, supra* note 3, art. 21.

33. Article 5 of the Convention states:

1. The court or courts of a Contracting State designated in an exclusive choice of court agreement shall have jurisdiction to decide a dispute to which the agreement applies, unless the agreement is null and void under the law of that State.
2. A court that has jurisdiction under paragraph 1 shall not decline to exercise jurisdiction on the ground that the dispute should be decided in a court of another State.
3. The preceding paragraphs shall not affect rules: a) on jurisdiction related to subject matter or to the value of the claim; b) on the internal allocation of jurisdiction among the courts of a Contracting State. However, where the chosen court has discretion as to whether to transfer a case, due consideration should be given to the choice of the parties.

*Convention, supra* note 3, art. 5.

34. Article 6 of the Convention provides:

A court of a Contracting State other than that of the chosen court shall suspend or dismiss proceedings to which an exclusive choice of court agreement applies unless:

- a) the agreement is null and void under the law of the State of the chosen court;
- b) a party lacked the capacity to conclude the agreement under the law of the State of the court seised;
- c) giving effect to the agreement would lead to a manifest injustice or would be manifestly contrary to the public policy of the State of the court seised;
- d) for exceptional reasons beyond the control of the parties, the agreement cannot reasonably be performed; or
- e) the chosen court has decided not to hear the case.

First, the Convention provides that the court designated in an exclusive choice-of-court agreement will have exclusive jurisdiction to decide the dispute and will not be allowed to decline jurisdiction “on the ground that the dispute should be decided by a court in another State.”<sup>36</sup> Second,

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*Id.* art. 6.

35. Article 8 of the Convention provides:

1. A judgment given by a court of a Contracting State designated in an exclusive choice of court agreement shall be recognised and enforced in other Contracting States in accordance with this Chapter. Recognition or enforcement may be refused only on the grounds specified in this Convention.
2. Without prejudice to such review as is necessary for the application of the provisions of this Chapter, there shall be no review of the merits of the judgment given by the court of origin. The court addressed shall be bound by the findings of fact on which the court of origin based its jurisdiction, unless the judgment was given by default.
3. A judgment shall be recognised only if it has effect in the State of origin, and shall be enforced only if it is enforceable in the State of origin.
4. Recognition or enforcement may be postponed or refused if the judgment is the subject of review in the State of origin or if the time limit for seeking ordinary review has not expired. A refusal does not prevent a subsequent application for recognition or enforcement of the judgment.
5. This Article shall also apply to a judgment given by a court of a Contracting State pursuant to a transfer of the case from the chosen court in that Contracting State as permitted by Article 5, paragraph 3. However, where the chosen court had discretion as to whether to transfer the case to another court, recognition or enforcement of the judgment may be refused against a party who objected to the transfer in a timely manner in the State of origin.

*Id.* art. 8.

36. *Id.* art. 5(1)–(2). Article 5(2) thus forbids a court from using the doctrine of forum non conveniens to transfer the case to a court in a foreign State. *Draft Report, supra* note 3, art. 5. The doctrine of forum non conveniens, which appears mostly in common law systems, allows a court with proper jurisdiction to stay or dismiss a case where there is a more appropriate forum for the proceedings. Ronald A. Brand, *Comparative Forum Non Conveniens on Jurisdiction and Judgments*, 37 *TEX. INT’L L. J.* 467, 468 (2002). For example, assume a claim is brought in New York state court for breach of contract involving products manufactured in Germany. The plaintiff is a German corporation and the manufacturer of the products is a United States corporation with its principle place of business in Delaware. The New York courts are the chosen forum in the contract, and the contract also provides German law as the choice of law. All witnesses, except the CEO of the U.S. corporation, are located in Germany. The New York court would likely conclude that Germany is a better forum to determine the case and would dismiss the case based on the doctrine of forum non conveniens. In contrast, under the Convention, the New York court must hear the case. However, the court could transfer the case to a New York federal court or to a Delaware federal court because these courts are still within the larger

the Convention requires that if an exclusive choice-of-court agreement designating a signature State exists, a court not designated in the agreement must decline to exercise jurisdiction<sup>37</sup> over any proceeding inconsistent with the choice-of-court agreement—even if the court otherwise has jurisdiction under its national laws.<sup>38</sup> For example, if a party to an agreement attempts to circumvent the exclusive choice-of-court clause and brings a suit in a different forum than designated in the agreement, the court must refuse to take the case.<sup>39</sup> However, there are exceptions to this rule which would allow the court to accept jurisdiction despite the choice-of-court agreement if: (1) the agreement is “null and void;”<sup>40</sup> (2) a party “lacked capacity” to enter into the agreement;<sup>41</sup> (3) the “agreement cannot be performed” by the parties for “exceptional reasons” outside their control;<sup>42</sup> (4) upholding the agreement would lead to “manifest injustice” or would be “manifestly contrary to the public policy” of the State;<sup>43</sup> or (5) the “chosen court has decided not to hear the case.”<sup>44</sup>

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chosen “State,”—the United States. *Draft Report, supra* note 3, art. 5, n.92. In paragraphs 3(a) and (b) under article 5, the Convention further states that parties to the proceedings cannot waive subject matter jurisdiction or other internal procedural rules, such as rules precluding certain parties from bringing suit. *Id.* art. 5, para. 3(a)–(b). Thus, if the proceedings concern a matter for which a specialized court exists (such as patent or bankruptcy), and the chosen court is not the proper specialized court, then the chosen court would not be obliged to hear the case. *Id.* art. 5, para. 101. The chosen court could, however, transfer the case to the state court with the proper jurisdiction—even if the proper court is in a state other than the one designated in the choice-of-court agreement. *Id.* art. 5, paras. 101, 107.

37. *Convention, supra* note 3, art. 6. The provisions of this section are most applicable when a party to a choice of court agreement tries to bring suit in a court that is not the chosen court within the agreement.

38. *Draft Report, supra* note 3, art. 6, paras. 107, 119.

39. *See id.*

40. *Convention, supra* note 3, art. 6(a). This provision requires the agreement be “null and void” under the laws of the chosen State, thus application of the law of the chosen court is necessary. *Draft Report, supra* note 3, art. 7, para. 124.

41. *Convention, supra* note 3, art. 6(b). Under the “capacity” provision, the non-chosen court will apply its own choice-of-law rules to determine whether there was lack of capacity by one of the parties. *Draft Report, supra* note 3, art. 7, para. 125.

42. *Convention, supra* note 3, art. 6(d). This is intended to apply to cases when it would not be possible to bring proceedings before the chosen court, such as when there is a war in the State of the chosen court or the chosen court no longer exists. *Draft Report, supra* note 3, art. 7, para. 129.

43. *Convention, supra* note 3, art. 6(c). For a discussion on the public policy exception, see *infra* Part II.

44. *Convention, supra* note 3, art. 6(e). This could be covered under article 6(d), but the drafters thought it was worthy of its own treatment. *Draft Report, supra* note 3, para. 130.

Finally, when requested, a State must recognize and enforce a judgment given by a signature State designated in an exclusive choice-of-court agreement.<sup>45</sup> The Convention provides exceptions to this requirement as well.<sup>46</sup> Recognition or enforcement may be refused by a State on the grounds that: (1) the contract is invalid;<sup>47</sup> (2) a party lacked capacity to enter into the agreement;<sup>48</sup> (3) improper notice was given to the defendant;<sup>49</sup> (4) the judgment was obtained by procedural fraud;<sup>50</sup> (5) the

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45. See art. 8 *supra* note 35.

46. *Convention, supra* note 3, art. 9.

47. See *Convention, supra* note 3, art. 9(a). Article 9(a) provides that “recognition or enforcement may be refused if a) the agreement was null and void under the law of the State of the chosen court, unless the chosen court has determined that the agreement is valid.” *Id.* This clause is analogous to the exception in article 6(a).

48. See *Convention, supra* note 3, art. 9(b). This clause reads: “a party lacked the capacity to conclude the agreement under the law of the requested State.” *Id.* This clause is analogous to the one in article 6(b).

49. See *Convention, supra* note 3, art. 9(c). This clause provides that recognition or enforcement may be refused if:

c) the document which instituted the proceedings or an equivalent document, including the essential elements of the claim,

i) was not notified to the defendant in sufficient time and in such a way as to enable him to arrange for his defence, unless the defendant entered an appearance and presented his case without contesting notification in the court of origin, provided that the law of the State of origin permitted notification to be contested; or

ii) was notified to the defendant in the requested State in a manner that is incompatible with fundamental principles of the requested State concerning service of documents.

*Id.*

This exception applies if the defendant was not given enough time after notification to prepare his defense. *Id.* However, this exception is waived if the defendant made an appearance in the proceedings without contesting the notification or requesting an adjournment in order to properly prepare. See *id.* This prevents the defendant from raising insufficient notification as a ground for non-enforcement when it could have been raised in the initial proceedings. *Draft Report, supra* note 3, art. 9, para. 140. The exception however, will not be waived if the court giving the judgment does not allow notification to be contested. *Convention, supra* note 3, art. 9(c)(i). Provision 9(c)(ii) provides that recognition and enforcement can be refused if the manner of notification was “incompatible with fundamental principles” relating to service of process in the requested State. *Id.* art. 9(c)(ii). This provision only applies if recognition or enforcement is requested of the State in which service took place. *Draft Report, supra* note 3, art. 9, para. 140.

50. *Convention, supra* note 3, art. 9(d). This clause reads: “the judgment was obtained by fraud in connection with a matter of procedure.” *Id.* Fraud in this provision means “deliberate dishonesty or deliberate wrongdoing.” *Draft Report, supra* note 3, art. 9, para.

judgment violates public policy of the state;<sup>51</sup> (6) the judgment is inconsistent with a prior judgment in the State involving the same parties;<sup>52</sup> or (7) the judgment is inconsistent with a prior judgment given in another State.<sup>53</sup>

### III. THE PUBLIC POLICY EXCEPTION

Articles 6(c) and 9(e) of the Convention contain the public policy “escape clauses.” As mentioned above, although the court not chosen in the choice-of-court clause is required to suspend or dismiss the action, 6(c) allows the court to take jurisdiction of the case if giving effect to the agreement would be “manifestly contrary to the public policy of the State

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142. For example, this provision would apply if the plaintiff forged the defendant’s signature on a false document. *Id.*

51. *Convention, supra* note 3, art. 9(e). This provision reads: “recognition or enforcement would be manifestly incompatible with the public policy of the requested State, including situations where the specific proceedings leading to the judgment were incompatible with fundamental principles of procedural fairness of that State.” *Id.* The second half of this provision is meant to apply to States where due process of law, natural justice of the right to fair trial is constitutionally mandated. *Draft Report, supra* note 3, art. 9, para. 143. *See also* Part III *infra*.

52. *Convention, supra* note 3, art. 9(f). Article 9(f) reads: “the judgment is inconsistent with a judgment given in the requested State in a dispute between the same parties.” *Id.* This exception will typically arise in instances where the judgment that conflicts with the chosen court’s final judgment was given because the requested court thought that one of the article 6 exceptions applied. *Draft Report, supra* note 3, art. 9, para. 148. If the exception did apply, then the requested court can give preference to its own ruling. *Id.* If no exception applies, the requested court would have violated the Convention by hearing the proceeding and should give the chosen court’s judgment preference. *Id.*

53. *Convention, supra* note 3, art. 9(g). This provision states: “the judgment is inconsistent with an earlier judgment given in another State between the same parties on the same cause of action, provided that the earlier judgment fulfils the conditions necessary for its recognition in the requested State.” *Id.* This applies when both judgments were given by foreign courts. *Draft Report, supra* note 3, art. 9, para. 149. In this situation, the judgment given by the court designated in the choice-of-court agreement can be refused recognition and enforcement if the following requirements are met: (1) the judgment under the chosen court was given after the conflicting judgment; (2) both judgments involve the same parties; (3) the cause of action of the judgments is the same; and (4) the conflicting judgment must fulfill the requirements necessary for recognition in the requested state. *Id.* Note however, that in the *Draft Report* it was mentioned that provision (g) should be modified because it currently provides an incentive for states not to become parties to the Convention because it is not required that the conflicting judgment not be in contravention of the Convention. *Id.* Since non-Contracting States are not parties to the Convention their judgments will never be in contravention of the Convention. *Id.*

of the court seized.”<sup>54</sup> Similarly, Article 9(e) allows a court to refuse to recognize or enforce a foreign court judgment if “recognition or enforcement would be manifestly incompatible with the public policy of the requested State.”<sup>55</sup> Not surprisingly, what constitutes a violation of public policy is not defined in the Convention. However, the use of the public policy exception to deny recognition and enforcement of foreign judgments and forum-selection clauses is not new to the Convention; the exception has been widely recognized in U.S. law<sup>56</sup> and in other statutes and conventions as well.<sup>57</sup>

In practice however, there are few cases in the U.S. that have denied recognition and enforcement on public policy reasons alone, despite the fact that every state has the right to refuse enforcement of a foreign judgment.<sup>58</sup> Nevertheless, it is valuable to examine U.S. public policy jurisprudence to understand the application of the exception to foreign judgments and assess the viability of this exception as a means to protect those at-risk by the inclusion of non-negotiated contracts within the Con-

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54. *Convention, supra* note 3, art. 6(c). This clause also allows the court seized to accept jurisdiction if “giving effect to the agreement would lead to “manifest injustice.” *Id.*

55. *Id.* art. 9(e). This article continues with “including situations where the specific proceedings leading to judgment were incompatible with fundamental principles of procedural fairness of the State.” *Id.*

56. *See infra*, Part III.A. and B.

57. In the U.S., the United Nations Convention on the Recognition and Enforcement of Arbitral Awards does not require enforcement of an otherwise unenforceable arbitral award when such enforcement would be “contrary to the public policy” of the enforcing country. United Nations Convention on the Recognition and Enforcement of Arbitral Awards, art. 5(2)(b), Dec. 29, 1970, 21 U.S.T. 2517, 330 U.N.T.S. 3 [hereinafter New York Convention]. As the name suggests, the New York Convention sets out rules for recognition and enforcement for foreign arbitral awards. Similarly, a number of states have adopted the Uniform Foreign Money-Judgments Recognition Act (“UFMJRA”) which provides that recognition is not necessary if the action underlying the judgment is “repugnant to the public policy of [the] state.” Uniform Foreign Money-Judgments Recognition Act of 1962, § 4(b)(3), 13 U.L.A. 80 (Supp. 1998). The Brussels Convention, adopted in 1968, regulates the standards of jurisdiction and enforcement between Member States of the European Union. Its public policy exception states that a judgment will not be recognized “if such recognition is contrary to public policy in the State in which recognition is sought. Convention on Jurisdiction and the Enforcement of Judgments in Civil and Commercial Matters, tit. III, § 1, art. 27(1) Sept. 27, 1968, *as amended*, 1998 O.J. (C 27) 1, 10 [hereinafter Brussels Convention].

58. Andreas F. Lowenfeld and Linda J. Silberman, *United States of America, in ENFORCEMENT OF FOREIGN JUDGMENTS WORLDWIDE* 123, 129 (Charles Platto & William G. Horton eds., 2<sup>nd</sup> ed. 1993). Because there is no U.S. federal law governing the recognition and enforcement of foreign court judgments, state law applies, even in federal courts. *Id.* at 123.

vention. Similarly, despite the fact that there is currently no U.S. case law involving click-wrap agreements containing foreign forum-selection clauses which have resulted in contested foreign judgments, examining U.S. jurisprudence involving click-wrap agreements and forum-selection clauses in a domestic setting is also relevant. This will aid in assessing whether U.S. courts might perceive these types of agreements as violations of public policy.

#### *A. Public Policy Exception Jurisprudence*

##### 1. Non-Recognition of the Public Policy Exception

The leading case defining the public policy exception is *Parsons & Whittemore Overseas Co. Inc. v. Société Générale de l'Industrie du Papier (RAKTA)*.<sup>59</sup> Although this case was decided in the context of enforcement of a foreign arbitral award, the holding still applies to enforcement of foreign judgments in general.<sup>60</sup> In *Parsons*, the Egyptian corporation Société Générale de l'Industrie du Papier ("RAKTA") contracted with the American corporation Parsons & Whittemore Overseas Co. Inc. ("Overseas") to construct and manage a paperboard mill in Egypt.<sup>61</sup> The agreement contained an arbitration clause and a force majeure clause.<sup>62</sup> Near the end of the construction phase, Egypt severed ties with the United States and "ordered all Americans expelled from Egypt" except those approved for special visas.<sup>63</sup> Overseas subsequently abandoned the project and "notified RAKTA that it regarded this postponement as excused by the force majeure clause."<sup>64</sup> RAKTA disagreed that

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59. *Parsons & Whittemore Overseas Co. Inc. v. Société Générale de l'Industrie du Papier (RAKTA)*, 508 F.2d 969 (2d Cir. 1974); Lowenfeld & Silberman, *supra* note 58, at 129.

60. See Lowenfeld & Silberman, *supra* note 58, at 129. Although Lowenfeld and Silberman do not say why enforcement of a foreign arbitral award is relevant to the enforcement of foreign judgments in general, the author of this Note presumes it is because courts tend to use the same public policy analysis regardless of whether it is a foreign arbitration judgment or a foreign court judgment. Article 5(2)(b) of the New York Convention allows the court in which enforcement of the foreign arbitral award is sought to refuse enforcement if "enforcement of the award would be contrary to the public policy of [the forum] country." New York Convention, *supra* note 57, art. 5(2)(b). For further discussion on the New York Convention see note 57 *supra*.

61. *Parsons*, 508 F.2d at 972.

62. *Id.*

63. *Id.*

64. *Id.*

the delay fell under the force majeure clause, and brought an arbitration proceeding for damages for breach of contract.<sup>65</sup>

The arbitration panel awarded damages to RAKTA finding that the force majeure clause only covered part of the delay because Overseas had not made an effort to complete the contract.<sup>66</sup> One of Overseas' defenses during the U.S. enforcement proceedings was the public policy exception to the New York Convention.<sup>67</sup> Overseas argued that enforcing the arbitration award on the ground that it could complete the contract, despite the severance of American and Egyptian ties and the U.S. withdrawal of funding for international development, would contravene U.S. public policy.<sup>68</sup>

The United States Court of Appeals for the Second Circuit disagreed with Overseas' argument equating "national" policy with United States "public" policy.<sup>69</sup> The court concluded that to do so "would mean converting a defense intended to be of narrow scope into a major loophole" to the New York Convention.<sup>70</sup> The court subsequently upheld the arbitration award and reasoned that the public policy exception only applies "where enforcement would violate the forum state's most basic notions of morality and justice."<sup>71</sup>

Even when the substantive laws of the State handing down the judgment are different from those in the U.S., the public policy exception has been an inadequate reason to overturn a foreign judgment.<sup>72</sup> In *Somportex*, the District Court for the Third Circuit upheld a decision enforcing a British court default judgment against an American corporation.<sup>73</sup> There, the plaintiff, a British corporation, had entered into a contract whereby the American defendant corporation would distribute the defendant's gum in Great Britain.<sup>74</sup> When the transaction failed, the plaintiff filed suit in a British court for breach of contract.<sup>75</sup> The British court entered a default judgment against the defendant,<sup>76</sup> and the plaintiff subsequently

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65. *Id.*

66. *Id.*

67. *Parsons*, 508 F.2d at 972; *See also* note 39 *supra*.

68. *Id.* at 974.

69. *Id.*

70. *Id.*

71. *Id.*

72. *See Somportex Ltd. v. Philadelphia Chewing Gum Corp.*, 453 F.2d 435 (3d Cir. 1971), *cert. denied*, 405 U.S. 1017 (1972); *Sarl Louis Feraud Int'l v. Viewfinder*, 2005 U.S. Dist. LEXIS 22242, at \*16 (2005).

73. *Somportex*, 453 F.2d at 444.

74. *Id.* at 436

75. *Id.*

76. *Id.* at 439.

sought enforcement of the judgment in a U.S. court.<sup>77</sup> The defendant raised the public policy defense because the British court awarded attorney's fees, which would not have been "recoverable under Pennsylvania law."<sup>78</sup> The defendant argued that enforcement of the attorney's fees was contrary to Pennsylvania public policy.<sup>79</sup>

Nevertheless, the court dismissed the defendant's argument and agreed with the district court's decision that the "variance with Pennsylvania law is not such that the enforcement 'tends clearly to injure the public health, the public morals, the public confidence in the purity of the administration of the law, or to undermine that sense of security for individual rights, whether of personal liberty or of private property, which any citizen ought to feel, is against public policy.'"<sup>80</sup> The court concluded that the difference between British and Pennsylvania law was not enough to refuse enforcement on the basis of public policy.<sup>81</sup>

Similarly, courts have even found that a difference in substantive federal laws is insufficient justification for applying the public policy exception. In *Viewfinder*, the District Court for the Southern District of New York declined to apply the public policy exception despite inconsistencies between French and U.S. intellectual property laws.<sup>82</sup> The French plaintiff argued in its initial action that the American defendant, *Viewfinder*, violated the plaintiff's intellectual property rights and engaged in unfair competition by posting on its website photographs of models wearing the plaintiff's clothing.<sup>83</sup> The defendant raised the public policy defense, arguing that his actions did not "violate American trademark principles;" the website postings constituted fair use; and the plaintiffs "could not copyright their dress designs" under U.S. copyright law.<sup>84</sup>

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77. *Id.*

78. *Id.* at 443.

79. *Id.*

80. *Id.* (quoting the District Court quoting *Goodyear v. Brown*, 26 A. 665, 668 (P.A. 1893)).

81. *Id.* at 444.

82. *Sarl Louis Feraud Int'l v. Viewfinder*, 2005 U.S. Dist. LEXIS 22242, at \*16. However, the court did apply the public policy exception on other grounds, finding that the defendant's conduct was protected under the First Amendment, and thus, enforcing the agreement would violate U.S. public policy. *Id.* at \*19.

83. *Id.* at \*1. Even though the French court entered a default judgment against *Viewfinder* and therefore did not directly apply French intellectual property laws, the District Court addressed the defendant's intellectual property law public policy argument anyways. *Id.* at \*15-17.

84. *Id.* at \*14-15. The fair use doctrine is an affirmative defense to copyright infringement. 17 U.S.C.A. § 107 (2005). The fair use doctrine allows the public to copy parts of a copyrighted work for purposes of criticism, comment, news reporting, teaching, scholarship or research. *Id.* Section 107 of the U.S. Copyright Act states:

The court disagreed with the defendant's argument and stated that the differences in French and American intellectual property law "do not come close" to meeting the public policy standard.<sup>85</sup>

Copyright and trademark law are not matters of strong moral principle. Intellectual property regimes are economic legislation based on policy decisions that assign rights based on assessments of what legal rules will produce the greatest economic good for society as a whole. ... If the United States has not seen fit to permit fashion designs to be copyrighted, that does not mean that a foreign judgment based on a contrary policy decision is somehow repugnant to the public policies underlying the Copyright Act and trademark law.<sup>86</sup>

Courts have also found that differences in procedural laws between the U.S. and a foreign State are insufficient reason to withhold enforcement under the public policy exception. In *Tahan v. Hodgson*, the Court of Appeals for the District of Columbia refused to find a violation of public policy solely because of a difference in procedure.<sup>87</sup> The defendant in this case argued that upholding an Israeli default judgment was against public policy because the notice he received was different than that re-

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Notwithstanding the provisions of sections 106 and 106A, the fair use of a copyrighted work, including such use by reproduction in copies or phonorecords or by any other means specified by that section, for purposes such as criticism, comment, news reporting, teaching (including multiple copies for classroom use), scholarship, or research, is not an infringement of copyright. In determining whether the use made of a work in any particular case is a fair use the factors to be considered shall include—

- (1) the purpose and character of the use, including whether such use is of a commercial nature or is for nonprofit educational purposes;
- (2) the nature of the copyrighted work;
- (3) the amount and substantiality of the portion used in relation to the copyrighted work as a whole; and
- (4) the effect of the use upon the potential market for or value of the copyrighted work.

The fact that a work is unpublished shall not itself bar a finding of fair use if such finding is made upon consideration of all the above factors.

*Id.*

85. *Viewfinder*, 2005 U.S. Dist. LEXIS 22242, at \*16.

86. *Id.* (citations omitted).

87. 662 F.2d 862, 866 (D.C. Cir. 1981).

quired under U.S. law.<sup>88</sup> The court felt that the differences in procedure did not violate public policy because the Israeli notice procedures were not "repugnant to notions of what is decent and just."<sup>89</sup>

## 2. Recognition of the Public Policy Exception

In most cases in which courts find public policy violations, there is at stake some interest of the forum greater than protecting the litigant,<sup>90</sup> such as a violation of the U.S. Constitution or the desire to prevent individuals from circumventing federal or state laws.<sup>91</sup> In *Matusevitch v. Telnikoff*,<sup>92</sup> the District Court for the D.C. Circuit refused to enforce a British court libel judgment on grounds that it violated U.S. and Virginia public policy.<sup>93</sup> A British public figure obtained a libel judgment against an American writer.<sup>94</sup> Subsequently, the writer challenged the action in the district court seeking summary judgment on the grounds that the foreign judgment was unenforceable.<sup>95</sup> The court distinguished this case from other cases that had rejected the public policy defense because those cases "concern[ed] minor differences in statutory law and in rules of civil procedure or corporate or commercial law."<sup>96</sup> The court described the United Kingdom libel standards, which place the burden of proving the truth of the statements on the defendant, as contrary to the U.S. libel standards, which require the plaintiff to prove that the statements were false and that the defendant had the necessary intent to commit libel.<sup>97</sup> Based on the evidence, the court concluded that because the

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88. *Id.* The defendant was served in Jerusalem by the plaintiff's attorney, but the defendant refused to acknowledge the service of process because the papers were written in Hebrew. *Id.* Under Rule 52(b)(2) of the Federal Rules of Civil Procedure, a "second" notice must be given at least three days prior to hearing and application for entry of a default judgment in some circumstances. *Id.* at 866.

89. *Id.* The court further pointed out that it "would be unrealistic for the United States to require all foreign judicial systems to adhere to the Federal Rules of Civil Procedure." *Id.*

90. Jonathan A. Pittman, Note, *The Public Policy Exception to the Recognition of Foreign Judgments*, 22 VAND. J. TRANSNAT'L L. 969, 991 (1989) (citing von Mehren & Patterson, *Recognition and Enforcement of Foreign Country Judgments in the United States*, 6 LAW & POL'Y INT'L BUS. 37, 63 (1974)).

91. See *Matusevitch v. Telnikoff*, 877 F. Supp. 1 (D.C. 1995); *Laker Airways v. Sabena, Belgian World Airlines* 731 F.2d 909 (D.C. Cir. 1984), *aff'g* *Laker Airways Ltd. v. Pan American World Airways*, 559 F. Supp. 1124 (D.D.C. 1983)

92. *Matusevitch*, 877 F. Supp. at 1.

93. *Id.* at 4.

94. *Id.* at 3.

95. *Id.* at 2.

96. *Id.*

97. *Id.*

defendant's statements were not made with actual malice, enforcement of the British judgment would be "repugnant" to both state and U.S. public policy.<sup>98</sup>

In *Laker Airways*, the plaintiff, British airline Laker Airways, filed an anti-trust action in the United States against a group of foreign and domestic airlines, claiming that the defendants' price fixing forced them out of business.<sup>99</sup> Several months later, some of the defendants filed their own suit in the High Court of Justice in the United Kingdom seeking an injunction forbidding the plaintiff from prosecuting them.<sup>100</sup> The British court ultimately issued the injunction, ordering the plaintiff to dismiss its action against the British airlines.<sup>101</sup> In the meantime, Laker Airways sought an anti-suit injunction from the United States Court for the District of Columbia to prevent the remaining defendant airlines from requesting an injunction from the British courts as well.<sup>102</sup> The court granted the anti-suit injunction and held that anti-suit injunctions were justified to prevent litigants' evasion of a forum's public policies.<sup>103</sup>

Although the case did not involve enforcement of a foreign judgment, the court in *Laker Airways* analogized the issuance of an anti-suit injunction to prevent a foreign court judgment with that of non-recognition of a foreign judgment.<sup>104</sup> The court concluded that in both instances, states are "not required to give effect to foreign judicial proceedings" based on "policies which do violence to its own fundamental interest."<sup>105</sup> Here, the court found that the anti-trust laws were of "admitted economic importance to the United States," and thus, public policy mandated that the anti-suit injunction be issued to prevent the defendants from "evad[ing] culpability under [the] statutes."<sup>106</sup>

In *Ackermann v. Levine*, the plaintiff, a member of a German law firm, sought recognition and enforcement of a German default judgment to recover legal fees against the defendant, an American citizen.<sup>107</sup> The defendant had hired the plaintiff to help him negotiate a New Jersey real estate investment deal with some German banks.<sup>108</sup> The defendant had specifically authorized the attorney to represent him in negotiations, but

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98. *Id.* at 6.

99. *Laker Airways*, 731 F.2d at 915, 917.

100. *Id.* at 915.

101. *Id.*

102. *Id.*

103. *Id.* at 931.

104. *Id.*

105. *Id.*

106. *Id.* at 932.

107. 788 F.2d 830, 837 (2d Cir. 1986).

108. *Id.* at 835-36.

no fees were ever discussed.<sup>109</sup> The plaintiff eventually sent the defendant a bill for his services which were computed in accordance with a German legal fee statute.<sup>110</sup> Three months later, the plaintiff won a default judgment in a West German court against the defendant.<sup>111</sup> The District Court for the Southern District of New York found the German judgment to be unenforceable because it was up to the attorney, not the client, to ensure that the client understood the compensation agreement, and because the parties had never discussed the fees, the judgment violated U.S. public policy.<sup>112</sup>

The Court of Appeals for the Second Circuit reversed the district court's decision in part, holding that the "narrow public policy exception to enforcement [was] not met" just because the defendant was not informed of the German legal fee statute.<sup>113</sup> Furthermore, the court noted that the exception would not be met even if the attorney's fees were more than American attorneys might have charged.<sup>114</sup> However, the court did find a public policy violation on a narrower basis.

The court found that in order to recover attorney's fees, New York public policy requires there be evidence of client authorization for the alleged work performed by the attorney and evidence the attorney actually performed the work for which he charged.<sup>115</sup> The court held that the part of the German judgment that included fees for the "study of project files" and "discussion with client and his counsel" were unenforceable because there was no evidence of authorization for the work or proof of actual work product.<sup>116</sup> The court felt that recognizing this portion of the judgment could cause "American courts [to] become the means of enforcing unconscionable attorney fee awards" which could lead to the endangerment of "'public confidence' in the administration of the law."<sup>117</sup> Furthermore, the court noted, recognizing the foreign judgment would "impose upon American citizens doing business abroad an undue risk in dealing with foreign counsel," which could undermine transnational legal relations.<sup>118</sup> Thus, in a sense, both New York and Germany had a substantial interest in not enforcing unconscionable attorney's fees.<sup>119</sup>

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109. *Id.*

110. *Id.* 836–37.

111. *Id.* 837.

112. *Id.* at 841.

113. *Id.* at 842.

114. *Id.*

115. *Id.* at 842–43.

116. *Id.* at 844–45.

117. *Id.* at 844.

118. *Id.* at 844.

119. *See Pittman, supra* note 89, at 991.

In sum, the public policy exception has been construed very narrowly throughout U.S. jurisprudence regardless of whether the differences in the U.S. federal or state laws are substantive or procedural in nature and whether the outcome would have been different in U.S. courts. In the rare instances when courts have refused recognition or enforcement of a foreign judgment because of public policy, it has been to protect a higher federal or state interest, rather than out of fairness to the litigant.

*B. Click-wraps, Shrink-wraps, Forum-Selection, and Public Policy*

In general, U.S. courts have enforced forum-selection clauses<sup>120</sup> within click-wrap and shrink-wrap agreements.<sup>121</sup> Although there are no Supreme Court cases enforcing click-wrap agreements, lower courts have often justified upholding these agreements based on precedent set by the Supreme Court decision in *Carnival Cruise Lines, Inc. v. Shute*<sup>122</sup> and the

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120. The seminal case for U.S. forum-selection clause enforcement is *Bremen v. Zapata*. 407 U.S. 1 (1972). In *Bremen*, an American company contracted with a German corporation to tow a drilling rig from the U.S. to the Adriatic Sea. *Id.* at 1. The contract, drafted by the German company, provided that “any dispute arising must be treated before the London Court of Justice.” *Id.* En route to the Adriatic Sea, the rig was severely damaged during a storm in the Gulf of Mexico. *Id.* The American company sued the German company in a U.S. court for damages. *Id.* The United States Supreme Court announced a strong policy in favor of enforcing forum-selection clauses in “freely negotiated, private international agreements, unaffected by fraud, undue influence or overwhelming bargaining power.” *Id.* at 12. The Court stated:

In such circumstances, it should be incumbent upon the party seeking to escape his contract to show that trial in the contractual forum will be so gravely difficult and inconvenient that he will for all practical purposes be deprived of his day in court. Absent that, there is no basis for concluding that it would be unfair, unjust, or unreasonable to hold that party to his bargain.

*Id.* at 18.

121. See *ProCD, Inc. v. Zeidenberg*, 86 F.3d 1447 (7<sup>th</sup> Cir. 1996) (enforcing a software shrink-wrap agreement); *Decker v. Circus Circus Hotel* 49 F. Supp. 2d 743 (D.N.J. 1999) (finding a click-wrap forum-selection clause enforceable); *Forrest v. Verizon Communications, Inc.* 805 A.2d 1007 (D.C. 2002) (enforcing a click-wrap agreement which required that all disputes be brought in Virginia); *Hughes v. McMnamon* 204 F. Supp. 2d 178 (D. Mass. 2002) (enforcing a click-wrap forum-selection clause designating Virginia as the exclusive choice-of-court); *But see America Online v. Superior Court*, 108 Cal. Rptr. 2d 699 (Cal. Ct. App. 2001) (holding forum-selection clause was not enforceable because it violates California public policy). For an overview of click-wrap agreement jurisprudence see William J. Condon Jr., Comment, *Electronic Assent to Online Contracts: Do Courts Consistently Enforce Clickwrap Agreements?*, 18 REGENT U. L. REV. 433 (2004).

122. 499 U.S. 585 (1991).

Seventh Circuit Court of Appeals case *ProCD, Inc. v. Zeidenberg*.<sup>123</sup> In *Shute*, the Court upheld a non-negotiated contract because it was reasonable that the terms were non-negotiable.<sup>124</sup> In *ProCD*, the court established that shrink-wrap agreements were enforceable.<sup>125</sup> Courts have since reasoned that if shrink-wrap contracts are enforceable because an individual gives their consent to the terms by not returning the product, then it follows that an agreement where an individual assents in a more express way by clicking “I Agree” should also be enforceable.<sup>126</sup> Courts have generally held that as long as the vendor makes the terms available for the individual’s acceptance, and does not try to hide them, the agreement will be enforceable.<sup>127</sup> Courts have further justified their reasoning on federal and state public policy grounds concluding that enforcement of click-wrap agreements supports the freedom of contract, encourages nationwide commerce,<sup>128</sup> “protects small businesses, and promotes the Internet as a valuable vehicle for conducting business.”<sup>129</sup>

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123. 86 F.3d 1447 (7th Cir. 1996).

124. See Condon, *supra* note 121, at 440. In *Shute* the court enforced a contract of adhesion between Carnival Cruise lines and the plaintiff which required that all litigation relating to the cruise be brought in the state of Florida. 499 U.S. at 587–88, 595. The court reasoned that although the contract was one of adhesion, it was a routine transaction. *Id.* at 593. And because it did not eliminate the plaintiff’s “right to ‘a trial by a court of competent jurisdiction’” it was enforceable. *Id.* at 596 (quoting 46 U.S.C. app. § 183(c) (2001)).

125. See Condon, *supra* note 121, at 440. In *ProCD*, the court enforced the terms of a shrink-wrap agreement, even though the defendant was not aware of the terms of the agreement until after the purchase of the software. 86 F.3d at 1450. The court reasoned that the shrink-wrap agreement was analogous to other “pay now, terms later” transactions, such as insurance, airline tickets and concert tickets, which were enforceable under the UCC. *Id.* at 1451–52. Therefore, because the defendant was given the opportunity to review the terms and return the software if he did not accept them, the shrink-wrap agreement was enforceable. *Id.*

126. See *i.LAN Systems, Inc. v. NetScout Service Level Corp.*, 183 F. Supp. 2d 328, 338 (D. Mass. 2002) (relying on *ProCD* and finding that click-wrap agreements are enforceable); *Decker*, 49 F. Supp. 2d at 748 (relying on *Shute* and holding that a non-negotiated but accepted contract was enforceable).

127. See *Shute*, 499 U.S. 585; *Caspi v. Microsoft Network, L.L.C.*, 732 A.2d 528, 530, 532 (N.J. Super. Ct. App. Div. 1999) (comparing terms placed in small print on a passenger ticket with terms placed in a scrollable window of a computer and finding that regardless of the medium, both provide sufficient notice of contract terms). See also Condon, *supra* note 121, at 446.

128. See *Forrest v. Verizon Communications, Inc.*, 805 A.2d 1007, 1013 n.13 (D.C. 2002) (citing *Paul Business Systems, Inc. v. Canon U.S.A., Inc.* 397 S.E.2d 804, 807 (Va. 1990)). The *Forrest* court stated that “a contract is no less a contract simply because it is entered into via a computer.” *Id.* at 1101.

129. Condon, *supra* note 121, at 446 (citing *Stomp, Inc. v. NeatO L.L.C.*, 61 F. Supp 2d 1074, 1080–81 (C.D. Cal. 1999)).

Although there are strong policy reasons supporting click-wraps, at least one court has found that a click-wrap agreement can violate public policy. In *America Online, Inc. v. Superior Court*, a California Appeals court found a click-wrap agreement unenforceable because it violated California public policy of protecting consumers from deceptive business practices.<sup>130</sup> The case involved an AOL click-wrap agreement that included a forum-selection and choice-of-law clause designating Virginia as the exclusive choice of forum and law.<sup>131</sup> The court said that to be valid, a forum-selection clause, among other things, must not “substantially diminish the rights of California consumers in a way that violates California public policy.”<sup>132</sup> The court concluded that because Virginia limited the remedies available to California consumers by not allowing non-statutory class-action suits, it thereby violated California public policy.<sup>133</sup>

### C. Lessons Learned

In looking at the public policy jurisprudence in context with the click-wrap cases above, it is hard to make a viable argument that the public policy “escape clauses” in the Convention are anything more than a political tool to make States feel comfortable with adopting the Convention.<sup>134</sup> First, the click-wrap cases and the precedent they rely on demonstrate that there is a strong U.S. policy favoring enforcement of contracts entered into freely, regardless of whether or not they were negotiated.<sup>135</sup> The U.S. courts’ desire to allow party autonomy in contracts and to encourage online transactions seems to have outweighed the basic contract principle of having an “arms length transaction.”<sup>136</sup> Thus, a defendant urging a U.S. court to not recognize a foreign judgment on the basis that it was non-negotiated is not likely to be successful unless there is a larger state or federal public policy violation like in *America Online*.<sup>137</sup>

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130. 108 Cal. Rptr. 2d 699, 702, 710 (Cal. Ct. App. 2001).

131. *Id.* at 701–02.

132. *Id.* at 707–08. The court stated that the California Consumer Legal Remedies Act was designed “to protect consumers against unfair and deceptive business practices and to provide efficient and economical procedures to secure such protection.” *Id.* at 710.

133. *Id.* at 702. *But cf. Forrest*, 805 A.2d at 1012 (citing cases which have upheld forum-selection clauses because other remedies other than class action were still available to the individual).

134. See Karen Minehan, Note, *The Public Policy Exception to the Enforcement of Foreign Judgments: Necessary or Nemesis?*, 18 LOY. L.A. INT’L & COMP. L.J. 795, 817–18 (1996), for a discussion of the public policy exception as a necessary political tool for the Convention “because it counters the fears of recalcitrant countries.”

135. See *supra* note 121.

136. See *supra* note 128–29.

137. See *America Online*, 108 Cal. Rptr. 2d 699.

Second, the public policy cases prove that the public policy bar is extremely high. The party resisting enforcement must prove more than a mere difference in law or outcome between the foreign State and the U.S.<sup>138</sup> The violation must be extreme.<sup>139</sup> But what exactly is enough, besides a direct constitutional violation, to violate a forum's "most basic notions of morality and justice" is unclear.<sup>140</sup> On one hand, the *Ackermann* case could be read as expanding the public policy exception because finding enforcement of unconscionable attorney's fees as against public policy does not seem to be on the same plane as a constitutional violation.<sup>141</sup> On the other hand, the *Viewfinder* case, although only a single federal court case, seems to narrow the public policy exception.<sup>142</sup> If violation of the principles of U.S. copyright law is not a violation of public policy, then it seems that critics of the inclusion of non-negotiated contracts are rightly concerned.<sup>143</sup> Even though *Viewfinder* did not involve a contract between two parties, it seems that under that case, if a U.S. court is willing to enforce a judgment contrary to U.S. copyright law that was not based on a contract,<sup>144</sup> then it would follow that they would be just as likely to enforce a clause in a click-wrap agreement that contracts away U.S. copyright rights.<sup>145</sup> If this is the case, then the fears expressed by libraries may be realistic.<sup>146</sup>

Third, forum shopping for the most favorable laws does not seem to violate public policy under the current line of cases. Although the *America Online* case recognized the public policy exception when there was circumvention of California's public policy,<sup>147</sup> this case is probably limited in its application to the Convention because it involved a consumer and consumer protection laws.<sup>148</sup> The Convention does not cover con-

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138. See *Somportex*, 453 F.2d at 443 (finding that a difference in laws governing attorney fee awards does not violate public policy.); See generally Part III.A. *supra*.

139. See *Matusevitch*, 877 F. Supp. at 4 (finding that the difference between U.K. and U.S. libel laws was substantial enough to recognize the public policy exception); See generally *supra* Part III.A.2.

140. *Parsons*, 508 F.2d at 974.

141. See *Ackermann*, 788 F. 2d at 844.

142. See *Viewfinder*, 2005 U.S. Dist. LEXIS 22242, at \*16.

143. *Id.*

144. *Id.*

145. This is the same type of reasoning that courts used to determine that if shrink-wrap agreements were enforceable, then a click-wrap agreement to which a party expressly assents in a direct way should also be enforceable. See *supra* note 126.

146. See *supra* notes 17 and 18.

147. See *America Online*, 108 Cal. Rptr. at 702.

148. It is also important to note that it seems that California is the only U.S. state that rejects click-wrap agreements. See *supra* note 121.

sumer contracts.<sup>149</sup> Moreover, while the *Laker Airways* case suggested that a court would be justified in refusing to enforce a foreign judgment if the plaintiff had somehow circumvented the enforcing court's public policy interests,<sup>150</sup> the U.S. tends to enforce both forum-selection clauses and click-wrap agreements.<sup>151</sup> Thus, a defendant's argument that the forum shopping was a form of circumvention of the forum's public policies would be less effective because the plaintiff could just counter that the forum was agreed to in the contract.

Finally, the public policy and click-wrap cases show that because most U.S. jurisdictions already have a public policy exception available when considering these types of cases, it is unlikely that formalizing it in the Convention will change their existing practices. Thus, as mentioned before, if the Convention is adopted, those at-risk by the inclusion of non-negotiated contracts will have to look elsewhere for protection.

### III. OTHER OPTIONS<sup>152</sup>

#### A. Declaration

One option for critics of the inclusion of non-negotiated contracts is to urge the U.S. to make a declaration<sup>153</sup> that it will not apply the Conven-

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149. See *Convention*, *supra* note 3, art. 2(1).

150. *Laker Airways*, 731 F.2d at 931–32.

151. See *supra* note 120–21.

152. Direct revisions to the Convention are not suggested as options here since the approved Convention was already signed by the Member States and all previously recommended revisions to the non-negotiated contract aspect of the Convention have been rejected. Besides removing non-negotiated contracts from the scope of the Convention, some of the previously suggested revisions have included the addition of a clause protecting certain institutions: "Agreements conferring jurisdiction and similar clauses in non-negotiated contracts with non-profit, non-commercial organizations, including non-profit libraries, archives, and educational institutions, shall be without effect." See Robert Oakley Letter, *supra* note 17. Adding the following "fairness" clause was another recommendation: "The agreement on choice of court shall be void or voidable if it has been obtained by an abuse of economic power or other unfair means." James Love, *What You Should Know About the Hague Conference on Private Int'l Law's Proposed Convention on Jurisdiction and Foreign Judgments in Civil and Commercial Matters*, CPTEch.org, <http://www.cptech.org/ecom/jurisdiction/whatyoushouldknow.html>. One reason for not adding a fairness clause was that it would reduce the certainty of the Convention because it would be difficult to determine what various jurisdictions will deem as "fair" or a "weaker business." Hague Conference on Private Int'l L., *Choice of Court Agreements in International Litigation: Their Use and Legal Problems to Which They Give Rise in the Context of the Interim Text*, para. 16, Prel. Doc. No. 18, Feb. 2002, [http://www.hcch.net/upload/wop/gen\\_pd18e.pdf](http://www.hcch.net/upload/wop/gen_pd18e.pdf).

153. For example, "Canada is on record as saying that it will not apply the Convention to asbestos cases." *Delegates Sign Convention*, *supra* note 12, at 18.

tion to non-negotiated contracts. Article 21 of the Convention allows a signature State to declare that it will not apply the Convention to a specific matter, if it has a strong interest in that matter.<sup>154</sup> The matter to which the declaration pertains must be “clearly and precisely defined” and must be “no broader than necessary.”<sup>155</sup> Furthermore, the Convention will not apply to the subject matter for which the declaration is made within the declaring State, nor will it apply to that subject matter within the other signature States where an exclusive choice-of-court agreement has designated the declaring State as the exclusive forum.<sup>156</sup> Unfortunately, it is unlikely that the U.S. will actually make such a declaration since it took over ten years to reach an agreement on a final Convention and because the U.S. negotiators seem to support the inclusion of non-negotiated contracts.<sup>157</sup> The negotiators hope that the Convention will become the litigation counterpart to the New York Convention<sup>158</sup> and will provide businesses in international transactions a choice between selecting arbitration or litigation as the method to resolve disputes.<sup>159</sup> Furthermore, the purpose of the Convention will be defeated if many States make declarations on many matters.<sup>160</sup>

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154. *Convention, supra* note 3, art. 21. Article 21, declarations with respect to specific matters, states in full:

1. Where a State has a strong interest in not applying this Convention to a specific matter, that State may declare that it will not apply the Convention to that matter. The State making such a declaration shall ensure that the declaration is no broader than necessary and that the specific matter excluded is clearly and precisely defined.

2. With regard to that matter, the Convention shall not apply – a) in the Contracting State that made the declaration; b) in other Contracting States, where an exclusive choice of court agreement designates the courts, or one or more specific courts, of the State that made the declaration.

*Id.*

155. *Id.* art. 21(1).

156. *Id.* art. 21(2).

157. *See supra* note 26.

158. *See supra* note 57.

159. *See* Ronald A. Brand, *The New Hague Convention on Choice of Court Agreements*, AM. SOC'Y INT'L L. INSIGHTS, July 2005, available at <http://www.asil.org/insights/email/insights0507262.html>.

160. *See Delegates Sign Report, supra* note 12, at 18. The objective of the Convention is to create clarity and certainty in transactions, if there are many exceptions then businesses will be left with uncertainty as to the effectiveness of the Convention.

### *B. Supplemental Convention*

Another option is for the U.S. is to try to make a declaration and then enter into a separate bilateral agreement regarding non-negotiated contracts with other Member States that are a party to the Convention. This would allow the U.S. to choose which States' non-negotiated contract judgments to recognize.<sup>161</sup> However, it will be time consuming to negotiate an agreement with individual States and would require the U.S. to pass judgment on another country's court system.<sup>162</sup> In the end, this could lead to a negative effect on U.S. relations.

### *C. Wait and See*

Another option for critics is to continue to lobby Congress and then just "wait-and-see" whether other States decide to adopt the Convention. Without a significant number of signature States, the Convention will be of little effect and there may not be any reason for concern.<sup>163</sup> Furthermore, if the Convention is adopted and the critics' concerns turn out to be correct, they can still petition the U.S. to make a declaration as mentioned above or petition the Secretary General of the HCPIL to amend the Convention.<sup>164</sup>

## V. CONCLUSION

The Hague Convention on Choice of Courts provides a way to bring certainty and clarity in on-line and off-line international business-to-business transactions. However, this benefit may bring risks to smaller businesses and other organizations such as libraries and non-profits that purchase information goods and services on-line. These groups may be forced to defend a suit in a foreign country which could lead to an adverse foreign judgment which a U.S. court may then be obligated to en-

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161. See Trevor C. Hartley, *Accession and Bilateral Agreements*, in THE HAGUE CONVENTION ON JURISDICTION AND JUDGMENTS 110 (Andreas F. Lowenfeld & Linda J. Silberman eds., 2001) (defining bilateralization). For an overview of the benefits and downfalls of bilateralization, see Lindsay Loudon Vest, Note, *Cross-Border Judgments and the Public Policy Exception: Solving the Foreign Judgment Quandary by Way of Tribal Courts*, 153 U. PA. L. REV. 797, 813 (2004).

162. See Vest, *supra* note 161, at 814.

163. See Standeford, *supra* note 16 (suggesting that there is no point in having the Convention if countries such as China and Russia do not join the Convention).

164. Article 24(b) states that the Secretary General of the HCPIL shall: "make arrangements for: ...b) consideration of whether any amendments to this Convention are desirable." *Convention, supra* note 3, art. 24(b).

force.<sup>165</sup> The survey of case law above shows that the public policy exception is a very narrow exception and is usually only recognized in instances where there is a violation of a larger state or national public policy, such as a constitutional violation<sup>166</sup> or when the court feels there was a purposeful evasion of U.S. laws.<sup>167</sup> Even in cases where there are differences of procedural or substantive laws, courts have not been willing to recognize the public policy exception.<sup>168</sup> The fact that a contract was not negotiated is not a major concern of courts either since there has historically been an acceptance of agreements that are entered into freely.<sup>169</sup>

In sum, the public policy exception, based on precedent, is not likely to provide much protection for at-risk organizations when it comes to non-negotiated contracts. Libraries, small business, and other organizations that frequently transact via non-negotiated contracts can and should continue to lobby Congress and voice their concerns over the inclusion of non-negotiated contracts, even though it is unlikely that the U.S. will make a declaration excluding non-negotiated contracts. If the Convention is ratified by the U.S. and numerous other States, those at-risk can always refuse to make purchases online until the Convention is modified or the drafters of the non-negotiated contracts modify their forum-selection clause. Although this option is not ideal, it is a way for those concerned by the inclusion of non-negotiated contracts within the Convention to protect themselves.

*Keri Bruce*\*

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165. It would feel obligated to enforce because of the requirements under article 8 and 9 of the Convention and out of principles of comity set out in *Hilton v. Guyot*. See *supra* notes 9, 34, 45–52.

166. See *Matusевич*, 877 F. Supp. at 6.

167. See *Laker Airways*, 731 F.2d at 931; See generally *supra* Part III.A.2.

168. See *supra* Part III.A.1.

169. See *supra* note 119. See generally *supra* Part III.B.

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# TAKING A GAMBLE ON PUBLIC MORALS: INVOKING THE ARTICLE XIV EXCEPTION TO GATS

## I. INTRODUCTION

On July 31, 2001, the U.S. Second Circuit Court of Appeals handed down a decision against Jay Cohen<sup>1</sup> that became the basis of a landmark trade dispute against the United States in the World Trade Organization (“WTO”). Jay Cohen is an American citizen who moved to the tiny Caribbean twin island nation of Antigua and Barbuda (“Antigua”)<sup>2</sup> to establish the World Sports Exchange, an internet and telephone based gambling business directed at customers in the United States.<sup>3</sup> After being convicted of violating the Wire Communications Act<sup>4</sup> for operating this gambling service, Cohen found an ally in his adopted home, Antigua. Claiming that the United States was violating the General Agreement on Trade in Services (“GATS”),<sup>5</sup> Antigua brought the issue

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1. See *United States v. Cohen*, 260 F.3d 68, 78 (2d Cir. 2001) (affirming the district court’s conviction and twenty-one month imprisonment sentence of Cohen for facilitation of offshore gambling activities).

2. See CIA World Factbook, *Antigua and Barbuda*, available at <https://www.cia.gov/cia/publications/factbook/geos/ac.html>.

3. *Cohen*, 260 F.3d at 70.

4. 18 U.S.C. § 1084 (1961). The statute states, in pertinent part, the following:

(a) Whoever being engaged in the business of betting or wagering knowingly uses a wire communication facility for the transmission in interstate or foreign commerce of bets or wagers or information assisting in the placing of bets or wagers on any sporting event or contest, or for the transmission of a wire communication which entitles the recipient to receive money or credit as a result of bets or wagers, or for information assisting in the placing of bets or wagers, shall be fined under this title or imprisoned not more than two years, or both;

(b) Nothing in this section shall be construed to prevent the transmission in interstate or foreign commerce of information for use in news reporting of sporting events or contests, or for the transmission of information assisting in the placing of bets or wagers on a sporting event or contest from a State or foreign country where betting on that sporting event or contest is legal into a State or foreign country in which such betting is legal.

*Id.*

5. General Agreement on Trade in Services, Apr. 15, 1994, Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Agreement Establishing the World Trade Organization, Annex 1B, 1869 U.N.T.S. 183, 33 I.L.M. 1144, 1167 (1994) [hereinafter GATS].

to the WTO in a case that was characterized by referral to the biblical battle between David and Goliath.<sup>6</sup>

Initially, an adjudicatory panel established by the WTO's Dispute Settlement Body issued a Report ruling in favor of Antigua.<sup>7</sup> However, on appeal the Panel's holding was subsequently reversed by the Appellate Body based on the argument by the United States that it has the right to prohibit internet gambling services.<sup>8</sup> The United States claimed that this right exists under the general exceptions clause, Article XIV of the GATS, which allows Members to implement measures that protect public morals and order, even if the measures violate the GATS.<sup>9</sup> Part II of this Note will discuss in detail the background of this dispute, the claims made by Antigua, the defense asserted by the United States, and the rulings of the Panel and Appellate Body.

Part III of this Note will specifically focus on the analyses employed by the Panel and the Appellate Body in determining whether the United States' measures prohibiting internet gambling services fell within the protection of Article XIV of the GATS. Although the methods of the Panel and Appellate Body were largely parallel, they diverged on the crucial issue of burden of proof.<sup>10</sup> In its ruling, the Panel reproved the United States for not having thoroughly investigated WTO-consistent alternatives to its violating measures, and found that the United States thus did not meet its burden of proof.<sup>11</sup> The Appellate Body, however,

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6. See, e.g., James D. Thayer, *The Trade of Cross-Border Gambling and Betting: The WTO Dispute Between Antigua and the United States*, 2004 DUKE L. & TECH. REV. 0013, Abstract (2004), <http://www.law.duke.edu/journals/dltr/articles/2004dltr0013.html>; Joost Pauwelyn, *WTO Condemnation of U.S. Ban on Internet Gambling Pits Free Trade Against Moral Values*, THE AM. SOC'Y OF INT'L L., Nov. 2004, available at <http://www.asil.org/insights/2004/11/insight041117.html>; Ellen Gould, *The US-Gambling Decision: A Wakeup Call for WTO Members*, CAN. CTR. FOR POLICY ALTERNATIVES, Trade and Investment Series Vol. 5 No. 4 (2004); *WTO Rules Against US Gambling Ban*, BBC NEWS, Nov. 11, 2004, available at <http://news.bbc.co.uk/2/hi/business/4001793.stm>.

7. Panel Report, *United States—Measures Affecting the Cross-Border Supply of Gambling and Betting Services*, WT/DS285/R (Nov. 10, 2004) [hereinafter Internet Gambling Panel Report].

8. Appellate Body Report, *United States—Measures Affecting the Cross-Border Supply of Gambling and Betting Services*, WT/DS285/AB/R (Apr. 7, 2005) [hereinafter Internet Gambling Appellate Body Report].

9. Dispute Settlement: Dispute DS285, Key Facts and Summary of the Dispute to Date *United States—Measures Affecting the Cross-Border Supply of Gambling and Betting Services*, [http://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds285\\_e.htm](http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds285_e.htm) (last visited May 17, 2007) [hereinafter Key Facts and Summary].

10. *Id.*; see also Internet Gambling Appellate Body Report, *supra* note 8.

11. Internet Gambling Panel Report, *supra* note 7.

found that the failure of the United States to research or offer substitute measures did not bar it from satisfying its burden of proof, and accepted the Article XIV defense.<sup>12</sup>

Part IV of this Note will examine the issue of burden of proof in the use of the Article XIV defense by comparing the findings of the Panel and the Appellate Body with prior uses of similar defenses in WTO disputes. Finally, Part V of this Note will argue that, once a party's measures are found to be in violation of a WTO agreement, it is that party's burden to show that the measures at issue satisfy the requirements of a general exceptions clause. This is a high burden requiring, among other things, that the violating measures are *necessary* for the protection of public morals or order.<sup>13</sup> Contrary to the decision of the Appellate Body, Part V of this Note will conclude that the Panel was correct in originally rejecting the defense argued by the United States.<sup>14</sup> The United States did not have a valid claim for taking exception to its trade obligations by prohibiting trade in the service of cross-border remote gambling without seeking in good faith WTO-consistent alternate measures.<sup>15</sup> The United States had the burden to show that its prohibitions met the requirements of Article XIV, and it did not meet that burden. Part V of this Note will also contend that the holding of the Appellate Body that a Member such as the United States could implement measures that violate the GATS without having sought WTO-consistent alternative measures to meet its policy goals undermines the integrity of the heavily-negotiated trade agreements and the overall goal of the WTO to liberalize trade.<sup>16</sup>

## II. CLAIM BY ANTIGUA AGAINST THE UNITED STATES

Antigua, one of the smallest nations in the world with a population of only 68,108,<sup>17</sup> is a base for many international internet gambling operations. Its economy is largely connected to trade in this service,<sup>18</sup> which

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12. Internet Gambling Appellate Body Report, *supra* note 8.

13. GATS, *supra* note 5, 33 I.L.M. at 1167, art. XIV.

14. Internet Gambling Panel Report, *supra* note 7.

15. *Id.*

16. Ctr. for Int'l Env'tl. Law, A Center for International Environmental Law Issue Brief For the World Summit on Sustainable Development 26 August – 4 September 2002: WTO Negotiations to Liberalize Trade in Services: New Challenges for Sustainable Development (2002), available at <http://www.ciel.org/Publications/services.pdf>.

17. CIA World Factbook, *supra* note 2.

18. Thayer, *supra* note 6. In an attempt to diversify its economy from reliance on sugar and tourism, Antigua developed an infrastructure to support internet based gambling and betting services. By 1999, three thousand people were employed by the gambling and betting industry in Antigua and the government was receiving over \$7.4 million

has helped Antigua weather downturns in its sugar and tourism sectors.<sup>19</sup> Recently, however, Antigua's gambling and betting services industry suffered a drastic decline<sup>20</sup> for which it specifically blamed U.S. prohibitions and market access restrictions on cross-border gambling services.<sup>21</sup>

In March of 2003, Antigua requested consultations with the United States regarding measures applied by U.S. central, regional and local authorities which made illegal the cross-border supply of gambling and betting services.<sup>22</sup> Antigua argued that these prohibitive measures constituted an infringement of the obligations of the United States under the GATS Articles II, VI, VIII, XI, XVI, and XVII,<sup>23</sup> and the U.S. Schedule of Specific Commitments annexed to the GATS.<sup>24</sup>

The GATS consists of general principles which govern trade in services among WTO Members and regulate the specific commitments that each Member assigns to it.<sup>25</sup> Under the GATS, Members are required to establish "schedules of specific commitments" listing their terms of trade for various services.<sup>26</sup> Members decide which services to commit to the provisions of the agreement and what limitations they want to place on the commitment of that service.<sup>27</sup> This list of commitments makes up the GATS Schedule of the Members, which is then annexed to the GATS.<sup>28</sup>

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annually from the licensing fees of 119 internet gambling and betting operations, which accounted for over ten percent of the nation's gross domestic product. *Id.*

19. *WTO Rules Against US Gambling Ban*, *supra* note 6; Thayer, *supra* note 6.

20. Thayer, *supra* note 6. From 1999 to 2003, at least thirty-five banks licensed in Antigua closed, the number of licensed gambling and betting operations decreased over 710%, the number of people employed in the industry decreased 750%, and the government licensing fees decreased over 410%. *Id.*

21. *Id.* Specifically, Antigua contended that the economic downturn in its gambling and betting services industry was a direct result of (1) the U.S. Internet Gambling Enforcement Act, H.R. 556, 107<sup>th</sup> Cong. (2002); (2) the self-regulation of the credit card industry in the United States; and (3) the Second Circuit ruling against Jay Cohen (referring to *Cohen*, 260 F.3d at 70). *Id.*

22. Request for Consultations by Antigua and Barbuda, *United States—Measures Affecting the Cross-Border Supply of Gambling and Betting Services*, WT/DS285/1 (Mar. 27, 2003).

23. GATS, *supra* note 5, 33 I.L.M. at 1167. These Articles refer to the following: Article II: Most-Favored-Nation Treatment; Article VI: Domestic Regulation; Article VIII: Monopolies and Exclusive Service Providers; Article XI: Payments and Transfers; Article XVI: Market Access; Article XVII: National Treatment.

24. U.S. Schedule of Specific Commitments Under the General Agreement on Trade in Services, With Explanatory Materials Prepared by the U.S. International Trade Commission under Investigation No. 332-354, U.S. Int'l Trade Comm'n (May 1997).

25. See Thayer, *supra* note 6.

26. GATS, *supra* note 5, 33 I.L.M. at 1167, art. XX:1.

27. Gould, *supra* note 6, at 3.

28. *Id.* at 3.

Within the context of its own schedule, each Member must allow market access to foreign service providers and treat foreign service providers in a manner no less favorable than its own domestic suppliers of like services.<sup>29</sup>

After its consultations with the United States failed, on June 12, 2003, Antigua requested that the WTO establish an adjudicatory panel to resolve its allegations that the United States was acting in contravention to its GATS obligations. Antigua's two major complaints were that: 1) while U.S. authorities allow numerous U.S. operators to offer various gambling and betting services within the United States, there is no possibility for foreign operators to obtain authorization to supply gambling and betting services from outside the United States; and 2) the U.S. authorities restrict international transfers and payments related to gambling and betting services offered from outside the United States.<sup>30</sup>

*A. WTO Panel Report Ruling in Favor of Antigua*

The success of Antigua's case first depended on whether the WTO would interpret U.S. commitments in the GATS to include gambling services.<sup>31</sup> In its schedule to the GATS, the United States had agreed not to restrict the importation of "recreational services."<sup>32</sup> While Antigua construed this clause to allow the free flow of cross-border gambling services, the United States maintained that it had never intended that interpretation.<sup>33</sup> As evidence of its position concerning its commitments, the United States pointed to the explicit exclusion of sporting services from its commitment schedule, which, according to the United States, encompassed betting on sports.<sup>34</sup> Moreover, the United States argued that the existence of domestic prohibitions against internet gambling<sup>35</sup> further proved that it never intended to include such activity in the trade agreement. According to the United States, its prohibition represented "vital policy objectives" rendering it "incomprehensible for the United States to make [gambling services] the subject of a specific commitment."<sup>36</sup>

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29. Thayer, *supra* note 6.

30. Request for the Establishment of a Panel by Antigua and Barbuda, *United States—Measures Affecting the Cross-Border Supply of Gambling and Betting Services*, WT/DS285/2 (June 13, 2003).

31. Gould, *supra* note 6, at 4.

32. *Id.*

33. *Id.*

34. Internet Gambling Panel Report, *supra* note 7.

35. Pauwelyn, *supra* note 6.

36. Internet Gambling Panel Report, *supra* note 7.

On the issue of whether the United States commitments included internet gambling services, the November 10, 2004 WTO Panel ruling<sup>37</sup> applied the rules of interpretation under the Vienna Convention<sup>38</sup> and sided with Antigua, holding that gambling services were indeed covered under the GATS category “recreational services” and were not a sporting service.<sup>39</sup> The Panel further found that because various U.S. federal and state laws contained restrictions on gambling services, the United States was failing to offer Antigua’s gambling service suppliers the proper treatment as set out under its GATS Schedule of Commitments.<sup>40</sup> Specifically, the Panel Report examined the Federal Wire Act,<sup>41</sup> Travel Act,<sup>42</sup> and Illegal Gambling Business Act,<sup>43</sup> and the state laws of Colorado, Louisiana, Massachusetts, Minnesota, New Jersey, New York, South Dakota, and Utah that restrict or prohibit gambling.<sup>44</sup> After this review, the Panel concluded that all three federal laws and the state laws of Louisiana, Massachusetts, South Dakota, and Utah violated the specific market access commitments of the United States for gambling and betting services under the GATS Article XVI.<sup>45</sup>

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37. *Id.*

38. Vienna Convention on the Law of Treaties, May 23, 1969, arts. 31.1, 31.2, 31.3 and 32, 1155 U.N.T.S. 331, 8 I.L.M. 679 (1969) [hereinafter Vienna Convention]. In applying the Vienna Convention, the Panel looked to literal dictionary definitions for insight on “ordinary meaning” under Vienna Convention Article 31.1, as well as looking to other WTO documents as “context,” “subsequent practice,” or “supplementary means of interpretation” under Vienna Convention Articles 31.2, 31.3, and 32, respectively. Internet Gambling Panel Report, *supra* note 7.

39. Internet Gambling Panel Report, *supra* note 7.

40. *WTO Panel Rules in Favour of Antigua, Barbuda in Gambling Dispute*, INT’L CTR. FOR TRADE AND SUSTAINABLE DEVELOPMENT, BRIDGES WEEKLY TRADE NEWS DIGEST, Vol. 8, No. 39, Nov. 17, 2004.

41. 18 U.S.C. § 1084 (1961) (prohibiting gambling business from knowingly receiving or sending certain types of bets or information that assist in placing bets over interstate and international wires).

42. 18 U.S.C. § 1952 (1961) (imposing criminal penalties for those who utilize interstate or foreign commerce with the intent to distribute the proceeds of any unlawful activity, including unlawful gambling).

43. 18 U.S.C. § 1955 (1970) (criminalizing under certain conditions the operation of a gambling business that violates the law of the state where the gambling takes place).

44. See COLO. REV. STAT. § 18-10-103; LA. REV. STAT. ANN. § 14:90.3 (1968); MASS. ANN. LAWS ch. 271 § 17A (1958); MINN. STAT. ANN. §§ 609.755, Subdivisions 2–3 (1963) and 609.755(1) (1963); N.J. CONST. art. IV, § 7; N.J. ADMIN. CODE § 2A:40-1; N.Y. CONST. art. I, § 9; GEN. OBLIG. § 5-401; S.D. CODIFIED LAWS §§ 22-25A-1–22-25A-15 (2000); UTAH CODE ANN. § 76-10-1102 (1973).

45. Key Facts and Summary, *supra* note 9. However, the Panel decided that the measures at issue did not violate the domestic regulation provisions of the GATS Article VI, and did not rule as to Antigua’s claims concerning payments and transfers provisions

In its defense the United States was forced to rely on the invocation of the never-before used GATS Article XIV exception provision for protection of public morals or public order, or for securing compliance with U.S. laws or regulations.<sup>46</sup> The United States depended heavily on this Article XIV exception in order to win its case. Specifically, the United States argued for protection under XIV(a) by claiming that the Wire Act, the Travel Act and the Illegal Gambling Business Act are necessary to protect “public morals” and “public order” within the meaning of Article XIV(a) because of the heightened risks that remote gambling posed to society.<sup>47</sup> The United States presented evidence demonstrating that minors could too easily access internet gambling sites,<sup>48</sup> and argued that the

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of GATS Article XI or national treatment provisions of GATS Article XVII for the sake of judicial economy. *Id.*

46. *Id.* Article XIV of the GATS provides, in relevant part, that:

Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any Member of measures:

(a) necessary to protect public morals or to maintain public order (Footnote 5: The public order exception may be invoked only where a genuine and sufficiently serious threat is posed to one of the fundamental interests of society);

. . .

(c) necessary to secure compliance with laws or regulations which are not inconsistent with the provisions of this Agreement including those relating to:

(i) the prevention of deceptive and fraudulent practices or to deal with the effects of a default on services contracts;

(ii) the protection of the privacy of individuals in relation to the processing and dissemination of personal data and the protection of confidentiality of individual records and accounts;

(iii) safety; . . .

GATS, *supra* note 5, 33 I.L.M. at 1167, Art. XIV.

47. Internet Gambling Panel Report, *supra* note 7.

48. *Id.* (citing Amit Asaravala, *Why Online Age Checks Don't Work*, WIRED NEWS, Oct. 10, 2002). Also, the Panel referred to a quote by the Senior Vice President for Public Policy of Visa U.S.A. in his testimony before the Commission on Online Protection in 2000 where he stated that

[T]he [Child Online Protection] Act basically assumes that only adults have access to a credit card or debit card. To the contrary...[a]ccess to a credit card or a debit card is not a good proxy for age. The mere fact that a person uses a credit card or a debit card in connection with a transaction does not mean that this person is an adult.

sites were vulnerable to use by organized crime for laundering money.<sup>49</sup> In response, Antigua questioned the validity of the argument by the United States for the protection of public morals and public order on the bases that the United States is itself a significant consumer of gambling and betting services and that state-sanctioned gambling opportunities are available in forty-eight states.<sup>50</sup>

Furthermore, regarding its defense under Article XIV(c), the United States argued that the Wire Act, the Travel Act and the Illegal Gambling Business Act serve as law enforcement tools to secure compliance with other WTO-consistent U.S. laws, in particular, state gambling laws and criminal laws relating to organized crime.<sup>51</sup> As to this defense, Antigua responded that the United States did not meet its burden to provide sufficient information on the laws upon which it relied for the defense.<sup>52</sup> In rebuttal, the United States stated that Members' legislation is presumed to be WTO-consistent, including all legislation invoked by the United States in support of its Article XIV defense.<sup>53</sup>

The Panel applied a two-tiered test to evaluate the Article XIV defense. Thus, in order for the United States to successfully claim protection under this exception, the Panel would first have to find that its measures were necessary to protect public morals or public order, or to secure compliance with its laws.<sup>54</sup> Second, the measures must not have been

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Mark MacCarthy, Senior Vice President for Pub. Policy, Visa U.S.A., Testimony Before the Commission on Online Protection (June 9, 2000).

49. Internet Gambling Panel Report, *supra* note 7.

50. *Id.* In its first submission to the WTO Panel, Antigua claimed that “[t]he United States is the world’s largest consumer of gambling and betting services, with a massive domestic industry responsible for generating gross revenues of approximately US \$68.7 billion in 2002.” First Submission of Antigua and Barbuda, *United States — Measures Affecting the Cross-Border Supply of Gambling and Betting Services*, WT/DS285 (Oct. 8, 2003), available at [http://www.antigua-barbuda.com/business\\_politics/pdf/Antigua\\_FirstSubmission\\_ExecutiveSummary.pdf](http://www.antigua-barbuda.com/business_politics/pdf/Antigua_FirstSubmission_ExecutiveSummary.pdf) (citing Joe Weintert, *U.S. Gambling Losses Hit \$68.7B. Last Year*, PRESS OF ATLANTIC CITY (N.J.), Aug. 17, 2003, at G3). Among the estimated 1800 internet gambling operations currently in existence globally, up to 70% of all bets come from within the United States. Megan E. Frese, *Rolling the Dice: Are Online Gambling Advertisers “Aiding and Abetting” Criminal Activity or Exercising First Amendment-Protected Commercial Speech?*, 15 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 547, 549–50 (2005).

51. Internet Gambling Panel Report, *supra* note 7.

52. *Id.*

53. *Id.*

54. *Id.*

55. *Id.*

applied arbitrarily or discriminatorily, as required by the *chapeau*, or introductory provision of Article XIV.<sup>55</sup>

Ultimately, the finding of the Panel against the United States in this case hinged on its ruling that the United States did not successfully meet the requirements to invoke an Article XIV defense. The Panel held that, because the United States did not sufficiently seek alternate measures that would meet U.S. policy objectives without violating its GATS commitments, it did not meet its burden to prove that its measures at issue were “necessary” under Article XIV(a).<sup>56</sup>

Further, as for the exception claimed by the United States under Article XIV(c), the Panel went through the same pattern of analysis as it did for Article XIV(a), and reached the same conclusions.<sup>57</sup> Specifically, the Panel held that while the interest protected by the disputed statutes are important and make a significant contribution to enforcing criminal laws relating to organized crime, the measures have a significant impact on trade.<sup>58</sup> The United States was thus at fault for its failure to explore and exhaust WTO-consistent alternatives by consulting and/or negotiating to determine whether there was a way to address its concerns in a WTO-consistent manner.<sup>59</sup>

This finding that the United States inadequately sought WTO-consistent alternatives effectively defeated the defense claimed by the United States in this dispute. Nevertheless, the Panel moved to the second tier of analysis in the provision, the introductory provisions of Article XIV, the so-called *chapeau*, by considering Antigua’s other claims against the United States.<sup>60</sup> The Panel found that the United States may be applying its measures in a way that violates the requirement in the *chapeau* to Article XIV of the GATS that “measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail.”<sup>61</sup> The Panel based this conclusion on evidence that inconsistent U.S. enforcement efforts benefited U.S.-based suppliers of gambling services in that foreign suppliers were more often the targets of prosecution than U.S.-based suppliers.<sup>62</sup>

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56. *Id.*

57. *Id.*

58. *Id.*

59. *Id.*

60. *Id.*

61. Key Facts and Summary, *supra* note 9.

62. Pauwelyn, *supra* note 6.

The ruling of the Panel was a major triumph for Antigua, yet there were serious doubts as to whether Antigua could garner enough strength to enforce the decision, and whether the ruling would survive appeal by the United States.<sup>63</sup> Further dampening Antigua's victory, the United States suggested it would refuse to accept the WTO ruling or to adjust its laws to conform to that ruling.<sup>64</sup> In fact, the United States went so far as to threaten to activate its right to change the terms under which it joined the WTO in the first place.<sup>65</sup> As expected, the United States did appeal the Panel ruling on January 7, 2005.<sup>66</sup>

### *B. U.S. Victory in the WTO Appellate Body Ruling*

On April 7, 2005 the Appellate Body of the WTO handed down its noteworthy decision regarding Antigua's dispute, reversing the Panel's decision against the United States.<sup>67</sup> The Appellate Body affirmed the Panel's finding that the U.S. Schedule under the GATS did indeed include a commitment to grant full market access in gambling and betting services, though the Appellate Body relied on different instruments to come to this conclusion than did the Panel.<sup>68</sup> Next, the Appellate Body

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63. *US-Antigua Gambling Dispute Raises Systemic Issues*, INT'L CTR. FOR TRADE AND SUSTAINABLE DEVELOPMENT, BRIDGES WEEKLY TRADE NEWS DIGEST, Vol. 8, No. 40, Nov. 24, 2004.

64. *Id.*

65. WTO Rules Against US Gambling Ban, *supra* note 6.

66. Notification of Appeal by the United States, *United States—Measures Affecting the Cross-Border Supply of Gambling and Betting Services*, WT/DS285/6 (Jan. 7, 2005).

67. Internet Gambling Appellate Body Report, *supra* note 8. The Appellate Body's ruling in favor of the United States was in fact a largely expected outcome. Joost Pauwelyn, *WTO Softens Earlier Condemnation of U.S. Ban on Internet Gambling, but Confirms Broad Reach into Sensitive Domestic Regulation*, THE AM. SOC'Y OF INT'L L., Apr. 2005, available at <http://www.asil.org/insights/2005/04/insights050412.html>.

68. Key Facts and Summary, *supra* note 9. Specifically, the Appellate Body disagreed with the Panel's use of some dictionaries' inclusion of "gambling" or "betting" in their definitions of "sporting," "recreational services," and "entertainment" in order to conduct an "ordinary meaning" interpretation under Article 31 of the Vienna Convention. *Id.* The Appellate Body also disapproved of the Panel's reliance on a GATS Services Sectoral Classification List and the General Agreement on Tariffs and Trade 1993 Scheduling Guidelines for an Article 31 context based interpretation because these documents were not agreements relating to the GATS that were accepted by the parties as binding. *Id.* Instead, the Appellate Body sought context in the United States' Schedule as a whole and the structure of the GATS itself. *Id.* Comparing the United States' Schedule with those of other Members, the Appellate Body noted that unlike the United States, other Members had explicitly committed or excluded gambling and betting services. *Id.* Also, there were no other examples where the category of "sporting services" clearly included gambling and betting services. *Id.* Finding this inconclusive, the Appellate Body then turned to an Article 32 means of interpretation, namely by using the GATS Services Sectoral Classifi-

upheld the finding by the Panel that the federal Wire Act, Travel Act and Illegal Gambling Business Act violated the GATS market access obligations under Article XVI, though it reversed the Panel's finding of GATS violations in the state laws of Louisiana, Massachusetts, South Dakota, and Utah because of Antigua's inability to establish a *prima facie* case on that issue.<sup>69</sup>

The Appellate Body proceeded by conducting a substantive review of the Article XIV defense claimed by the United States.<sup>70</sup> In examining the Panel's analysis of Article XIV(a), the Appellate Body upheld the finding of the Panel that the federal Wire Act, Travel Act, and Illegal Gambling Business Act were designed to protect public morals.<sup>71</sup> The Appellate Body also considered the alleged discriminatory application of the U.S. federal statutes by reviewing the Panel's finding that the United States had not prosecuted certain domestic remote gambling service providers and that the U.S. Interstate Horseracing Act ("IHA")<sup>72</sup> may allow remote betting within the United States.<sup>73</sup> However, on this issue of discriminatory application, the Appellate Body reversed the ruling of the Panel that the United States did not satisfy the *chapeau* of Article XIV.<sup>74</sup>

The Appellate Body then made a crucial departure from the Panel by finding that the measures at issue were necessary, without requiring the United States to have sought WTO-consistent alternatives.<sup>75</sup> Thus, the Appellate Body reversed the ultimate finding of the Panel against the

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cation List and the General Agreement on Tariffs and Trade 1993 Scheduling Guidelines as relevant "preparatory work". *Id.* Within these documents the Appellate Body found sufficient evidence that the United States' GATS commitments include gambling and betting services. *Id.*

69. Internet Gambling Appellate Body Report, *supra* note 8.

70. *Id.*

71. *Id.*

72. The Interstate Horseracing Act ("IHA") allows an off-track betting system to accept interstate off-track wagers via telephone or other electronic media in the same or another state with respect to a horserace. 15 U.S.C. § 3002 (1978).

73. Internet Gambling Panel Report, *supra* note 7.

74. Internet Gambling Appellate Body Report, *supra* note 8. Although the Appellate Body upheld the finding of the Panel regarding the discriminatory nature of the IHA, the Appellate Body disagreed with the Panel regarding the enforcement of the other three federal statutes. *Id.* Because these statutes were facially neutral, the Panel looked to evidence of discriminatory application, which consisted of five cases: one case of prosecution against a foreign service supplier, one case of pending prosecution against a domestic supplier and three cases of no prosecution against domestic suppliers. *Id.* The Appellate Body viewed these cases as "isolated instances of enforcement" that did not merit dependence by the Panel. *Id.*

75. Internet Gambling Appellate Body Report, *supra* note 8; Internet Gambling Panel Report, *supra* note 7.

Article XIV defense claimed by the United States, and found that the United States did sufficiently show that the federal statutes in question are “necessary to protect public morals or to maintain public order” and are justified as such because they are not applied arbitrarily or discriminatorily.<sup>76</sup>

To counter the finding of the Appellate Body that the U.S. measures are protected under Article XIV, Antigua raised a due process argument that the Panel should not have even considered the defense claimed by the United States because its delayed presentation of that defense deprived Antigua of “a full and fair opportunity to respond to the defence.”<sup>77</sup> However, based on Antigua’s comments at the appellate hearing and Antigua’s failure to raise this objection to the Panel, the Appellate Body reasoned that Antigua was apparently aware that the United States might argue for exception under Article XIV and had an adequate opportunity to respond.<sup>78</sup> The Appellate Body also considered arguments from both the United States and Antigua regarding accusations against the Panel for forming arguments and rebuttals in place of the parties whose responsibility it was to do so.<sup>79</sup> The Appellate Body ruled that the Panel had not usurped the respective duties of the parties to present their own arguments and rebuttals.<sup>80</sup>

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76. Key Facts and Summary, *supra* note 9. Because the Appellate Body already established that Antigua failed to make a *prima facie* claim against the eight U.S. state laws in its dispute, the Appellate Body limited its review of the U.S. Article XIV defense to only the three federal laws that were found to be in violation of U.S. GATS Article XVI commitments. Internet Gambling Appellate Body Report, *supra* note 8.

77. *Id.* (quoting Antigua’s other appellant’s submission, para. 73).

78. *Id.*

79. *Id.* Antigua accused the Panel of bearing the burden of the United States by constructing an Article XIV defense for the United States. *Id.* To support this claim, Antigua identified three public morals or public order concerns that the Panel raised on its own initiative: money laundering, fraud, and public health. The United States made a parallel contention that after it established a proper Article XIV defense for the three federal acts in question, the Panel improperly constructed a rebuttal under the Article XIV chapeau when Antigua itself failed to do so. *Id.* According to the Appellate Body, a panel may freely use the arguments submitted by the parties or develop its own legal reasoning to support its findings and conclusions, though it may not put forward evidence in support of a defense or rebut a claim. *Id.* Nevertheless, the Appellate Body easily dismissed Antigua’s claim here because it found that the United States had in fact raised all of its public morals and public order concerns. *Id.* Also, as to the claim regarding the rebuttal under the chapeau, the Appellate Body found evidence that the United States had stated that its laws were applied in a nondiscriminatory fashion and that Antigua had contested this by stating the opposite. *Id.*

80. *Id.*

Thus, the United States successfully justified its inconsistent measures under Article XIV(a) of the GATS through the Appellate Body's finding that although the federal Wire Act, Travel Act, and Interstate Gambling Act violate U.S. commitments under the GATS, those measures are necessary to protect public morals or maintain public order, and are not applied arbitrarily or discriminatorily.<sup>81</sup>

### III. ANALYSIS OF THE RULINGS OF THE WTO PANEL AND APPELLATE BODY REGARDING THE GATS ARTICLE XIV EXCEPTION

#### *A. Article XIV Analysis of the WTO Panel*

When evaluating the Article XIV exception, the Panel applied the two-tiered analysis developed in other cases concerning Article XX of the General Agreement on Tariffs and Trade ("GATT")<sup>82</sup> to aid in interpretation since Article XIV had not been previously invoked.<sup>83</sup> Reliance on Article XX of the GATT was based on the finding of "textual similarity between Article XX of the GATT of 1994 and Article XIV of the GATS" and "similar purposes that both Articles are designed to serve."<sup>84</sup> According to this "two-tiered" approach, a measure must first fall within the scope of one of the recognized exceptions in order to enjoy provisional justification, and second, must meet the requirements of the introductory provisions of the Article, the *chapeau*.<sup>85</sup> There are two elements

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81. *Id.*

82. General Agreement of Tariffs and Trade 1994, Apr. 15, 1994, Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Agreement Establishing the World Trade Organization, Annex 1A, Multilateral Agreement on Trade in Goods, 1867 U.N.T.S. 187, 33 I.L.M. 1144, 1153 (1994) [hereinafter GATT]; General Agreement on Tariffs and Trade, Oct. 30 1947, 55 U.N.T.S. 194, 61 Stat. A3, A32 (1947) [hereinafter GATT 1947].

83. Internet Gambling Panel Report, *supra* note 7.

84. *Id.* See also Caroline Bissett, *Comment: All Bets are Off(line): Antigua's Trouble in Virtual Paradise*, 35 U. MIAMI INTER-AM. L. REV. 367, 397 (2004). Specifically, the Panel reviewed the Appellate Body's findings in the following disputes: Appellate Body Report, *United States—Standards for Reformulated and Conventional Gasoline*, WT/DS2/AB/R (May 20, 1996) [hereinafter Gasoline Appellate Body Report]; Appellate Body Report, *United States—Import Prohibition of Certain Shrimp and Shrimp Products*, WT/DS58/AB/R (Oct. 12, 1998) [hereinafter Shrimp Appellate Body Report]; Appellate Body Report, *Korea—Measures Affecting Imports of Fresh, Chilled and Frozen Beef*, WT/DS161/AB/R, WT/DS169/AB/R (Dec. 11, 2000) [hereinafter Beef Appellate Body Report].

85. Internet Gambling Panel Report, *supra* note 7. See also Hans-Joachim Priess & Christian Pitschas, *Protection of Public Health and the Role of the Precautionary Principle Under WTO Law: A Trojan Horse Before Geneva's Walls?*, 24 FORDHAM INT'L L. J.

necessary for the successful invocation of Article XIV(a): (1) the measure must be designed to “protect public morals” or to “maintain public order”; and (2) the measure must be “necessary” to serve this purpose.<sup>86</sup> Taking into consideration the sensitive nature of classifying “public morals,” the Panel easily decided that the first of the above two elements may be satisfied by U.S. legislation against internet gambling.<sup>87</sup>

Regarding the second element, the Panel used the “process of weighing and balancing a series of factors” developed by the Appellate Body in the *Korea—Various Measures on Beef* and *EC—Asbestos* disputes in order to determine necessity.<sup>88</sup> This test assesses:

- (a) the importance of interests or values that the challenged measure is intended to protect....
- (b) the extent to which the challenged measure contributes to the realization of the end pursued by that measure.... [and]
- (c) the trade impact of the challenged measure.<sup>89</sup>

The Panel found that the first part of the balance test was satisfied because the legislative history of the measures at issue showed that the societal interests served by the measures were “vital and important in the highest degree,” comparable to the interest in protecting human life and health against a life-threatening health risk in the asbestos dispute.<sup>90</sup> The

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519, 536 (2000) (discussing the application of the “two-tiered approach” in article XX cases).

86. Priess & Pitschas, *supra* note 85.

87. Internet Gambling Panel Report, *supra* note 7.

88. Beef Appellate Body Report, *supra* note 84. *See also* Appellate Body Report, *European Communities—Measures Affecting Asbestos and Asbestos-Containing Products*, WT/DS135/AB/R, (Mar. 12, 2001) [hereinafter Asbestos Appellate Body Report].

89. Internet Gambling Panel Report, *supra* note 7.

90. *Id.* Specifically, the Panel recited comments made in 1961 by then Attorney General Robert F. Kennedy about the intended effect of the Wire Act and the Travel Act, that “profits from illegal gambling are huge and they are the primary source of the funds which finance organized crime, all throughout the country,” Testimony of Attorney General Robert Kennedy, Hearings Before the Senate Judiciary Committee on the Attorney General’s Program to Curb Organized Crime and Racketeering, 87<sup>th</sup> Cong., 1st Sess., p. 4 (1961), and the Congressional statement of findings prefatory to the Illegal Gambling Business Act:

- (1) organized crime in the United States is a highly sophisticated, diversified, and widespread activity that annually drains billions of dollars from America’s economy by unlawful conduct and the illegal use of force, fraud, and corruption;
- (2) organized crime derives a major portion of its power through money obtained from such illegal endeavors as syndicated gambling...and other forms of social exploitation;
- (3) this money and power are increasingly used to infil-

second part of the balance test was also easily satisfied by the inherent prohibitions in the disputed measures.<sup>91</sup>

In evaluating the third part of the balancing test, the Panel focused on the difference between the harms caused by the remote and non-remote supply of gambling because of its conclusion that “the United States does not prohibit outright the non-remote supply of gambling and betting services.”<sup>92</sup> The Panel found specific harms related to remote gambling, “namely the volume, speed and international reach of remote gambling transactions combined with the offshore locations of most remote suppliers and the virtual anonymity of such transactions.”<sup>93</sup> These factors purportedly facilitate use by minors, money laundering, fraud, and health problems related to the isolated environment of online gambling that protects gamblers from social stigma and allows them to gamble without interruption for extended periods of time.<sup>94</sup> For these reasons, the Panel concluded that the application of U.S. laws towards domestic non-remote gambling operations was not discriminatory in relation to its prohibition of remote gambling services despite having a significant impact on trade.<sup>95</sup>

However, to complete the evaluation of whether the measures in dispute were “necessary,” the Panel reiterated that Members may only derogate their GATS obligations under Article XIV if they have “explored and exhausted reasonably available WTO-consistent alternatives” to those measures.<sup>96</sup> Further, the Panel restated the finding of the Appellate Body in the *U.S.—Malaysia* shrimp dispute that although there may be situations where unilateral measures are justified under Article XX of

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trate and corrupt legitimate business and labor unions and to subvert and corrupt our democratic processes; (4) organized crime activities in the United States weaken the stability of the Nation’s economic system, harm innocent investors and competing organization, interfere with free competition, seriously burden interstate and foreign commerce, threaten the domestic security, and undermine the general welfare of the Nation and its citizens.

Congressional Statement of Finding and Purpose, Note on 18 U.S.C. § 1961 (1970), p. 812.

91. Internet Gambling Panel Report, *supra* note 7.

92. *Id.*

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.* This approach is taken from a WTO Panel decision against the United States, which was not adopted, in its dispute against Mexico regarding tuna and dolphin protection measures under Article XX of the 1947 General Agreement on Tariffs and Trade. Panel Report, *United States—Restrictions on Imports of Tuna*, DS21/R-39S/155 (Sept. 3, 1991) [hereinafter Tuna I Panel Report].

the GATT of 1994, a multilateral approach is strongly preferred “as far as possible.”<sup>97</sup>

It is at this key element regarding WTO-consistent alternatives that the United States failed to satisfy the standard put forth by the Panel for the invocation of the Article XIV exception. Addressing this critical issue, Antigua asserted that it had regulatory regimes in place to address the specific harms of remote gambling services.<sup>98</sup> Antigua further claimed that it had offered to consult with the United States to meet any remaining concerns notwithstanding its regulatory regime, but that it was repudiated by the United States even in its invitation to engage in international cooperation to deal with the specific concerns of the United States regarding remote gambling and betting services.<sup>99</sup>

The United States, on the other hand, countered that it had significant interactions with Antigua on law enforcement issues, but that it found it impossible to consider assistance from Antigua effective in curtailing illegal and harmful internet gambling operations.<sup>100</sup> The United States also claimed that it was reluctant to work with Antigua after Antigua took a public position against the United States by filing an amicus-brief in support of Cohen, the aforementioned founder of the Antigua-based World Sports Exchange gambling site, to the Supreme Court.<sup>101</sup> Further, the United States pointed out the inconsistency of expecting it to engage in international negotiations to establish a regime allowing the cross-border supply of a service while no domestic regulatory regime exists permitting that service’s remote supply.<sup>102</sup>

The Panel considered the argument of the United States, yet determined that it failed to pursue in good faith a course of action to explore the possibility of finding a reasonably available WTO-consistent alternative, and was therefore not protected by Article XIV.<sup>103</sup>

#### *B. Article XIV Analysis of the WTO Appellate Body*

In conducting a substantive review of the Article XIV defense claimed by the United States, the Appellate Body took the same approach as the Panel and relied on prior uses of the textually similar defense under Arti-

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97. Internet Gambling Panel Report, *supra* note 7 (quoting Shrimp Appellate Body Report, *supra* note 84).

98. *Id.*

99. *Id.*

100. *Id.*

101. *Id.*

103. *Id.*

cle XX of the GATT.<sup>104</sup> The Appellate Body also recognized the two-tiered analysis the Panel used, to wit, that a measure must fall within the scope of one of the exceptions listed under Article XIV and that the measure must not be applied discriminatorily or arbitrarily.<sup>105</sup>

After having upheld the Panel's finding that the federal Wire Act, Travel Act, and Illegal Gambling Business Act were designed to protect public morals,<sup>106</sup> the Appellate Body next considered whether the measures were "necessary" pursuant to Article XIV(a).<sup>107</sup> On this issue, both the United States and Antigua raised arguments against the Panel's ruling.<sup>108</sup> Antigua claimed that, as a finding of necessity requires a sufficient nexus or degree of connection between the measure and the interest protected, the Panel failed to establish that nexus between gambling and the concerns raised by the United States.<sup>109</sup> Also, Antigua argued that the Panel did not adequately discuss the "reasonably available alternatives" that Antigua had offered to counteract the concerns of the United States because the Panel limited its analysis to the realm of existing U.S. regulatory measures.<sup>110</sup>

The United States argued against the Panel's conclusion that the United States must have first explored and exhausted all reasonably available WTO-consistent alternatives before adopting an inconsistent measure, ostensibly by consulting with Antigua regarding the prohibition on the cross-border supply of gambling and betting services.<sup>111</sup> In so doing, the United States contended, the Panel erroneously imposed on it "a procedural requirement...to consult or negotiate with Antigua before the United States may take measures to protect public morals [or] protect public order."<sup>112</sup> The United States further argued that in previous dis-

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104. GATT, *supra* note 82, 33 I.L.M. at 1153, art. XX. This article, like Article XIV of the GATS, allows exceptions for measures that are, to name a few,

(a) necessary to protect public morals; (b) necessary to protect human, animal or plant life or health; ... (d) necessary to secure compliance with laws or regulations which are not inconsistent with the provisions of this Agreement, including those relating to customs enforcement, the enforcement of monopolies operated under paragraph 4 of Article II and Article XVII, the protection of patents, trade marks and copyrights, and the prevention of deceptive practices.

*Id.*

105. Internet Gambling Appellate Body Report, *supra* note 8.

106. *Id.*

107. *Id.*

108. *Id.*

109. *Id.*

110. *Id.*

111. *Id.*

112. *Id.* (quoting United States' appellant's submission).

putes, the availability of theoretical alternative measures did not preclude the Panel from deeming the challenged measures “necessary.”<sup>113</sup>

According to the Appellate Body, a measure is “necessary” where it is relatively important, realizes the ends it pursues, and does not restrictively impact international commerce disproportionate to its importance, and where there are not reasonably available WTO-consistent alternatives.<sup>114</sup> An alternative would not be considered “reasonably available,” for example, if the responding Member cannot use it, if it imposes an undue burden on the Member, or if it does not provide the level of protection sought under Article XIV(a).<sup>115</sup>

Notwithstanding the consideration of “necessity,” the Appellate Body followed the same reasoning as the Panel until making a crucial departure in deciding the issue of burden of proof. The Appellate Body sided with the United States, affirming that the party invoking a defense bears the burden of demonstrating that its violating measure satisfies the requirements of the invoked defense,<sup>116</sup> but holding that it is *not* the burden of the responding Member to identify WTO-consistent reasonably available alternative measures.<sup>117</sup> According to the Appellate Body, after the responding Member has established a *prima facie* case for the use of a defense, the complaining party may raise valid alternative measures.<sup>118</sup> Subsequently the burden would shift back to the responding Member to respond in rebuttal that the alternatives are not legitimate.<sup>119</sup>

The Appellate Body further disagreed with the focus of the Panel on whether the United States in good faith consulted with Antigua regarding WTO-consistent alternative measures because “consultations are by definition a process, the results of which are uncertain and therefore not capable of comparison with the measures at issue in this case.”<sup>120</sup> The Appellate Body firmly held that consultations should not be considered an alternative measure reasonably available to the United States.<sup>121</sup> Also, because the emphasis placed by the Panel on the absence of consultations

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113. *Id.*

114. *Id.*

115. Asbestos Appellate Body Report, *supra* note 88; Irene McConnell, *The Asbestos Case at the World Trade Organization: The Treatment of Public Health Regulations Under the General Agreement of Tariffs and Trade 1994 and the Agreement on Technical Barriers to Trade*, 10 TULSA J. COMP. & INT'L L. 153, 165–6 (2002); *see also* Beef Appellate Body Report, *supra* note 84.

116. Internet Gambling Appellate Body Report, *supra* note 8.

117. *Id.*

118. *Id.*

119. *Id.*

120. *Id.*

121. *Id.*

showed that the Panel did in fact consider alternatives not currently in place in the United States, the Appellate Body dismissed the argument by Antigua that the review of the Panel was prohibitively limited.<sup>122</sup> Additionally, since it decided that the responding party does not bear the burden of identifying alternative measures, the Appellate Body rejected the contention by Antigua that the Panel should have continued an analysis into additional alternative measures that Antigua did not itself present.<sup>123</sup>

Having found that the United States established a *prima facie* case of necessity and that Antigua did not provide a reasonably available alternative measure, the Appellate Body reversed the determination of the Panel that the failure of the United States to enter consultations with Antigua precluded a finding that the inconsistent federal measures were “necessary” pursuant to Article XIV.<sup>124</sup> The defense claimed by the United States therefore prevailed and Antigua’s victory was overturned.

#### IV. COMPARATIVE ANALYSIS OF THE STANDARD FOR BURDEN OF PROOF IN PREVIOUS USES OF THE GENERAL EXCEPTIONS PROVISION

Many times, the successful invocation of a general exceptions provision, such as Article XIV of the GATS and Article XX of the GATT, turns on the existence of any reasonable WTO-consistent alternative measure that nullifies a “necessity” requirement. Even where the invoked exception does not explicitly contain a “necessity” requirement, as in Article XX(g), the WTO has interpreted the *chapeau* as implicitly containing it.<sup>125</sup> Article XX, and specifically its “necessity” requirement, have consistently been narrowly interpreted by the Dispute Settlement Bodies of the WTO.<sup>126</sup> Throughout cases involving the use of these de-

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122. *Id.*

123. *Id.*

124. *Id.*

125. A responding party may claim protection under an exception that has a lower standard for the required nexus between the measure and its goal. A common example of such is GATT Article XX(g), which allows protection for measures “relating to the conservation of exhaustible natural resources...” (emphasis added). GATT, *supra* note 82, 33 I.L.M. at 1153, art. XX. In these cases, the WTO has nevertheless sought necessity within its second-tier analysis of the *chapeau*, when examining whether the measure was applied in an arbitrary or unjustifiably discriminatory manner. Arie Reich, *Privately Subsidized Recycling Schemes and Their Potential Harm to the Environment of Developing Countries: Does International Trade Law Have a Solution?*, 23 VA. ENVTL. L.J. 203, 242 (2004). See also John H. Knox, *The Judicial Resolution of Conflicts Between Trade and the Environment*, 28 HARV. ENVTL. L. REV. 1 (2004).

126. Salmon Bal, *International Free Trade Agreements and Human Rights: Reinterpreting Article XX of the GATT*, 10 MINN. J. GLOBAL TRADE 62, 69 (2001) (expanding on the scope and practice of Article XX).

fenses, the burden of proof has always been on the party invoking the exception to justify its WTO-inconsistent measure.<sup>127</sup> A responding Member's use of a general exceptions clause has been allowed only where it could establish its *prima facie* case for the use of the defense by proving that there were no WTO-consistent alternative measures available.<sup>128</sup> Based on the rulings in these previous disputes, the use of the general exceptions clause by the United States does not pass muster.

*A. Thai Cigarette Dispute (1990)*<sup>129</sup>

In response to the claim by the United States that Thailand's import restrictions on cigarettes violated the GATT Article XI:1,<sup>130</sup> Thailand argued that its measures were justified under Article XX(b) for the protection of human life.<sup>131</sup> The Panel found that the import restriction was in fact inconsistent with the GATT and then considered Thailand's defense, ultimately concluding that the measure was not "necessary."<sup>132</sup> The Panel stated that Thailand's import restrictions "could be considered 'necessary'...only if there were no alternative measures consistent with the General Agreement [on Tariffs and Trade], or less inconsistent with it, which Thailand could reasonably be expected to employ to achieve its

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127. Padideh Ala'i, *Free Trade or Sustainable Development? An Analysis of the WTO Appellate Body's Shift to a More Balanced Approach to Trade Liberalization*, 14 AM. U. INT'L L. REV. 1129, 1137 (1999) (discussing the difficulty of meeting that burden in Article XX cases).

128. *Id.*

129. Panel Report, *Thailand—Restriction on Importation of and Internal Taxes on Cigarettes*, DS10/R-37S/200 (Nov. 7, 1990) [hereinafter *Cigarette Panel Report*]. The United States brought this dispute against Thailand for placing a prohibition on the importation of cigarettes and other tobacco goods while authorizing the domestic sale of cigarettes. J.H.H. Weiler & Sungjoon Cho, *International and Regional Trade Law: The Law of the World Trade Organization: Unit VIII: General Exceptions* (2004), [http://www.nyulawglobal.org/researchtools/wto/pdfs/WTO\\_2004\\_UnitVIII.pdf](http://www.nyulawglobal.org/researchtools/wto/pdfs/WTO_2004_UnitVIII.pdf).

130. GATT 1947, *supra* note 82, 61 Stat. at A32, Art. XI. Article XI:1 reads, in pertinent part: "No prohibitions or restrictions...made effective through...import or export licenses...shall be instituted or maintained by any contracting party on the importation of any product of the territory of any other contracting party..." *Id.*

131. Weiler & Cho, *supra* note 129, at 8. To wit, Article XX(b) of GATT 1947 excepts measures "necessary to protect human, animal or plant life or health." GATT 1947, *supra* note 82, 61 Stat. at A61, Art. XX. Thailand claimed that its import restriction was necessary for this purpose because American cigarettes posed a greater health risk than its domestic brands: they contained unknown and potentially dangerous chemicals, were more addictive, and were milder tasting and thus more attractive. *Cigarette Panel Report*, *supra* note 129.

132. Weiler & Cho, *supra* note 129, at 8; *see also* Kruis, *supra* note 133, at 925.

health policy objectives.”<sup>133</sup> Because the United States had suggested several alternatives to Thailand’s regulations, the Panel found that Thailand’s measures were not actually “necessary.”<sup>134</sup>

This case set a high standard of review for WTO-inconsistent measures. In naming the suggested alternative measures, such as labeling and disclosure regulations, a ban on cigarette advertisements, or higher taxes for cigarettes, the Panel ignored whether these alternatives were politically or economically feasible to Thailand.<sup>135</sup> However, in the internet gambling dispute at hand, the Appellate Body was relatively far more forgiving to the United States in evaluating its reasons for not pursuing alternative measures with Antigua.

*B. United States Tuna Dispute (1991)*<sup>136</sup>

Mexico brought a complaint against the United States for its dolphin-friendly tuna importing restrictions.<sup>137</sup> In response, the United States invoked GATT Articles XX(b) and (g) exceptions for its measures.<sup>138</sup> The necessity test was applied to this case and the Panel stated that since the United States was invoking the defense, it had the burden of proving necessity.<sup>139</sup> The Panel found that the United States had not satisfactorily pursued a consistent measure in that it did not try to negotiate any inter-

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133. Elizabeth E. Krus, *The United States Trade Embargo on Mexican Tuna: A Necessary Conservationist Measure or an Unfair Trade Barrier?*, 14 LOY. L.A. INT’L & COMP. L.J. 903, 925 (1992) (quoting Cigarette Panel Report, *supra* note 129); *see also* Ala’I, *supra* note 127.

134. Krus, *supra* note 133, at 925. According to Report,

The United States considered that Thailand, like other contracting parties, could pursue the objective of seeking to prevent the increase in the number of smokers without imposing a ban on imports. The experience of other countries had shown that decreases in the level of smoking resulted from diminished demand achieved through education and the recognition of the effects of smoking rather than restraints on the availability of cigarettes.

Cigarette Panel Report, *supra* note 129.

135. Reich, *supra* note 125, at 243.

136. Laura Yavitz, *The WTO and the Environment: The Shrimp Case That Created a New World Order*, 16 J. NAT. RESOURCES & ENVTL. L. 203, 207 (2001–02).

137. *Id.* at 207.

138. *Id.* at 207. GATT 1947 Article XX(b) excepts measures “necessary to protect human, animal or plant life or health” and Article XX(g) excepts measures “relating to the conservation of exhaustible natural resources...” GATT 1947, *supra* note 82, 61 Stat. at A61, art. XX.

139. Krus, *supra* note 133, at 925–6.

national cooperative arrangements for protecting dolphins.<sup>140</sup> For this reason, the United States did not meet its burden and its Article XX defense failed.<sup>141</sup> Through this analysis, the Panel indirectly inserted the requirement that in order to satisfy “necessity,” the responding party must have exhausted all other options before imposing the measure.<sup>142</sup>

In the internet gambling dispute, however, the Appellate Body held that the United States neither needed to exhaust, nor even name alternative measures.<sup>143</sup> Thus, the holding of the Appellate Body in the internet gambling dispute that a complaining Member ought to raise valid alternative measures directly counters the Panel’s holding in the tuna dispute that a responding Member has the burden of proving necessity. Also, contrary to the holding of the Panel in the tuna dispute, the Appellate Body dismissed the requirement that the United States pursue international cooperation, specifically with Antigua, because of the assertion by the United States that Antigua’s position was deleterious to the interests of the United States.<sup>144</sup> Furthermore, the Appellate Body never suggested that the United States should have complied with the holding in the tuna dispute by attempting to initiate international agreements, even with the exclusion of Antigua, to support its concerns for public morals and public order regarding the cross-border trade in gambling and betting services.<sup>145</sup>

### *C. United States Gasoline Dispute (1996)*<sup>146</sup>

In the gasoline dispute brought by Venezuela and Brazil, a United States measure was found in violation of GATT Article III,<sup>147</sup> and the United States again used Article XX(b) and Article XX(g) defenses.<sup>148</sup> The Panel decided that under Article XX(b) the measure did involve pro-

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140. Yavitz, *supra* note 136, at 216. In its decision, the panel held that the Article XX exception clause “was intended to allow contracting parties to impose trade restrictive measures inconsistent with the General Agreement to pursue overriding public policy goals to the extent that such inconsistencies were unavoidable.” Tuna I Panel Report, *supra* note 96.

141. Yavitz, *supra* note 136, at 216.

142. Ala’I, *supra* note 127.

143. Internet Gambling Appellate Body Report, *supra* note 8.

144. *Id.*

145. *Id.*

146. Gasoline Appellate Body Report, *supra* note 84. Brazil and Venezuela brought this dispute against the United States for a U.S. rule that regulated the gasoline that could be imported into the United States. Weiler & Cho, *supra* note 129.

147. GATT, *supra* note 82, 33 I.L.M. at 1153, art. III. Article III relates to national treatment. *Id.*

148. Weiler & Cho, *supra* note 129.

tection of human, animal, and plant life or health, however the defense again failed because it was not “necessary” since there were other WTO-consistent, or less inconsistent, measures reasonably available to the United States.<sup>149</sup> The Panel clearly noted that the burden fell to the United States to prove that its objectives precluded the effective use of measures that were WTO-consistent, or less inconsistent.<sup>150</sup>

On appeal, the Appellate Body followed the standard approach of requiring the responding Member to satisfy all the elements of the general exception it is invoking, including the *chapeau* requirements.<sup>151</sup> Its decision held that the contravening measure fell within the terms Article XX(g) in that it related to the conservation of exhaustible natural resources, but that it did not satisfy the *chapeau* because the United States had not sufficiently explored means of mitigating the problem in cooperation with Venezuela and Brazil.<sup>152</sup> In this way, the Appellate Body imposed an “exploration” requirement on a responding party in order to pass a necessity test.

The exploration requirement posited by the Appellate Body in the gasoline dispute is incongruously similar to that which was disposed of by the Appellate Body in the internet gambling dispute. In the dispute over the internet gambling prohibitions of the United States, the Appellate Body claimed that the Panel erroneously focused on whether the United States attempted in good faith consultations with Antigua because consultations should not be considered an alternative measure reasonably available to the United States.<sup>153</sup> However, the exploration requirement

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149. *Id.*

150. Panel Report, United States—Standards for Reformulated and Conventional Gasoline, WT/DS2/R (Jan. 29, 1996).

151. Jeffrey Waincymer, *Reformulated Gasoline Under Reformulated WTO Dispute Settlement Procedures: Pulling Pandora Out of a Chapeau?*, 18 MICH. J. INT'L L. 141, 177 (1997) (asserting that, “In upholding the view that parties seeking to rely on an exempting provision should have the onus of proof under it, the Appellate Body’s approach is consistent with that of previous panels.”).

152. Weiler & Cho, *supra* note 129. Specifically, the Appellate Body concluded that

[T]he United States had not pursued the possibility of entering into cooperative arrangements with the governments of Venezuela and Brazil or, if it had, not to the point where it encountered governments that were unwilling to cooperate. . . . [The record] does not reveal what, if any, efforts had been taken by the United States [sic] to enter into appropriate procedures in cooperation with the governments of Venezuela and Brazil. . . .

Yavitz, *supra* note 136, at 219–20; see also Andrew Green, *Climate Change, Regulatory Policy and the WTO: How Constraining are Trade Rules?*, 8 J. INT'L ECON. L. 143, 178–79 (2005).

153. Internet Gambling Appellate Body Report, *supra* note 8.

of the gasoline dispute, along with its reiteration that a responding Member carries the onus of proof for the invocation of an exceptions clause, indeed suggest that the United States should have at least attempted consultations with Antigua as a means of finding alternative measures.

*D. United States Shrimp Dispute (1998)*<sup>154</sup>

In the shrimp dispute, India, Malaysia, Pakistan and Thailand brought a complaint against the United States and the Appellate Body held that U.S. measures were inconsistent with GATT Article XI.<sup>155</sup> As in the gasoline dispute, the measure did fall under Article XX(g) according to the Appellate Body, but failed the necessity test imposed on it through the *chapeau* analysis.<sup>156</sup> In this part of its review, the Appellate Body applied a necessity test to the “unjustifiable discrimination” clause of the *chapeau*.<sup>157</sup> It held that failure to engage the exporting countries in negotiations, or to attempt diplomacy before applying inconsistent measures, nullifies the use of a general exceptions defense.<sup>158</sup> Specifically, recognizing the need for international cooperation, the Appellate Body expressed that the failure of a responding party to seek alternate means through international agreement rendered the measure unjustifiable.<sup>159</sup>

Once again, the ruling of the Appellate Body in the shrimp dispute, where it required a responding party to seek international cooperation to achieve the goals of its violating measure, directly contradicts its ruling in the internet gambling dispute.<sup>160</sup> In the shrimp dispute, negotiations or diplomacy by the responding Member were mandatory elements to satisfy a general exceptions clause, whereas in the internet gambling dispute, lack of consultations with the complaining Member were regarded as insignificant.

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154. Shrimp Appellate Body Report, *supra* note 84.

155. Yavitz, *supra* note 136, at 208. Article XI eliminates any kind of quantitative restrictions on imports. GATT, *supra* note 82, 33 I.L.M. at 1153, art. XI.

156. Yavitz, *supra* note 136, at 208.

157. *Id.* at 222.

158. *Id.*

159. *Id.*; see also Patricia Larios, The Fight at the Soda Machine: Analyzing the Sweetener Trade Dispute Between the United States and Mexico Before the World Trade Organization, 20 AM. U. INT'L L. REV. 649, 667 (2005) (stating that “[t]he Appellate Body concluded that the measure unjustifiably and arbitrarily discriminated between countries, mainly because of the United States’ failure to negotiate via and international agreement”).

160. Larios, *supra* note 159, at 667.

## V. CONCLUSION

Under the holding of the Appellate Body in the case against the United States for its measure prohibiting internet gambling services, it is the duty of the complaining party, not the responding party, to name alternatives. Further, failure to consult with the complaining party about alternatives cannot preclude the responding party from using a general exceptions defense because consultations are only the “process” of conceiving alternatives.<sup>161</sup> This formula imprudently creates a disincentive for WTO Members to ever consider WTO-consistent alternatives.

It is incumbent on the country invoking a general exceptions provision to prove that the measure at issue meets the standard for the “necessity” requirement in that provision.<sup>162</sup> The responding country should bear the burden because its measure is in violation of an agreed term of trade, and this carries the presumption that the measure at issue is biased to the advantage of domestic producers. Therefore it is the duty of the regulating country to substantiate that its measure is necessary, that it has exhaustively considered alternative options before adoption of that measure,<sup>163</sup> that the measure is the least trade-restrictive measure among other available alternative measures, or that there are no other reasonable WTO-consistent measures that meet its policy goals. The responding party may even satisfy its burden by showing a “good faith effort” in negotiating WTO-consistent alternatives.<sup>164</sup>

Although WTO Panel and Appellate Body decisions do not create or rely on legally binding precedent, it has been the tradition of the WTO Dispute Settlement Bodies to consider and apply interpretations and con-

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161. Internet Gambling Appellate Body Report, *supra* note 8.

162. Kazumochi Kometani, *Trade and Environment: How Should WTO Panels Review Environmental Regulations Under GATT Articles III and XX?*, 16 *NW. J. INT'L L. & BUS.* 441, 466 (1996) (citing Panel Report, Canada—Administration of the Foreign Investment Review Act, L/5504–30/S140 (Feb. 7, 1984); Panel Report, United States—Restriction on Imports of Tuna, DS29/R (June 16, 1994)).

163. Ala’I, *supra* note 127 (referring to the standard established by the Panel in its Tuna I decision, Tuna I Panel Report, *supra* note 96).

164. Yavitz, *supra* note 136, at 227 (Identifying this standard in the gasoline and shrimp disputes).

[T]he Gasoline Appellate Body not only suggested that the conclusion of an environmental agreement would satisfy the requirements of Article XX, but...it noted that the United States failed to show that it even tried to negotiate such an agreement... [T]he Shrimp Appellate Body noted that the United States did not reach or seriously attempt to reach an environmental agreement.

*Id.*

clusions from previous disputes.<sup>165</sup> Thus, the Appellate Body should have drawn on its previous analyses and conclusions, and affirmed the decision of the Panel in Antigua's dispute with the United States on its measures prohibiting the cross-border trade in gambling and betting services. Applying the same standard for burden of proof in the GATS Article XIV defense as in the GATT Article XX defense, Members should be required to thoroughly explore or consider WTO-consistent alternatives before implementing a measure that violates its GATS or GATT commitments. Otherwise, the integrity of the international trading system and the efforts of the WTO to liberalize trade may be too easily undermined by protective policies and frivolous exceptions.

*Irem Dogan\**

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165. Joel P. Trachtman, *The Domain of WTO Dispute Resolution*, 40 HARV. INT'L L.J. 333, 353 (1999); see also Understanding on Rules and Procedures Governing the Settlement of Disputes, Apr. 15, 1994, art. 3(2), Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Agreement Establishing the World Trade Organization, Annex 2, 1869 U.N.T.S. 401, 33 I.L.M. 1144, 1226 (1994).

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# A SHOT ACROSS THE BOW: CHANGING THE PARADIGM OF FOREIGN DIRECT INVESTMENT REVIEW IN THE UNITED STATES

## I. INTRODUCTION

What do voting machines and ports have in common? Surprisingly, both may implicate vital national security considerations.<sup>1</sup> In 2006, congressional concerns and public outcry precipitated investigations into the foreign ownership of ports and voting machines, a little anticipated consequence of increased concerns about national security following the events of September 11, 2001 that will test American commitment to its historic policy of open borders in foreign investment.<sup>2</sup>

In March 2006, the proposed acquisition of a British company, Peninsular & Oriental Steam Navigation Co. (P&O), by Dubai Ports World (DPW), a company owned by the government of Dubai in the United Arab Emirates (UAE), brought a little known inter-agency committee, the Committee on Foreign Investment in the United States (CFIUS), to the “intersection of the global economy and the war on terrorism.”<sup>3</sup> Under the direction of the Secretary of the Treasury, CFIUS reviews proposed foreign direct investment (FDI) within the framework of U.S. open investment policy, providing the President with a basis to restrict FDI where necessary to protect national security.<sup>4</sup> Following the World Trade

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1. See, e.g., Elisabeth Bumiller et al., *Threats and Responses: The Reaction; Panel Saw No Security Issue In Port Contract, Officials Say*, N.Y. TIMES, Feb. 23, 2006, at A1; Tim Golden, *U.S. Investigates Voting Machines' Venezuela Ties*, N.Y. TIMES, Oct. 29, 2006, at A11.

2. The acquisition of a British company involved in producing U.S. military aircraft and tanks by Dubai International Capital, a company based in the United Arab Emirates (UAE), failed to elicit similar concerns. Robert McMahon, *The Chill After the Ports Storm*, COUNCIL ON FOREIGN RELATIONS, May 23, 2006, [www.cfr.org/publication/10755/chill\\_after\\_the\\_ports\\_storm.html](http://www.cfr.org/publication/10755/chill_after_the_ports_storm.html).

3. Bill Spindle et al., *In Ports Furor, a Clash over Dubai*, WALL ST. J. Feb. 23, 2006, at A1. Shoe-bomber Richard Reid was a British citizen, yet no objections were raised that a British company operated U.S. ports. Eben Kaplan, *The UAE Purchase of American Port Facilities*, COUNCIL ON FOREIGN RELATIONS, Feb. 21, 2006, [www.cfr.org/publication9918/uae\\_purchase\\_of\\_american\\_port\\_facilities.htm](http://www.cfr.org/publication9918/uae_purchase_of_american_port_facilities.htm) [hereinafter Kaplan, *UAE Purchase*].

4. The President's authority to investigate the effects on national security of mergers, acquisitions, and takeovers is limited to those that “could result in foreign control of persons engaged in interstate commerce in the United States.” 50 U.S.C. app. § 2170. See, e.g., Bumiller et al., *supra* note 1.

Center attacks of September 11, 2001, investigations revealed the vulnerability of domestic infrastructure like airports, bridges, and ports to terrorist attack.<sup>5</sup> The acquisition of P&O would have given DPW, and through it, the government of Dubai, ownership of port leases at six major U.S. cities.<sup>6</sup> A media furor ensued, highlighting the concern that foreign ownership of domestic infrastructure itself represented a national security concern. Over twenty bills were introduced in Congress to address the threat to national security represented by direct foreign investment in the United States.<sup>7</sup> Two separate bills passed in the House and Senate respectively contain the framework for reform of the current regulatory regime, which centers power of review in CFIUS.<sup>8</sup>

CFIUS emerged more recently in the context of a controversy regarding foreign ownership of Smartmatic, a leading manufacturer of U.S. electronic voting machines. In this case, CFIUS reviewed the 2005 acquisition of Sequoia Voting Systems, a Californian company, by Smartmatic, a privately held Venezuelan company.<sup>9</sup> The swathe of business interests implicated in a foreign investment review process that sweeps both ports and voting machines into its purview elicits questions as to what we are trying to protect, and from whom.

This Note argues that the current regulatory scheme is preferable to the proposed legislative reform because the existing regime has been successful in maintaining the primacy of traditional U.S. open investment policy without compromising national security. The DPW and Smartmatic deals nonetheless reveal a central problem with the existing paradigm: the lack of public and congressional confidence that CFIUS has conducted an effective review. Three central issues emerge from this common problem. First, congressional oversight is required to ensure CFIUS abides by its implementing legislation. Second, enhanced congressional oversight may be necessary to protect transactions from un-

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5. See generally OFFICE OF HOMELAND SECURITY, NATIONAL STRATEGY FOR HOMELAND SECURITY (2002), [http://www.whitehouse.gov/homeland/book/nat\\_strat\\_hls.pdf](http://www.whitehouse.gov/homeland/book/nat_strat_hls.pdf) [hereinafter NATIONAL STRATEGY].

6. Audrey Hudson, *Foreign Ownership of U.S. Terminals Remains Unknown*, WASH. TIMES, Mar. 8, 2006, at A9.

7. ALAN P. LARSON & DAVID M. MARCHICK, FOREIGN INVESTMENT AND NATIONAL SECURITY, COUNCIL ON FOREIGN RELATIONS, COUNCIL SPECIAL REPORT No. 18, 25 (2006) [hereinafter LARSON & MARCHICK, FOREIGN INVESTMENT]; Greg Simmons, *Foreign Investment Still a Concern for Congress*, FOX NEWS, May 4, 2006, <http://www.foxnews.com/story/0,2933,194186,00.html>.

8. National Security Foreign Investment Reform and Strengthened Transparency Act, H.R. 5337, 109th Cong. (2006); Foreign Investment and National Security Act, S. 3549, 109th Cong. (2006).

9. Golden, *supra* note 1.

necessary political and public controversy. Third, although the CFIUS review process proceeds ad hoc, its reviews of specific transactions nonetheless reveal larger security vulnerabilities. Enhanced congressional oversight, properly delimited, could provide the opportunity to draft tailored legislation to meet the security risks thus exposed while allowing individual transactions to proceed. While the proposed legislative reform, to some extent, might accomplish these objectives, it does so at the risk of deterring foreign investment while rendering CFIUS less effective. Instead, to ensure that the United States continues to benefit from FDI, congressional oversight must be limited to the extent necessary to address these problems.

Prefatory to the analysis of the existing and proposed legislation, Part II of this Note reviews the interrelation between foreign investment policy and national security, and in Part III, the facts and circumstances of the DPW and Smartmatic transactions. Part IV articulates two different models for the regulation of FDI, using the existing and proposed legislation as examples. The analysis demonstrates that the existing paradigm provides a better result by favoring open investment over national security concerns and reveals, through application of the proposed paradigm to the facts of the DPW and Smartmatic transactions, that the proposed paradigm sacrifices open investment policy with little tangible security benefit. Part V identifies the key problems with the existing paradigm that emerge from this analysis, and proposes an alternative strategy more consistent with the traditional open investment policy of the United States while taking into account the evolving challenges of national security.

## II. COMPETING VALUES: OPEN INVESTMENT AND NATIONAL SECURITY

U.S. economic policy traditionally emphasizes the importance of open investment; in fact, much of the United States' current preeminence and past development may be attributed to its historically liberal policy regarding foreign investment.<sup>10</sup> Conventional wisdom maintains that increasing the interrelation of different economies unites disparate national interests and promotes stability.<sup>11</sup> At the same time, encouraging FDI in

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10. Gerald T. Nowak, Note, *Above All, Do No Harm: The Application of the Exon-Florio Amendment to Dual-Use Technologies*, 13 MICH. J. INT'L L. 1002, 1014 (1992) (noting that the Erie Canal and the Louisiana Purchase were both financed by foreign capital).

11. LARSON & MARCHICK, FOREIGN INVESTMENT, *supra* note 7, at 6; Eben Kaplan, *Foreign Ownership of U.S. Infrastructure*, COUNCIL ON FOREIGN RELATIONS, Feb. 13, 2007, [http://www.cfr.org/publication/10092/foreign\\_ownership\\_of\\_us\\_infrastructure.html](http://www.cfr.org/publication/10092/foreign_ownership_of_us_infrastructure.html) [hereinafter Kaplan, *Foreign Ownership*]; see also UNITED STATES GOVERNMENT

the United States creates reciprocal opportunities for U.S. companies abroad.<sup>12</sup> Foreign investment helps fuel robust growth in the U.S. economy by providing capital to finance demands for investment that exceed the domestic economy's supply.<sup>13</sup> Foreign companies in the United States produce a significant percentage of U.S. exports and jobs.<sup>14</sup> In addition, foreign dollars spent in the United States on research and development contribute to the modernization and development of valuable products and technology<sup>15</sup> or enable a particular company or corporate division to continue operating in the United States.<sup>16</sup>

Within this context, new national security concerns emerged following the September 11, 2001 attacks on the World Trade Center in New York. Citing the modern transformation of business and government operations and their shared interdependence on "critical physical and information

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ACCOUNTING OFFICE [GAO], FOREIGN INVESTMENT: CONCERNS IN THE BANKING, PETROLEUM, CHEMICALS, AND BIOTECHNOLOGY SECTORS, GAO/NSIAD-90-129, 4 (May 30, 1990) (arguing that "foreign investments . . . should encourage increased stability by linking the economic interests of . . . countries with those of the United States") [hereinafter GAO May 1990]; GAO, CONTROLLING FOREIGN INVESTMENT IN NATIONAL INTEREST SECTORS OF THE U.S. ECONOMY, GAO/ID-77-18, 38 (Oct. 7, 1977) [hereinafter GAO Oct. 1977]; Davis B. Bobrow & Robert T. Kudrle, *Economic Interdependence and Security: U.S. Trade and Investment Policy for a New Era*, 3 MINN. J. GLOBAL TRADE 61, 77 (1994) (pointing out that foreign investment is more important for high technology sectors of the U.S. economy than other parts).

12. Kaplan, *Foreign Ownership*, *supra* note 11; see also Bobrow & Kudrle, *supra* note 11, at 77.

13. JAMES K. JACKSON, FINANCING THE U.S. TRADE DEFICIT, CONGRESSIONAL RESEARCH SERVICE [CRS] RL33274, 11 (Feb. 14, 2006) ("foreign capital inflows are needed to fill the gap between the demand for capital in the economy and the domestic supply of capital"); CRAIG ELWELL, THE U.S. TRADE DEFICIT: CAUSES, CONSEQUENCES, AND CURES, CRS RL31032, 5 (Aug. 12, 2004).

It is an economic identity that the amount of investment undertaken by an economy will be equal to the amount of saving—that is, the portion of current income not used for consumption—that is available to finance investment. But for a nation, this identity can be satisfied through the use of both domestic and foreign saving, or, domestic and foreign investment.

*Id.*

14. The trade deficit was in excess of \$725 billion in 2005. Foreign companies provide 5.3 million American jobs (often with higher wages than U.S. jobs) and produce twenty-one percent of U.S. exports. Kaplan, *Foreign Ownership*, *supra* note 12. The U.S. trade deficit last year widened more than seventeen percent from the previous year, and the only way to finance this deficit is by attracting foreign investment. Bernard Wysocki, Jr. et al., *Port Debate Exposes Conflicts Between Security Needs and Foreign Investment*, WALL ST. J., Feb. 23, 2006, at A1.

15. See LARSON & MARCHICK, FOREIGN INVESTMENT, *supra* note 7, at 7.

16. See *id.* at 22.

infrastructures,” Congress enacted the Critical Infrastructures Protection Act of 2001.<sup>17</sup> Critical infrastructure “means systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems and assets would have a debilitating impact on security, national economic security, national public health or safety, or any combination of those matters.”<sup>18</sup> This definition is the linchpin for subsequent homeland security and national defense legislation.<sup>19</sup> In the *National Strategy for Homeland Security*, the White House emphasized two axes of security vulnerability: infrastructure that delivers critical functions or services and the complex interdependency between them such that a successful attack at any point in these systems can reverberate throughout.<sup>20</sup> Threats include those presented by the privileged access of employees to information on “vulnerabilities, operations, and protective measures” for critical infrastructure or direct facilitation of attacks through provision of access to sensitive areas like loading docks, control centers, and airport tarmacs.<sup>21</sup>

Following the DPW deal, these broad national security concerns precipitated a reexamination of the nature and role of FDI in the United States.<sup>22</sup> Although Congress empowered the executive branch with broad authority in situations of national emergency,<sup>23</sup> the emergency powers do not apply extraterritorially.<sup>24</sup> Furthermore, foreign firms within the United States and abroad may be subject to influence by their home country governments or may suffer security breaches compromising sen-

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17. 42 U.S.C. § 5195c(a) & (b).

18. 42 U.S.C. § 5195c(e).

19. See generally NATIONAL STRATEGY, *supra* note 5. The *National Strategy for Homeland Security* identifies agriculture, food, water, public health, emergency services, government, defense industrial base, information and telecommunications, energy, transportation, banking and finance, chemical industry, postal, and shipping sectors as critical infrastructure. *Id.* at 29–30.

20. See *id.* at 30.

21. *Id.* at 34.

22. This Note uses the definition of foreign direct investment (FDI) provided in 15 C.F.R. § 806.15(a)(1), which states that FDI is “the ownership or control, directly or indirectly, by one foreign person of ten per centum or more of the voting securities of an incorporated U.S. business enterprise or an equivalent interest in an unincorporated U.S. business enterprise . . . .” 15 C.F.R. § 806.15(a)(1).

23. See, e.g., Trading with the Enemy Act, 50 U.S.C. app. § 5 (1917); International Emergency Economy Powers Act, 50 U.S.C. §§ 1701–1706 (1976); see Bobrow & Kudrle, *supra* note 11, at 80 (commenting that “the U.S. government has legal means to assure supply even from a foreign monopolist when its operations are located in the United States . . . the special emergency measures do not apply when the source of investment is located outside U.S. jurisdiction”).

24. Bobrow & Kudrle, *supra* 11, at 80.

sitive U.S. information.<sup>25</sup> The view that these risks warrant regulation of FDI in the United States reflects an underlying assumption that foreign companies, unlike U.S. companies, operate under competing interests that may undermine their compliance with U.S. laws and security.<sup>26</sup> With respect to the DPW transaction in particular, this view took concrete form when critics of the deal articulated concerns that Dubai's ports were a conduit for black market nuclear technology, that terrorists used Dubai's financial centers to circumvent U.S. economic sanctions and funnel funds, and that some September 11 terrorists were UAE citizens.<sup>27</sup>

The interrelationship between FDI and national security presents a dilemma: allow foreign ownership and tolerate an unquantifiable risk to national security or restrict foreign ownership and tolerate reduced capital and attendant business difficulties for U.S. firms.<sup>28</sup> Balanced against favoring the national security concern in this relationship is that the United States plays a significant role in defining global economic policy.<sup>29</sup> Tightening the reins on foreign investment in the United States may well reinforce isolationist urges elsewhere, with long-term consequences to American interests at home and abroad.<sup>30</sup> Given the interconnectedness of critical infrastructure,<sup>31</sup> greater security may require attracting foreign firms, not only because they provide expertise and capital, but because U.S. security depends on reciprocal security arrangements with both private and government owned and operated infrastructure worldwide.<sup>32</sup>

Striking the right balance between the competing values of open investment and national security remains especially important because examination of the data on foreign investment suggests that the United States has not used FDI as a vehicle for aligning foreign interests with its

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25. *Id.*; LARSON & MARCHICK, FOREIGN INVESTMENT, *supra* note 7, at 9–10.

26. Kaplan, *Foreign Ownership*, *supra* note 12; LARSON & MARCHICK, FOREIGN INVESTMENT, *supra* note 7, at 9.

27. Spindle et al., *supra* note 3; Bill Spindle & Yasmine El-Rashidi, *In Quest to Build A Financial Center, Hurdles for Dubai*, WALL ST. J., Mar. 2, 2006, at A1; Lawrence Lindsey, *Not For Sale to Foreigners*, WALL ST. J., Mar. 10, 2006, at A18.

28. See GAO, FOREIGN INVESTMENT: ANALYZING NATIONAL SECURITY CONCERNS, GAO/NSIAD-90-94, 26 (Mar. 1990) [hereinafter GAO Mar. 1990].

29. LARSON & MARCHICK, FOREIGN INVESTMENT, *supra* note 7, at 6.

30. See, e.g., *id.*; McMahon, *supra* note 2; Douglas Holtz-Eakin, Op-Ed., *You Can't Be CFIUS*, WALL ST. J., July 13, 2006, at A8.

31. Electricity, petroleum pipelines, trade, and the global transportation system are examples. See NATIONAL STRATEGY, *supra* note 5, at 35.

32. Ports and airports are examples of critical infrastructure that present a curious mixture of state and private interests both in the United States and worldwide. LARSON & MARCHICK, FOREIGN INVESTMENT, *supra* note 7, at 31.

own with equal consistency or success in all countries.<sup>33</sup> Although ninety percent of foreign investment in the United States derives from members of Organisation for Economic Co-operation and Development (OECD),<sup>34</sup> the vast majority of that investment originates in countries that are already U.S. allies.<sup>35</sup> In contrast, investments originating in the Middle East represent a small percentage of FDI in the U.S. economy, even though Middle Eastern countries are a significant destination of American goods and American FDI.<sup>36</sup> In 2004, Middle Eastern countries invested a relatively small \$192 million in hard U.S. assets, but Middle East oil exporters also held \$121.1 billion in U.S. securities, providing an untapped resource for investment in hard U.S. assets.<sup>37</sup> Similarly, Venezuela is a relatively insignificant percentage of FDI in the U.S. economy,<sup>38</sup> although American investment represents fifty-three percent of FDI in Venezuela.<sup>39</sup> The investments, valued at approximately \$10.8 billion, are diversified among petroleum, telecommunications, manufacturing, and finance sectors. The United States relies heavily on Venezuela

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33. See *supra* note 11 and accompanying text.

34. The OECD is the successor to the organization created to administer aid under the Marshall Plan following World War II. Today the organization is dedicated to the maintenance and development of free market economies. There are currently thirty member states, including the United States. See ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, ABOUT OECD, [http://www.oecd.org/about/0,2337,en\\_2649\\_201185\\_1\\_1\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/about/0,2337,en_2649_201185_1_1_1_1_1_1,00.html) (last visited May 27, 2007). The majority of foreign investment is in liquid assets; in 2004, “foreigners held \$1.9 trillion in U.S. corporate stocks, \$2.2 trillion in government securities, \$2.1 trillion in private bonds and \$2.9 trillion in debt . . . according to the Commerce Department’s Bureau of Economic Analysis . . . \$2.7 trillion . . . is invested in hard assets.” Wysocki, Jr. et al., *supra* note 14. Insofar as there are risks associated with liquid holdings in the United States that stem from the destabilizing effects of sudden withdrawals, increasing physical holdings of foreign firms provides ballast in the form of “a more permanent stake in the health of the U.S. economy.” LARSON & MARCHICK, FOREIGN INVESTMENT, *supra* note 7, at 23.

35. The greater percentage of foreign investment in the United States comes from the United Kingdom and the European Union. See UNCTAD, WORLD INVESTMENT REPORT 2005 and UNCTAD WORLD INVESTMENT REPORT 2006 available at [www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics); see also U.S. DEPARTMENT OF STATE, BACKGROUND NOTE: UNITED KINGDOM, <http://www.state.gov/r/pa/ei/bgn/3846.htm> (last visited May 27, 2007).

36. MARY JANE BOLLE, MIDDLE EAST FREE TRADE AREA: PROGRESS REPORT, CRS RL32638, 5–7 (2006).

37. These numbers exclude Israel. Wysocki, Jr. et al., *supra* note 14.

38. Venezuelan FDI totals \$5.5 billion, compared with \$252 billion from the United Kingdom. U.S. DEPARTMENT OF STATE, FOREIGN DIRECT INVESTMENT IN THE UNITED STATES, <http://www.state.gov/r/pa/prs/ps/2006/63553.htm> (last visited May 27, 2007).

39. U.S. DEPARTMENT OF STATE, VENEZUELA 2005 INVESTMENT CLIMATE STATEMENT, [www.state.gov/e/eb/ifa/2005/43503.html](http://www.state.gov/e/eb/ifa/2005/43503.html) (last visited May 27, 2007), U.S. DEPARTMENT OF STATE, BACKGROUND NOTE: VENEZUELA, <http://www.state.gov/r/pa/ei/bgn/35766.htm> (last visited May 27, 2007).

for its oil needs, and the United States trade deficit is on the rise, weighing in at \$19.5 billion in 2004.<sup>40</sup> This data, which shows a vast untapped pool of foreign capital, suggests that by shifting the balance in favor of national security so as to preclude investment from countries like the UAE or Venezuela, the United States would lose a significant opportunity to increase economic interdependence, align foreign interests with its own, and thereby improve national security.

The controversy that emerged regarding the DPW and Smartmatic deals are manifestations of the tension between traditional open investment policy and increased national security concerns.<sup>41</sup> Insofar as FDI increases stability, and hence, security, by aligning national interests, the chilly reception of DPW, the retroactive scrutiny of the Smartmatic deal, and the proposed legislative reform fires a clear shot across the bow to foreign investors and may well discourage future investments.<sup>42</sup>

### III. THE DILEMMA IN ACTION: DUBAI PORTS WORLD AND SMARTMATIC TRANSACTIONS

#### *A. Dubai Ports World*

DPW is part of Ports Customs & Freezone Corp., a company owned by the government of Dubai.<sup>43</sup> The company first entered the world stage with the acquisition of the port facilities of CSX Corporation of Jacksonville, Florida, a U.S. company that had no ownership interests in U.S. ports, but the acquisition of which expanded DPW's existing reach in the Middle East and India to include ports in China.<sup>44</sup> DPW cited its expansion as commercially motivated as part of a larger trend to global con-

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40. U.S. DEPARTMENT OF STATE, BACKGROUND NOTE: VENEZUELA, <http://www.state.gov/r/pa/ei/bgn/35766.htm> (last visited May 27, 2007) (Venezuela is one of the United States' four major foreign sources of oil); U.S. DEPARTMENT OF STATE, VENEZUELA 2005 INVESTMENT CLIMATE STATEMENT, [www.state.gov/e/eb/ifd/2005/43503.html](http://www.state.gov/e/eb/ifd/2005/43503.html) (last visited May 27, 2007).

41. See discussion *infra* Part III.

42. See, e.g., LARSON & MARCHICK, FOREIGN INVESTMENT, *supra* note 7, at 6 (noting that "both . . . economic health . . . and . . . long term security depend on . . . a welcoming environment"); W. Robert Shearer, *The Exxon-Florio Amendment: Protectionist Legislation Susceptible to Abuse*, 30 Hous. L. Rev. 1729, 1746-53 (1993) (discussing FDI and its role in building a robust economy, which itself provides national security, and advocating a total repeal of the review process to avoid discouraging FDI).

43. The government of Dubai is one of seven emirates that joined to form the UAE in 1971. See U.S. DEPARTMENT OF STATE, BACKGROUND NOTE: UNITED ARAB EMIRATES, <http://www.state.gov/r/pa/ei/bgn/5444.htm> (last visited May 27, 2007); Spindle et al., *supra* note 3.

44. Spindle et al., *supra* note 3.

solidation in the shipping and ports business.<sup>45</sup> The primary focus of DPW's attempt to acquire the British company, P&O, was to expand operations in China and India, thus complementing the geographic distribution of existing operations.<sup>46</sup> Although a company spokesperson stated that "[t]he U.S. is not the focus of the acquisition,"<sup>47</sup> the acquisition of P&O would give DPW control over terminals in six U.S. ports previously operated by the British company.<sup>48</sup>

The seventh largest port operator in the world, DPW operates in fourteen countries, provides support to U.S. military in Germany, Djibouti, and Dubai, and has been recognized for its high standards of port operation.<sup>49</sup> The senior management is composed of three citizens of the United States, one of Great Britain, two of India, one of the Netherlands, and four of Dubai. Of the four citizens of Dubai, two were educated at American universities.<sup>50</sup> The acquisition of P&O Ports North America, the U.S. operations of P&O, represented merely six to ten percent of the overall transaction; three of the leases to be acquired were joint ventures with U.S. companies.<sup>51</sup>

Critics of the deal issued statements in the press, precipitating a media uproar. Typically, reports focused on internal threats presented by the deal, citing UAE ties to terrorism, such that a UAE company operating U.S. ports would provide a conduit for terrorists to transport operatives and weapons to the United States.<sup>52</sup> While media reports and congres-

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45. *Testimony Before the Senate Commerce Committee*, 109th Cong. 2 (2006) (Statement of H. Edward Bilkey, Chief Operating Officer, Dubai Ports World), <http://commerce.senate.gov/pdf/bilkey-022806.pdf> [hereinafter Bilkey, *Testimony*].

46. Spindle et al., *supra* note 3.

47. *Id.* (quoting the Dubai Ports World spokesperson).

48. DPW's bid would affect operation of 850 port terminals in U.S. cities, including New York, New Jersey, Baltimore, New Orleans, Miami, and Philadelphia. *See* Hudson, *supra* note 6.

49. Bilkey, *Testimony*, *supra* note 45, at 1–2.

50. *Id.* at 2.

51. *Id.* at 2–3. The specific leases acquired are for port terminals located in Baltimore; Philadelphia, which was a fifty-fifty joint venture with Stevedoring Services of America; Miami, which was a fifty percent stake in Port of Miami Terminal Operating Company; New Orleans; and Newark, a fifty-fifty joint venture in the Port of Newark Container Terminal with Maersk Terminals. There were additional general stevedoring and cargo handling operations at additional locations and a passenger terminal in New York. *Id.* The \$6.8 billion deal involved ports in eighteen countries. *Q&A: U.S. Row Over Dubai Ports*, BBC NEWS, Mar. 9 2006, <http://news.bbc.co.uk/2/hi/business/4789368.stm> [hereinafter BBC NEWS, *Q&A*].

52. Critics specifically cited that two airplane hijackers involved in the 2001 World Trade Center attacks were from the UAE and that terrorist groups used the UAE a base of operations. Critics also emphasized that UAE is a primarily Arab and Muslim state. Kaplan, *UAE Purchase*, *supra* note 3; Gary Clyde Hufbauer, Op-Ed., *A Salute to Bush for*

sional statements inflamed public concerns, parties challenged the acquisition in courts in Great Britain, Florida, and New Jersey; all claims were rejected or rendered nugatory by subsequent developments.<sup>53</sup>

DPW contacted CFIUS to discuss the planned acquisition on October 17, 2005, and within two weeks, CFIUS engaged in an extensive preliminary review of the proposed transaction.<sup>54</sup> Official CFIUS review commenced on December 15, 2005.<sup>55</sup> Following its review, CFIUS recommended measures that would mitigate the national security concerns represented by the deal. Concessions included advance notice to the Department of Homeland Security (DHS) for changes in security arrangements, assignment of management of U.S. facilities to U.S. citizens, and the provision of confidential records relating to port management and employees without a subpoena.<sup>56</sup> DPW consented to the terms, and on January 17, 2006, CFIUS issued a formal letter allowing the acquisition

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*Standing Against Port Takeover Storm*, N.Y. DAILY NEWS, Feb. 27, 2006, available at <http://www.iie.com/publications/opeds/oped.cfm?ResearchID=602>.

53. A federal judge rejected New Jersey Governor Jon Corzine's request for an investigation and permission to inspect the documents submitted to CFIUS. Eller & Co, a stevedoring company in the Miami-Dade ports, attempted to block the takeover claiming that their business would be harmed by American retaliation if an Arab company were allowed to operate its ports. The Port Authority of New York and New Jersey filed suit in New Jersey state court to block the take over of operations at Port Newark. The plaintiffs sought relief on grounds that the landlord failed to seek approval of the tenants as required by the thirty year lease, emphasizing that as owners they needed to be "comfortable that whoever operates it is capable of it." They also alleged that the federal government had provided inadequate assurances about security issues. See *Ports Deal News Tracker*, WALL ST. J. ONLINE, Feb. 28, 2006, Mar. 1, 2006, & Mar. 2, 2006, <http://online.wsj.com/article/SB114071649414581503.html>.

54. Bilkey, *Testimony*, *supra* note 45, at 5.

55. *Id.* at 6. This sequence of events reflects standard operating practice for CFIUS. The governing statute imposes a short time-line for review, so a given transaction is extensively discussed before "official notice" is filed, triggering formal review and the statutory clock. See 31 C.F.R. § 800.401.

56. Specifically, DPW conceded it would: 1) maintain current levels of membership and cooperation in security arrangements; 2) provide DHS with thirty days advance notice of change in membership or cooperation in security arrangements; 3) operate U.S. facilities to the extent possible with current U.S. management; 4) designate a responsible corporate officer to serve as point of contact with the DHS on security matters; 5) provide relevant information promptly to DHS upon request; 6) assist and support law enforcement agencies (including disclosing information on the design, manufacture and operation of U.S. facilities); and 7) provide records relating to foreign operation direction, if any, of the U.S. facilities. Bilkey, *Testimony*, *supra* note 45, at 6-7; Robert Block, *Cherstoff Says U.S. Ports Takeover Would Tighten Grip on Security*, WALL ST. J., Mar. 27, 2006, at A3; Greg Hitt, *White House Cites Extra Safeguards in Ports Deal*, WALL ST. J., Feb. 23, 2006, at A3.

to proceed.<sup>57</sup> Following the media uproar, CFIUS, with the cooperation of DPW and P&O, commenced a second-stage extended investigation, which resulted in additional security concessions, including an interim agreement between DPW and P&O to permit the management and control of the North American operation to continue without direction or control from DPW until May 1, 2006 or until final approval of the transaction.<sup>58</sup> As furor over the deal refused to abate, DPW made additional unprecedented concessions: to install state-of-the-art radiation and gamma ray inspection devices at all current and future U.S. and foreign ports managed by DPW at company expense (estimated \$100 million cost); to grant the DHS a right to veto the choice of chief executive, board members, security officials, and all senior officers; and to create a supermajority of U.S. citizens on the board of directors.<sup>59</sup> DPW ultimately responded to American concerns by divesting its leases to American ports.<sup>60</sup>

### B. Smartmatic

The transaction at issue in the Smartmatic controversy is its acquisition of Sequoia Voting Systems (SVS), completed in March 2005.<sup>61</sup> Unlike P&O, the target of the DPW acquisition, SVS is an American company based in California that has provided voting equipment nationwide since the 1890s.<sup>62</sup> Smartmatic is privately held, with ninety-seven percent owned by four Venezuelan founders.<sup>63</sup> It owes its recent rise to a series of voting contracts with the government of Venezuela, the first of which was awarded in 2004, the year Hugo Chávez was confirmed President of Venezuela by popular referendum.<sup>64</sup> The company, in conjunction with Bizta, another small start-up, won contracts from American competitors.<sup>65</sup> The proceeds from those contracts allowed Smartmatic to acquire

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57. Bilkey, *Testimony*, *supra* note 45, at 7.

58. *Id.* at 7–8.

59. DPW also volunteered to maintain all records relating to security operations on U.S. soil available on request and to establish a Security and Financial Oversight Board chaired by American citizens reporting annually to the DHS. Neil King, Jr., *DP World Tried to Soothe U.S. Waters*, WALL ST. J., Mar. 14, 2006, at A4.

60. BBC NEWS, *Q&A*, *supra* note 51.

61. Alphonso Chardy, *U.S. Digs for Vote-Machine Links to Hugo Chávez*, MIAMI HERALD, Oct. 28, 2006, at A1.

62. Press Release, Sequoia Voting Systems, Sequoia Voting Systems Responds to Venezuela-Related Rumors and Misinformation (May 11, 2006), <http://www.sequoia.vote.com/article.php?id=74>.

63. Chardy, *supra* note 61.

64. Golden, *supra* note 1.

65. *Id.*

SVS as part of a larger global sales and marketing plan to establish its leadership in electronic voting worldwide.<sup>66</sup> Following acquisition by Smartmatic, SVS's sales spiked, and its machines were used in sixteen states in 2006.<sup>67</sup>

Smartmatic, originally a single office headquartered in Florida, just prior to its acquisition of SVS, reincorporated in an elaborate structure of holding companies; critics pointed to this as evidence of the company's attempt to obfuscate its ownership.<sup>68</sup> In addition, Bizta, an entirely separate company, obtained a loan from the Venezuelan government, which received a twenty-eight percent stake in Bizta as guarantee and pursuant to which the Venezuelan government appointed a senior official to the company's board of directors.<sup>69</sup> According to critics, because two members of the Bizta board are also on the board of Smartmatic, the Venezuelan government could exert influence over Smartmatic,<sup>70</sup> even though the loan to Bizta was discharged in 2004 before Smartmatic bought Bizta in 2005.<sup>71</sup>

Thus, critics, citing concerns that the Venezuelan government may be able to wield influence over American elections by virtue of its connections to Smartmatic, brought the acquisition to the attention of President Bush in May 2006.<sup>72</sup> On October 29, 2006, Smartmatic and SVS issued a press release announcing they had voluntarily notified CFIUS, and had submitted information regarding ownership and security of their voting products for review.<sup>73</sup> In the same release, the company clarified that

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66. *Id.*

67. Bob Davis, *Smartmatic to Shed U.S. Unit, End Probe into Venezuelan Links*, WALL ST. J., Dec. 22, 2006, at A6 (also noting that the Justice Department had conducted an investigation into whether Smartmatic paid bribes to Venezuelan officials to win the 2004 election contract).

68. The holding companies were set up in trusts based in Delaware, the Netherlands, and the Caribbean. Golden, *supra* note 1.

69. Davis, *supra* note 67.

70. Golden, *supra* note 1.

71. Davis *supra* note 67.

72. See Golden, *supra* note 1.

73. Press Release, Sequoia Voting Systems, Smartmatic and Sequoia Voting Systems Announce Voluntary CFIUS Filing (Oct. 29, 2006), <http://www.sequoia.vote.com/article.php?id=79> (the press release identified three entrepreneurs as the primary owners: Antonio Mugica, with 78.8%; Alfredo Anzola, with 3.87%; and Roger Pinate, with 8.47%) [hereinafter SVS Oct. 29, 2006 Press Release]. In contrast, Representative Maloney asserted in a press release that:

[w]hen I first raised this case with Treasury, I thought that it was ripe for a CFIUS investigation, because the integrity of our voting machines is vital to national security. At that time, Smartmatic flatly refused to undergo a CFIUS

“[n]o foreign government or entity—including Venezuela—has ever held an ownership stake in Smartmatic.”<sup>74</sup> Subsequently, on December 22, 2006, Smartmatic obtained CFIUS approval to withdraw from the review process, and announced plans to sell SVS.<sup>75</sup> As with the DPW ports deal, the Sequoia voting machines became the subject of litigation when a suit was brought against New Jersey elections officials alleging that “the state did not properly certify the machines and that the equipment could not adequately protect against vote fraud.”<sup>76</sup>

While the DPW controversy should be viewed in light of domestic concerns regarding port security following the events of September 11, 2001, concerns regarding the Smartmatic transaction must be viewed in light of the vocal hostility of the Chávez government to the Bush administration, partisan voting controversies following *Bush v. Gore*,<sup>77</sup> and larger policy concerns regarding the security and integrity of electronic voting systems.<sup>78</sup>

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review. But . . . the company could not overcome the cloud of doubt . . . had they been able to, we would not be talking about a sale of Sequoia today.

Press Release, Rep. Carolyn Maloney (D-NY), Smartmatic Announces It Will Sell Sequoia Voting Systems, Withdraw from CFIUS Review (Dec. 22, 2006), [http://maloney.house.gov/index.php?option=com\\_content&task=view&id=1255&Itemid=61](http://maloney.house.gov/index.php?option=com_content&task=view&id=1255&Itemid=61) [hereinafter Maloney Press Release].

74. SVS Oct. 29, 2006 Press Release, *supra* note 73.

75. N.Y. TIMES, *Voting Machine Maker for Sale*, N.Y. TIMES, Dec. 23, 2006, at A17 (quoting Sequoia officials that the controversy would have no effect on the company’s role in U.S. elections); Press Release, Sequoia Voting Systems, Smartmatic Corporation and Sequoia Voting Systems Move to Align Corporate Structures with Future Business Goals (Dec. 22, 2006), <http://www.sequoiavote.com/article.php?id=82> (noting that the U.S. Election Assistance Commission had not raised any concerns regarding the use of the company’s products in the 2006 elections, that the products met the highest industry standards, and that the products had passed “extensive federal and state testing”).

76. Richard G. Jones, *Proof Sought on Reliability of Vote Units*, N.Y. TIMES, Feb. 17, 2007, at B4.

77. *Bush v. Gore*, 531 U.S. 98 (2000); Ian Urbina, *U.S. Panel is Said to Alter Finding on Voter Fraud*, N.Y. TIMES, Apr. 11, 2007, at A1.

78. The GAO issued a 2007 report documenting security problems in voting systems, the latest in a series of reports since 2001. GAO, ELECTIONS: ALL LEVELS OF GOVERNMENT ARE NEEDED TO ADDRESS ELECTRONIC VOTING SYSTEM CHALLENGES, GAO-07-576T (Statement of Randolph C. Hite, Mar. 7, 2007). Most recently, the standoff between the United States and Venezuela was demonstrated when President Chávez called President Bush “the devil” at the United Nations and Venezuela’s challenge to the U.S. nomination of Guatemala to the United Nations Security Council. Warren Hoge, *Venezuelan’s Diatribe Seen as Fatal to U.N. Council Bid*, N.Y. TIMES, Oct. 25, 2006, at A6; *After 41 U.N. Ballots, Venezuela-Guatemala Logjam Persists*, N.Y. TIMES, Oct. 26, 2006, at A12; *see also* Michael Isikoff & Joseph Contreras, *Ortega and Ollie—Again*, NEWSWEEK, Nov. 6, 2006, at 9 (observing that the Bush administration is concerned

## IV. CHANGING THE PARADIGM

Following the Dubai Port World deal in 2006, two bills emerged as key contenders for CFIUS reform. Senator Richard Shelby of Alabama proposed the Foreign Investment and National Security Act of 2006 (S. 3549), which passed the Senate with unanimous consent.<sup>79</sup> A second bill, the National Security Foreign Investment Reform and Strengthened Transparency Act of 2006 (H.R. 5337), sponsored by Representative Roy Blunt of Missouri, passed the House with near unanimous approval.<sup>80</sup> Both seek to amend the Exon-Florio and CFIUS review process encapsulated in the Defense Production Act of 1950 and related executive orders. The way the current law and the proposed bill structure the CFIUS inquiry reflect two different views regarding the proper framework for analysis of risks presented by FDI. The paradigm reflected in the existing law may be characterized as a totality of the circumstances test, whereas the changes proposed in the Senate bill introduce a minimum threshold analysis. In the former, the significance of any one factor is weighed against the entire situation presented by the transaction. In the latter, certain types of activity and contacts trigger heightened scrutiny to determine if they are substantial enough to suggest impairment of national security. The differences between these two approaches reflect a fundamental shift in the relative primacy of open investment versus national security in the review process.

*A. The Current FDI Review Process: The Totality of the Circumstances Paradigm*

The principle inquiry in the existing Exon-Florio review process, which was first established in 1975<sup>81</sup> and expanded by Congress in 1988,<sup>82</sup> is triggered by voluntary notice from parties to a transaction.<sup>83</sup>

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Venezuelan President Chávez may be lending financial support to the re-election of ex-Sandinista leader Daniel Ortega in Nicaragua).

79. Foreign Investment and National Security Act, S. 3549, 109th Cong. (2006).

80. National Security Foreign Investment Reform and Strengthened Transparency Act, H.R. 5337, 109th Cong. (2006)

81. President Gerald Ford created CFIUS by executive order in 1975, but the executive branch had no authority to interfere in FDI aside from the President's powers to declare a national emergency or if regulatory authority under federal antitrust, environmental or securities laws. International Emergency Economic Powers, 50 U.S.C. §§ 1701–1706; Exec. Order No. 11,858, 40 F.R. 20,263 (May 7, 1975).

82. The review process in present form derives from a 1988 amendment to § 721 of the Defense Production Act (1950), the so-called Exon-Florio Amendment, which expanded presidential authority to block foreign acquisitions that threatened national security and formalized the CFIUS review process, which had proceeded on an informal basis pursuant to an executive order. The President delegated the authority granted him by the

Individual CFIUS members may also notify the committee of a transaction.<sup>84</sup> CFIUS, originally consisting of six members, has expanded to its present membership of twelve representatives of different departments and offices of the executive branch.<sup>85</sup>

In the two-prong inquiry, CFIUS must first determine whether there is credible evidence that a foreign person acquiring control may take action that threatens to impair national security and second, whether existing laws, other than Exon-Florio and the International Emergency Economic Powers Act, provide the President insufficient authority to protect national security in the matter before the President.<sup>86</sup> No particularized definition of “national security” was provided; legislators deliberately left the term to interpretation so as to ensure it would not be delimited by industry.<sup>87</sup>

Although notice is voluntary, consequences for failing to file are severe because failure to secure CFIUS approval or to fully disclose or to misrepresent in the process subjects the transaction to divestiture if at any

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1988 Exon-Florio Amendment to CFIUS via executive order. The Defense Production Act of 1950, 50 U.S.C. app. § 2170 (1994); Exec. Order No. 12,661, 40 F.R. 779 (Dec. 27, 1988); *see generally* JAMES K. JACKSON, THE EXON-FLORIO NATIONAL SECURITY TEST FOR FOREIGN INVESTMENT, CRS 22197, 2 (Feb. 23, 2006) (providing an overview of the legislative and regulatory history) [hereinafter JACKSON, NATIONAL SECURITY TEST].

83. 31 C.F.R. § 800.401(a) (voluntary notice by a party to a transaction). The Department of Treasury first promulgated guidelines in 1991. *See* JACKSON, NATIONAL SECURITY TEST, *supra* note 82, at 4.

84. 31 C.F.R. § 800.401(b).

85. Executive departments represented on CFIUS include: Department of Treasury (Chair), Department of Commerce, Department of State, Department of Homeland Security, Department of Justice, and the Department of Defense. Executive offices of the President represented on CFIUS include: Office of Management and Budget, Office of the U.S. Trade Representative, Council of Economic Advisers, Office of Science and Technology Policy, National Security Council, and the National Economic Council. *See* Saxton, *Committee Report*, *supra* note 86.

86. 50 U.S.C. app. § 2170(e); *see also* Jim Saxton, *Committee on Foreign Investment in the United States*, JOINT ECONOMIC COMMITTEE RESEARCH REPORT 109-34, Mar. 2006, available at [www.house.gov/jec](http://www.house.gov/jec) [hereinafter Saxton, *Committee Report*]. Industries such as power, banking, maritime, and aircraft are governed by industry-specific regulation that imposes limitations on foreign ownership. A report to Congress by the Comptroller General in 1977 examined the statutory framework governing these different sectors of “national interest” and concluded there was no need to introduce an additional layer of review on the influx of foreign capital because existing legislation already specifically addressed the risks of foreign ownership in those industries. GAO Oct. 1977, *supra* note 11, at 6–22, 38; *see also* JACKSON, NATIONAL SECURITY TEST, *supra* note 82, at 3.

87. “Critical technologies” are defined, but “national security” is not. *See* 50 U.S.C. app. § 2170 (k)(2); *see also* JACKSON, NATIONAL SECURITY TEST, *supra* note 82, at 3 (citing 134 CONG. REC. H2118 (daily ed. Apr. 20, 1988)).

time the acquisition raises security concerns.<sup>88</sup> Compliance gives the transaction the benefit of a safe harbor provision, minimizing risk of subsequent review or action by the President.<sup>89</sup>

The two-prong inquiry whereby CFIUS adduces the existence of credible evidence of a threat to national security and whether existing laws provide the President with sufficient authority to protect national security governs both phases of the CFIUS process: an initial thirty-day review and a second-stage forty-five day investigation.<sup>90</sup> If, upon completing the first-stage thirty day review, CFIUS is unable to resolve security concerns with the parties to the transaction, the companies will either withdraw notice to provide more time, or if withdrawal is not feasible either because the company refuses or the security risks are too great, CFIUS will proceed to a second stage, entailing a more extensive forty-five day investigation.<sup>91</sup> At all stages of the process, CFIUS proceeds by consensus; consequently, the objection of any one of the member agencies at the conclusion of the first-stage thirty day review triggers the second-stage forty-five day investigation, and upon conclusion of the investigation, if CFIUS cannot reach consensus regarding a recommended course

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88. 50 U.S.C. app. § 2170(d); 31 C.F.R. § 800.601(d)–(e).

89. 31 C.F.R. § 800.601(d). The regulation states that:

[a]ll authority available to the President under section 721(d), including divestment authority, shall remain available at the discretion of the President in respect of acquisitions which have been concluded at any time on or after the effective date, but only if the purpose for which divestment or other appropriate relief is sought is based on facts, conditions, or circumstances existing at the time the transaction was concluded. Such authority shall not be exercised if:

- (1) The Committee, through its Staff Chairman, has in writing advised a party (or the parties) that a particular transaction, with respect to which voluntary notice was attempted, was not subject to section 721;
- (2) The Committee has previously determined under § 800.502 not to undertake an investigation of the acquisition when proposed, pending, or completed; or
- (3) The President has previously determined not to exercise his authority under section 721 with respect to that acquisition.

*Id.*

90. 50 U.S.C. § 5170(e); 31 C.F.R. § 800.501(a); *see also* LARSON & MARCHICK, FOREIGN INVESTMENT, *supra* note 7, at 13.

91. A company may, provided CFIUS approves, withdraw its notice at any time prior to the president's final decision. 31 C.F.R. § 800.505; *see also* LARSON & MARCHICK, FOREIGN INVESTMENT, *supra* note 7, at 14–15. For review periods, *see* 31 C.F.R. § 800.404(a) (commencing thirty day review period) and § 800.504(a) (conclusion of investigation after forty-five days).

of action for the President, the report to the President must represent dissenting views.<sup>92</sup>

The existing law, whereby the mechanism is permissive, discretionary, ad hoc, and incorporates discreet reporting requirements, provides an example of a totality of the circumstances paradigm under which national security concerns are subordinated to the open investment principle. For example, although an investigation is required where the party acquiring control is a foreign government or person acting on behalf of a foreign government, the statute is otherwise permissive, accepting voluntary notifications from parties to a transaction.<sup>93</sup> Furthermore, Exon-Florio stipulates merely that CFIUS “may” consider several different factors in its inquiry, including the effect of the proposed investment on domestic production for projected national defense requirements, the consequences of sales of military technology to countries of concern with respect to terrorism and weapons of mass destruction, and the potential effects of the proposed transaction on U.S. defense technology leadership.<sup>94</sup> Consequently, the inquiry underlying the review and investigation entails consideration of both the past conduct and future intentions of the individual investor, and to a lesser extent, the nation of origin of the invest-

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92. 31 C.F.R. § 800.504; LARSON & MARCHICK, FOREIGN INVESTMENT, *supra* note 7, at 14.

93. On voluntary notice, see 31 C.F.R. § 800.601. The mandatory investigation requirement concerning foreign governments was introduced by the so-called Byrd Amendment to the Defense Production Act of 1950, enacted in the National Defense Authorization Act for Fiscal Year 1993, Pub. L. No. 102-484, § 837(b) (1992), and codified as 50 U.S.C. app. § 2170 (b). See also JACKSON, NATIONAL SECURITY TEST, *supra* note 82, at 3, note 11.

94. The statute specifically suggests consideration of:

- 1) domestic production needed for projected national defense requirements, 2) the capability and capacity of domestic industries to meet national defense requirements, including the availability of human resources, products, technology, materials, and other supplies and services, 3) the control of domestic industries and commercial activity by foreign citizens as it affects the capability and capacity of the United States to meet the requirements of national security, 4) the potential effects of the . . . transaction on the sales of military goods, equipment, or technology to any country (A) identified by the Secretary of State . . . or (B) listed under . . . the ‘Nuclear Non-Proliferation Special Country List’ . . . and 5) the potential effects of the . . . transaction on United States international technological leadership in areas affecting United States national security.

50 U.S.C. app. § 2170 (f); see also JACKSON, NATIONAL SECURITY TEST, *supra* note 82, at 3–4.

ment, but only insofar as this presents credible evidence of an impairment of national security.<sup>95</sup>

While the current law does not define national security, suggesting the scope of review is unlimited, in fact, the compass of these factors delineate the core inquiry for CFIUS, largely limiting its purview to acquisitions of controlling interests that have measurable consequences for the present and future capacity to meet defense production requirements.<sup>96</sup> At the same time, the undefined scope of national security encourages voluntary notification of CFIUS because where there is a question regarding whether or not a given transaction will implicate national security concerns, corporations seek to benefit from the safe harbor provision to minimize the risk of subsequent divestment.<sup>97</sup> Furthermore, in declining to specify national security or to articulate a mandatory list of factors for consideration, the current law permits CFIUS discretion to prioritize transactions for review and investigation, permitting it to traverse industries, formulations of management control, and chains of relationships to assess how, in the facts of a specific case, the transaction may implicate national security concerns.<sup>98</sup>

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95. On the balance between consideration of past and future conduct of an investor in evaluating security risks, see GAO May 1990, *supra* note 11, at 3; GAO Mar. 1990, *supra* note 28, at 12; GAO, NATIONAL SECURITY REVIEWS OF FOREIGN INVESTMENT, GAO/T-NSIAD-91-08, 9–10 (Feb. 26, 1991) (Testimony of Allan I. Mendelowitz) [hereinafter GAO Feb. 1991]. The Department of Treasury regulations define “control” as “the power, direct or indirect, whether or not exercised . . . to determine, direct, take reach or cause decisions regarding . . .” matters including: the transfer of principal assets; dissolution; closing or relocation of production, research, or development facilities; termination or non-fulfillment of contracts; and amendment of the entity’s operative agreement. The regulation also stipulates that where more than one foreign person has an interest, “consideration will be given to factors such as whether the foreign persons are related and/or whether they have commitments to act in concert.” 31 C.F.R. 800.204 (a) & (b).

96. “They required policy judgments about the consequences of dependence on foreign semiconductor firms for both the U.S. civilian and military sectors. Such decisions would require making assumptions about the Japanese firm’s intentions regarding the market power and technology transfer that it would gain from the acquisition.” GAO Mar. 1990, *supra* note 28, at 22 (discussing a Japanese firm’s proposed purchase of a U.S. semiconductor producer).

97. *Id.* at 14 (noting that failure to “provide a clear definition of national security or the criteria [meant] attorneys representing potential foreign investors feel compelled to clear most foreign investments with CFIUS before completing the transactions”); GAO DEFENSE TRADE: IDENTIFYING FOREIGN ACQUISITIONS AFFECTING NATIONAL SECURITY CAN BE IMPROVED, GAO/NSIAD-00-144, 5 (June 2000) [hereinafter GAO June 2000].

98. “CFIUS evaluates investment on a case-by-case basis and is able to gather extensive information about the firms involved . . . CFIUS does not perform analyses of foreign investment by industry sector, nor does it examine other larger questions which have arisen in public debate.” GAO Feb. 1991, *supra* note 95, at 9–10.

In addition, specific transactions are typically approved pending implementation of certain conditions, including limitations on involvement of an acquiring foreign party through, for example, addition of American citizens to the board.<sup>99</sup> These limitations are specifically tailored to address the security concerns of different agencies and are implemented in mitigation agreements. These agreements may include penalties for non-compliance and entail obligations greater than those usually required of domestic companies.<sup>100</sup> If no measures are perceived adequate to address the national security concerns raised by the transaction, CFIUS may recommend the President block the deal.<sup>101</sup>

Strict requirements for confidentiality govern the review and investigation process, and as a corollary, the reporting requirements to Congress are limited. The statute, in its current form, requires a report to the Secretary of the Senate and the Clerk of the House of Representatives only upon the President's final determination whether or not to take action.<sup>102</sup> The President's decision-making authority is only triggered upon completion of the discretionary second-stage forty-five day investigation by CFIUS.<sup>103</sup> The statute also requires a report to Congress every four years, which is intended to assist Congress in its oversight responsibilities by providing an assessment of whether the FDI activity in the prior four-year period provides credible evidence of a coordinated state-driven strategy to erode U.S. critical technology leadership.<sup>104</sup> The limited and

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99. For example, the acquisition of IBM's personal computer business by Chinese computer-maker Lenovo was approved provided it included additional security measures. See McMahon, *supra* note 2. Approval of the 2000 acquisition of Verio, Inc., an Internet service provider, by Nippon Telephone and Telegraph Company was contingent upon a strict prohibition against Japanese government involvement; the 2003 acquisition of Global Crossing, Ltd. by Hong Kong Hutchinson Whampoa Ltd. and Singapore Technologies Telemedia was contingent upon the passivity of Hutchison in management because of Hutchinson's connections to the Chinese military. Hutchinson eventually withdrew but Technologies Telemedia proceeded based on a concession to place Americans on the board of Global Crossing. JACKSON, NATIONAL SECURITY TEST, *supra* note 82, at 5.

100. LARSON & MARCHICK, FOREIGN INVESTMENT, *supra* note 7, at 11–12.

101. See 31 C.F.R. 800.504(b); LARSON & MARCHICK, FOREIGN INVESTMENT, *supra* note 7, at 11–12.

102. 50 U.S.C. app. § 2170 (g). Prior to the 1992 amendments, the President was only required to report to Congress if he exercised authority to block an acquisition. GAO, DEFENSE TRADE: MITIGATING NATIONAL SECURITY CONCERNS UNDER EXON-FLORIO COULD BE IMPROVED, GAO-02-736, 1 (Sept. 2002) [hereinafter GAO Sept. 2002].

103. 31 C.F.R. § 800.504.

104. For example, through acquisition of U.S. companies engaged in the research, development, and production of critical technologies or through industrial espionage. 50 U.S.C. app. § 2170 (k)(1).

discreet nature of these reporting requirements reflects an overall emphasis on discretion and confidentiality.

The totality of the circumstances paradigm reflected in the current law, characterized, as described above, by a voluntary, discretionary, and ad hoc review mechanism with limited reporting requirements, is responsive to the problem that threats to national security are likely to change over time and the nature of the threat presented by any given transaction is highly fact specific. The broad scope of “national security” preserves executive discretion to respond to these threats as they emerge.<sup>105</sup> Simultaneously, the scope of the factors the statute suggests for review allows for effective prioritization of resources in response to these emerging threats. In addition, the entirely voluntary notification system avoids the appearance of a mandatory screening process while ensuring adequate review of transactions that entail security concerns.<sup>106</sup> This is reinforced by a strong incentive to provide notice, because the transaction may be subject to divestment at any time.<sup>107</sup> The reliance on negotiated mitigation agreements ensures that the means are narrowly tailored to the specific potential negative security consequences of a transaction while minimizing the risk that a particular transaction could be burdened with the costs of larger national security concerns.<sup>108</sup> Finally, the strict confidentiality requirements and limited reporting means reviews are, for the most part, safely sequestered from the political arena.<sup>109</sup>

On the other hand, the existing regime may be criticized as under-inclusive. Reliance on a system of voluntary notification likely results in under-reporting of transactions that present security risks, as some would

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105. See, e.g., Alan F. Holmer, Judith H. Bello, & Jeremy O. Preiss, *The Final Exon-Florio Regulations on Foreign Direct Investment: The Final Word or Prelude to Tighter Controls?*, 23 LAW & POL'Y INT'L BUS. 593, 609 (1992).

106. *Id.* at 595, 609–610 (observing that the open definition of national security encourages filing, and that the burdens are small because parties are free to consult with CFIUS to elicit guidance, especially in the context of large corporate transactions); LARSON & MARCHICK, FOREIGN INVESTMENT, *supra* note 7, at 11 (discussing the “specter” of mandatory investment screening and noting that the current regime encourages filing if there is “any possibility that a transaction might raise national security issues”).

107. 50 U.S.C. app. § 2170 (d); see also Saxton, *Committee Report*, *supra* note 86 (noting that “compliance is very high because the President may order the divestment of a domestic acquisition at any time in the future if the foreign acquirer did not notify CFIUS”).

108. See, e.g., Matthew R. Byrne, Note, *Protecting National Security and Promoting Foreign Investment: Maintaining the Exon-Florio Balance*, 67 OHIO ST. L.J. 849, 890–91, 904 (2006) (discussing benefits of mitigation agreements).

109. S. REP. NO. 109-264, 12 (2006); see LARSON & MARCHICK, FOREIGN INVESTMENT, *supra* note 7, at 15–17 (discussing the generally limited involvement of both the legislative and executive branches, contributing to an apolitical review process).

argue was the case with Smartmatic.<sup>110</sup> Moreover, the discretionary review may fail to take into account the national security implications of a particular transaction in its broader geo-political context, as some would argue was the case with DPW.<sup>111</sup> Similarly, the high order assigned to confidentiality comes at the expense of congressional and public confidence in the adequacy of the review.<sup>112</sup> Finally, permissive withdrawal regulations may allow an end-run on the review process because CFIUS does not monitor drop-outs.<sup>113</sup> This problem is replicated in the failure to monitor and enforce compliance with formal mitigation agreements.<sup>114</sup> Both instances permit a risk that deals presenting security concerns remain unaddressed.<sup>115</sup>

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110. Maloney Press Release, *supra* note 73 (Rep. Maloney commenting on Smartmatic deal). The existing law does not always reach privately owned or smaller companies, which may exclude “some of the most advanced technologies being developed.” GAO Mar. 1990, *supra* note 28, at 15; *see also* GAO June 2000, *supra* note 97, at 7. This report identified three transactions that were notified to member agencies but had not been reported to CFIUS. These included a 1999 acquisition of a U.S. manufacturer of ceramic body armor by a German firm; a 1998 acquisition of a U.S. laser manufacturer by a French firm; and a 1995 acquisition of a U.S. bearing manufacturer by a Hong Kong firm. The ceramic body armor manufacturer and the bearing manufacturer could have been captured by CFIUS because the companies deal in classified products that required Department of Defense reporting; the laser manufacturer cancelled its defense contracts, and did not believe its business fell within the purview of Exon-Florio. In all three cases, the firms agreed to cooperate with CFIUS. *Id.* at 10–13.

111. As an example, critics of CFIUS handling of the DPW deal commented that the current review process does not consider the underlying conditions in the UAE and the company’s vulnerability to infiltration and corruption. Kaplan, *UAE Purchase*, *supra* note 3 (quoting Congressman Peter King (R-NY)). Critics also expressed concern that the scope of interests encompassed in national security review were limited to those parties about whom threatening intelligence was reported and where the acquisition would affect export-control technologies or classified contracts; it was not expanded to include consideration of U.S. critical infrastructure. Letter from Rep. Bennie Thompson to Comptroller General David Walker, (Feb. 23, 2006), <http://hsc.house.gov/about/subcommittees.asp?ID=47&SubSection=0&Issue=0&DocumentType=0&PublishDate=0&subcommittee=8>.

112. S. REP. NO. 109-264, *supra* note 109, at 2; JACKSON, NATIONAL SECURITY TEST, *supra* note 82, at 4.

113. The GAO reported that two deals were completed prior to filing with CFIUS where notification was withdrawn because suitable mitigation measures could not be agreed upon, and the companies failed to re-file. The GAO concluded “[a]s a result, potential threats to national security . . . remained.” GAO Sept. 2002, *supra* note 102 at 2.

114. *Id.*

115. *Id.* at 12 (discussing the need for post-mitigation agreement monitoring).

*B. The Senate Bill: The Minimum Threshold Paradigm*

Following the DPW imbroglio, the Senate sought to reform the review process.<sup>116</sup> In comparison to the existing totality of the circumstances regime, the Senate bill effects a paradigm shift by incorporating a type of minimum threshold analysis under which the review mechanism is mandatory, categorical, and incorporates expansive reporting requirements.<sup>117</sup> The proposed bill retains the mandatory investigation of investments by foreign governments or on behalf of a foreign government.<sup>118</sup> In addition, where the transaction implicates control of critical infrastructure or where the security risks identified through review of an expanded list of factors and, in both instances, the security concerns are unmitigated, the bill requires CFIUS to undertake a forty-five day investigation.<sup>119</sup> Like the existing law, the bill declines to define “national security,” and retains the core factors for consideration in review and investigation discussed above, but limits the discretion of CFIUS by making their consideration mandatory.<sup>120</sup> The bill also introduces new factors, including, *inter alia*, potential effects on critical infrastructure and technologies, whether the country of origin is a potential regional military threat, and individual country assessments.<sup>121</sup> The incorporation of

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116. This has been a persistent concern with respect to the Exon-Florio review process and it has elicited not infrequent GAO reports. *See* GAO, DEFENSE TRADE: NATIONAL SECURITY REVIEWS OF FOREIGN ACQUISITIONS OF U.S. COMPANIES COULD BE IMPROVED, GAO-07-661T, 8 (Mar. 23, 2007) (Statement of Ann M. Calvaresi-Barr) (discussing a series of GAO reports since 2000) [hereinafter GAO Mar. 2007].

117. S. 3549 § 2.

118. The bill changes the voluntary notice provisions with regard to any transaction involving a foreign government and critical infrastructure by making notification of CFIUS in both of those circumstances mandatory, with penalties for non-compliance to be promulgated by CFIUS following enactment of the bill. *Id.* § 2(b)(5).

119. *Id.* § 2 (b)(1)(A)(ii) & (b)(1)(B).

120. *Id.* § 2(g) (“For purposes of determining whether to take action . . . and for purposes of reviews and investigations . . . shall consider . . .”) (emphasis added). On the decision not to define “national security” for the purposes of CFIUS review, see *supra* notes 87 & 97.

121. S. 3549 § 2(g)(1), (g)(2), & (g)(6)(B). Altogether, § 2(g) requires consideration of:

- (1) potential effects on United States critical infrastructure, including major energy assets;
- (2) potential effects on United States critical technologies;
- (3) domestic production needed for projected national defense requirements;
- (4) the capability and capacity of domestic industries to meet national defense requirements, including the availability of human resources, products, technology, materials, and other supplies and services;
- (5) the control of domestic industries and commercial activity by foreign citizens as it affects the capability and capacity of the United States to meet the requirements of national security;

these particular factors and the fact that they are mandatory introduces greater structure into the CFIUS inquiry, and creates a priori assumptions about what kinds of conduct and activity give rise to a threat to impair national security, reflecting a departure from the principle that has governed CFIUS in the past: ownership itself is a small part of a given vulnerability.<sup>122</sup>

By incorporating critical infrastructure and technology as mandatory criteria, the bill would require CFIUS to review and investigate transactions with unmitigated security risks that occur in any of the twenty-two key critical infrastructure industries, implicating transactions in areas as diverse as food supply and highways, bridges, and vaccinations.<sup>123</sup> The same is true for critical technologies, which encompass dual-use technologies, and thus, technologies used for both private commercial and defense contracting purposes are brought squarely within the purview of CFIUS review.<sup>124</sup> The incorporation of these specific categories of indus-

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(6) the potential effects of the proposed or pending transaction on sales of military goods, equipment, or technology to any country (A) identified by the Secretary of State (i) . . . as a country that supports terrorism; (ii) . . . as a country of concern regarding missile proliferation; or (iii) . . . as a country of concern regarding the proliferation of chemical and biological weapons; (B) identified by the Secretary of Defense as posing a potential regional military threat to the interests of the United States; or (C) listed . . . on the 'Nuclear Non-Proliferation Special Country list' . . . ; (7) the potential effects of the proposed or pending transaction on United States international technological leadership in areas affecting United States national security; (8) the long term projection of United States requirements for sources of energy and other critical resources and materials; and (9) the assessments developed under subsection (c)(7) of the country in which the foreign persons acquiring United States entities are based.

*Id.* § 2(g).

122. Kaplan, *Foreign Ownership*, *supra* note 12 (quoting Douglas Holtz-Eakin and Todd Malan).

123. The law introduces a requirement that all transactions resulting in foreign control of "critical infrastructure" as defined in the Defense Production Act of 1950 and the Homeland Security Act of 2002, and is intended "to create a realistic standard by which CFIUS should measure the potential impact on national security," while allowing CFIUS to promulgate regulations that "exclude from mandatory investigation commercial assets that clearly do not by themselves constitute critical infrastructure." The provisions exclude cases that are resolved through prior mitigation agreements. S. REP. NO. 109-264, *supra* note 109, at 7; *see also* JOHN MOTEFF & PAUL PARFOMAK, CRITICAL INFRASTRUCTURE AND KEY ASSETS: DEFINITION AND IDENTIFICATION, CRS RL 32631 (Oct. 1, 2004) (discussing evolution of the concept of critical infrastructure).

124. *See generally* Nowak, *supra* note 10 (analyzing the potential application of the 1992 amendments to Exon-Florio to dual-use technologies for protectionist ends, which would result in the diversion of foreign investment from the United States to foreign competitors, ultimately weakening the defense industrial base).

tries as factors for consideration necessarily entails a shift from a primarily management control-based inquiry focused on issues of defense supply to a broader inquiry that creates a categorical presumption of risk based on foreign ownership of property, including purely physical security.<sup>125</sup>

Similar consequences follow from the introduction of mandatory consideration of individual country assessments. Under the bill, CFIUS must consider individual country assessments when evaluating the risk of the proposed transaction not only with respect to a foreign government, but also with respect to an investment contemplated by a private citizen of that nation.<sup>126</sup> Individual country assessments, to be issued following enactment of the bill, encompass: (i) a country's past adherence to non-proliferation control regimes; (ii) the country's past relationship with the United States, specifically the country's record on cooperation with the United States in counter-terrorism efforts; and (iii) the risk the country presents with respect to transshipment and diversion of technologies, especially those with military applications and entails analysis of the country's national export control laws and regulations.<sup>127</sup>

As with the incorporation of the critical infrastructure and technologies requirement, the country assessments dramatically expand the scope of the current review. The elements encompassed in the country assessment assign greater weight to historical factors in considering the risk of a potential investment than exist in the current paradigm.<sup>128</sup> Insofar as the country assessment must be applied to private individuals as well as governments or persons acting on behalf of governments, the assessment creates a categorical presumption of risk with respect to private invest-

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125. See LARSON & MARCHICK, FOREIGN INVESTMENT, *supra* note 7, at 29 (recommending Congress refrain from incorporating critical infrastructure into the review process, and noting that “[t]he administration and Congress should work together to determine how best to protect critical infrastructure, regardless of who owns a particular company”). CFIUS’ operative definition of control is provided in the regulations promulgated under the existing law, and may or may not be retained if the bill is passed. The current operational definition of control resides in 31 C.F.R. § 800.204.

126. S. 3549 § 2(g).

127. *Id.* § 2(c)(7).

128. In the current law, where a totality of the circumstances review is conducted, the past conduct and future plans of the individual investor, and to a lesser extent, the investors country of origin, are considered but only insofar as they implicate national security in light of the risk presented by the overall transaction, and thus, no categorical presumption against certain countries is created. See *supra* notes 93–94 and accompanying text.

ment from those countries, based purely on the individual investor's citizenship.<sup>129</sup>

As with the existing statute, the proposed bill requires strict confidentiality, but enhances congressional oversight by introducing expansive reporting requirements.<sup>130</sup> These include notice to Congress upon initiation and completion of the first-stage thirty-day review, and if the second-stage investigation is deemed necessary or required by the statute (as with governments party to a transaction) upon initiation and conclusion of the forty-five day second-stage investigation.<sup>131</sup> Both concluding notices require certification by the Chair and Vice Chair of CFIUS and include a report as to measures taken, factors considered, and ultimate decisions.<sup>132</sup> CFIUS must provide these notices to the Majority and Minority Leaders of the Senate, the ranking members of the Committee on Banking, Housing and Urban Affairs and of any committees in the House and Senate with oversight of an agency on CFIUS that is assigned to lead review or investigation of the transaction.<sup>133</sup> The bill provides the Majority and Minority Leaders discretion to release these reports to other members of Congress where the transaction concerned implicates critical infrastructure in their home state.<sup>134</sup> The proposed bill also retains the four-year reporting requirement of the existing bill, but incorporates this as a subset of a new annual report.<sup>135</sup> Finally, where a proposed transaction concerns critical infrastructure, CFIUS must notify the governor of the affected state.<sup>136</sup>

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129. The proposed bill by its terms requires that country assessments be considered for all reviews and investigations, whether from a private citizen or government party. S. 3549 § 2(g).

130. *Id.* § 2 (h)(1).

131. *Id.* § 2 (j)(1) & (2) (providing requirements for notice and reports to Congress keyed to the stages of the review process set forth in subsections (a) and (b)).

132. *Id.* § 2(j)(3).

133. *Id.* § 2(j)(3)(C).

134. *Id.* § 2(j)(3)(D).

135. The annual report is required to include a discussion of the potential impact on the U.S. defense industrial base and critical infrastructure of foreign acquisitions during preceding year, and an aggregate analysis of the previous four years, prospective discussion of risks to national security and critical infrastructure, evaluation of whether there is credible evidence of a coordinated strategy by one or more countries or companies to acquire critical infrastructure or companies involved in research development or production critical technologies, and whether there are industrial espionage activities directed by foreign governments against private U.S. companies. *Id.* § 2(j)(4)(A)–(B); *see also* S. REP. NO. 109-264, *supra* note 109, at 13–15.

136. S. 3549 § 2(h)(2). The governor notice requirement stemmed from concerns voiced by state-level officials that they had no information regarding a pending transaction that could adversely affect their state, especially with respect to critical infrastruc-

The bill further disciplines the process by implementing safeguards for transactions that are notified to CFIUS. Withdrawal and resubmission of a filing triggers a mandatory forty-five day investigation.<sup>137</sup> The bill also requires CFIUS to monitor withdrawn transactions that nonetheless proceed and to initiate review if parties do not voluntarily re-file.<sup>138</sup> Where CFIUS resolves national security risks through mitigation agreements,<sup>139</sup> the bill provides for ongoing oversight of such agreements by CFIUS,<sup>140</sup> underwritten by a grant of authority to the Attorney General to investigate and enforce the agreements in the District of Columbia.<sup>141</sup>

The minimum threshold analysis introduced by the new bill shifts the existing balance by subordinating the open investment principle to national security concerns. This shift is reflected in the presumptions the bill creates regarding two categories of risks: those presented by ownership of infrastructures and technology deemed "critical" and those presented by the national origin of the proposed individual or country investment.<sup>142</sup>

The benefit of this shift is that in clearly articulating sources of risks, including long-term risks, the review process is more likely to ensure that questionable transactions are investigated by CFIUS, reducing the likelihood that risky transactions will "slip through the cracks." As noted above, the definition of critical infrastructure is broad and encompasses economic security criteria.<sup>143</sup> Consequently, the mandatory consideration

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ture, with view to discussing potential security concerns, subject to the same confidentiality requirements that apply to the federal government. S. REP. NO. 109-264, *supra* note 109, at 12.

137. S. 3549 § 2(b)(3).

138. *Id.* § 2(b)(4).

139. Though such mitigation agreements resolve most investigations in approval, the current review process does not address enforcement subsequent to approval. *See* S. REP. NO. 109-264, *supra* note 109, at 13.

140. S. 3549 § 2(i)(4).

141. Remedies include injunctive relief, damages, and divestiture. *Id.* § 2(i)(5).

142. The existing statutory framework was criticized in 2002 on similar grounds because the broad discretion conferred by the statute could be interpreted as broadly as the proposed bill. *See generally* Christopher R. Fenton, Note, *U.S. Policy Toward Foreign Direct Investment Post-September 11: Exon-Florio in the Age of Transnational Security*, 41 COLUM. J. TRANSNAT'L L. 195 (2002) (noting that the existing statutory framework in the new post-September 11 security context could be expanded to include consideration of threats identified on the basis of individual and organizational relationships, rather than investor nationality, as necessary to adequately address threats posed by non-state actors, and thus will expand scope of review to encompass foreign control of domestic industries, particularly those required for the anti-terror campaign).

143. "The term 'critical infrastructure' . . . includ[es] national economic security and national public health or safety . . ." S. 3549 § 2(m)(2).

of critical infrastructure ensures that FDI that may entail long-term consequences for the United States through control of American assets, whereby foreign owners may exert their influence in a fashion inimical to American interests, for example by effectuating technology transfer or transferring American jobs overseas, is thoroughly investigated.<sup>144</sup>

In addition, requiring CFIUS to consider country assessments as part of its review ensures that each transaction is placed in a broader geopolitical context. With respect to the DPW deal, for example, the security risks presented by the UAE's acquisition of a controlling interest would be considered in light of factors like its proximity to Iran, the evidence that Pakistani scientist Abdul Qadeer Khan exploited Dubai's relaxed environment to smuggle nuclear components to Iran, Libya and North Korea, and its role as a conduit for funding of the September 11, 2001 terrorist attacks.<sup>145</sup> Furthermore, the inclusion of this factor in the review process creates an incentive for private parties to encourage states, and for states themselves, to establish a good track record of compliance with U.S. foreign policy.

Similarly, the expanded reporting requirements promise to introduce greater discipline in the process by ensuring Congress is informed about deals at initiation and conclusion, making oversight more effective.<sup>146</sup> A corollary benefit would be increased public and congressional confidence that reviews are handled as required by law, minimizing the public controversy that follows when a transaction is criticized in popular press. This, in turn, could prevent the public controversy that resulted in alienation of the investors in both the DPW and Smartmatic deals, and ultimately, divestment of their U.S. holdings.<sup>147</sup>

By the same token, this approach may be criticized as over-inclusive. The incorporation of mandatory consideration of transactions affecting critical infrastructure<sup>148</sup> includes a diverse array of industry sectors.<sup>149</sup> As

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144. See, e.g., GAO Mar. 1990, *supra* note 28, at 11, 25.

145. See S. REP. NO. 109-264, *supra* note 109, at 10–11.

146. *Id.* at 13.

147. See BBC NEWS, *Q&A*, *supra* note 60; NY TIMES, *Voting Machine Maker for Sale*, *supra* note 75.

148. 42 U.S.C. § 5195(c) (“[S]ystems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems and assets would have a debilitating impact on security, national economic security, national public health or safety, or any combination of those matters.”).

149. The *National Strategy for Homeland Security* identifies the critical infrastructure sectors as agriculture, food, water, public health, emergency services, government, defense industrial base, information and telecommunications, energy, transportation, banking and finance, chemical industry, postal, and shipping. NATIONAL STRATEGY, *supra* note 5, at 29–30. As the linchpin for all homeland defense legislation, see *id.* at 47–50.

discussed above, this creates a categorical presumption that investment in certain industries and physical assets presents a national security risk and introduces overt economic security factors that have been rejected in the past, in part because requiring consideration of transactions that were not at the core of national security would limit executive discretion to respond to national security considerations while also deterring foreign investment.<sup>150</sup> Worse, given the small membership of CFIUS, it risks defusing its focus and diverting limited resources from transactions CFIUS would otherwise prioritize.<sup>151</sup> This is especially true in light of the fact that critical infrastructure encompasses at least twenty-five percent of the economy.<sup>152</sup> Moreover, the incorporation of country assessments risks alienating foreign governments because they may be deployed as an overarching policy tool, whereby foreign investment is conditioned upon establishing a record of cooperation with U.S. policy goals.<sup>153</sup> Because “past CFIUS cases indicate it is inherently more difficult for a CFIUS agency to argue that foreign firms from allied countries

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*See generally* MOTEFF & PARFOMAK, *supra* note 123 (helpful overview of evolution of the definition of critical infrastructure).

150. *See* Holmer et al., *supra* note 105, 608, 615–17 (listing series of bills introduced in the early 1990s that attempted to introduce economic security criteria but failed); LARSON & MARCHICK, FOREIGN INVESTMENT, *supra* note 7, at 28; Deborah M. Mostaghel, *Dubai Ports World Under Exxon-Florio: A Threat To National Security or a Tempest In a Seaport?*, 70 ALB. L. REV. 583, 591–3, 622 (2007).

151. Byrne, *supra* note 108, at 905 (noting that inclusion of economic security in CFIUS review would dilute the focus from “true threats” and allow its diversion to general economic protectionism with the added risk that foreign nations would emulate this policy, jeopardizing U.S. foreign investments abroad).

152. LARSON & MARCHICK, FOREIGN INVESTMENT, *supra* note 7, at 29.

153. *See* Wysocki, Jr. et al., *supra* note 14. Unlike the Senate bill, the U.S. Model Bilateral Investment Treaty rejects nationality as a proxy for any purpose. Article 9(1) states “[n]either Party may require that an enterprise of that Party that is a covered investment appoint to senior management positions natural persons of any particular nationality.” Article 9(2) allows a party to require a majority of a managing board of directors “be of a particular nationality or resident in a particular territory, provided that the requirement does not materially impair the ability of the investor to exercise control over its investment.” U.S. Department of State, U.S. Model Bilateral Investment Treaty (2004), <http://www.state.gov/documents/organization/38710.pdf>. One scholar has suggested that the proliferation of bilateral investment treaties, despite the failure of the international community in the aggregate to attain consensus on general principles governing foreign investment, is evidence of legal obligations undertaken by states has resulted in “something like customary law.” Andreas F. Lowenfeld, *Investment Agreements and International Law*, 42 COLUM. J. TRANSNAT'L L. 123, 150 (2003).

may threaten national security” this is particularly problematic as a criteria for FDI risk assessment.<sup>154</sup>

In expanding CFIUS’ scope through inclusion of critical infrastructure and country assessments as factors, the bill broadens the sweep of CFIUS review and investigation, effectively expanding its operational definition of “national security” but without articulating any clear guidance to investors.<sup>155</sup> In this way, the bill unnecessarily risks alienating foreign investors and governments because differing views of national security are already accounted for in CFIUS membership.<sup>156</sup> By decreasing CFIUS’ discretion and increasing the number of factors for consideration, the bill implicates an underlying concern that the operational definition of national security currently employed by CFIUS is too narrow.<sup>157</sup> Broadly defined, “national security” may encompass concerns about the growth and direction of the U.S. economy at large, consequences for the U.S. economy where foreign capital may be from a country vulnerable to social or political crises and general commercial competitiveness from risks presented by technology transfer.<sup>158</sup> Since different views of national security are currently taken into account in the diverse CFIUS membership,<sup>159</sup> where such views are materially different, their consid-

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154. GAO Feb. 1991, *supra* note 95, at 8. This trend is also reflected in the larger pattern of foreign investment discussed above, which noted that the predominant source of FDI in the United States is countries typically allied with the United States. Alienating investments from countries that are less clearly allied runs counter to the principle of open investment whereby aligning economic interests contributes to overall stability, and consequently to the maintenance of national security. *See* discussion *supra* Part II.

155. An article discussing the 1991 regulations promulgated by the Treasury Department noted that the regulations failed to define national security with any specificity, despite complaints from investors and multi-national corporations that had lobbied for a bright line test because the regulations provided inadequate guidance. *See* Holmer et al., *supra* note 105, at 595, 608–10.

156. The debate regarding the definition of “national security” in Exon-Florio has plagued the review process since its inception. *See id.* In 1990, a GAO report concluded that “the absence of a specific definition of national security” had not negatively impacted CFIUS investigations. GAO Mar. 1990, *supra* note 28, at 11. In 2003, CFIUS was expanded to include the DHS, which conducts reviews of critical infrastructure to identify and handle threats. *See* Exec. Order No. 13,286, 68 F.R. 10,619 (Feb. 28, 2003).

157. At present, the term “national security” is undefined. In practice, the scope of the review process provides an operational definition. A narrow definition concerns primarily firms whose business derives from defense contracts. A broader definition encompasses firms engaged in non-defense commercial business. *See* GAO Mar. 1990, *supra* note 28, at 11.

158. *See, e.g.,* GAO May 1990, *supra* note 11, at 3.

159. By requiring CFIUS to examine security risks in terms of aggregate effects over long-term, and thus limiting foreign investment could “translate into inferiority in the development, prototyping, manufacturing and production and product improvement

eration is ensured by the CFIUS practice of proceeding by consensus.<sup>160</sup> This means the dissenting vote of any one member automatically triggers the second-stage review, whereupon the dissenting vote must be brought to the attention of the President as part of the final determination whether to exercise his or her authority to block a deal.<sup>161</sup>

In addition to expanding the operative definition of national security, the bill also expands reporting requirements, but fails to provide clear guidelines for confidentiality and disclosure on the part of Congress, risking politicization of a review process that had previously been safely sequestered from Congress.<sup>162</sup> This in turn, combined with the requirement to notify and consult with state governors regarding investment in their state's critical infrastructure,<sup>163</sup> which by definition includes economic security criteria, introduces a strong likelihood that the review process will be exploited for protectionist ends.<sup>164</sup>

Finally, the combination of increased oversight and stricter enforcement of national security mitigation agreements could entail inappropriate involvement in the business decisions of companies.<sup>165</sup> Especially in conjunction with other aspects of the bill, the provisions governing mitigation agreements introduce a risk of protectionism, whereby CFIUS could become a vehicle for the imposition of performance requirements on foreign acquisitions by U.S. companies.<sup>166</sup> Because these mitigation agreements have the full force of law and are subject to investigation and enforcement, the bill may be a further deterrent to foreign investors faced with internalizing the cost of broad U.S. policy concerns regarding national security.<sup>167</sup>

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strategies . . . ." Bobrow & Kudrle, *supra* note 11, at 74–5; *see also* Nowak, *supra* note 10.

160. Byrne, *supra* note 108, at 909.

161. *Id.*

162. *See* LARSON & MARCHICK, FOREIGN INVESTMENT, *supra* note 7, at 15–17.

163. S. 3549 § 2(h)(2).

164. *See* LARSON & MARCHICK, FOREIGN INVESTMENT, *supra* note 7, at 29. The existing review process has itself been criticized as a vehicle for domestic protectionism. *See generally* Shearer, *supra* note 42. The litigation brought by the Port Authority of New York and New Jersey and the Miami-based stevedoring company cited contractual claims and concerns over security in their suits to block the deal. Concerns regarding layoffs, etc. may have been an underlying motivation for the suit. *See, e.g.*, WALL ST. J. ONLINE, *Ports Deal News Tracker*, *supra* note 53.

165. GAO Sept. 2002, *supra* note 102, at 24, 27.

166. *Id.* at 28.

167. A corporation's primary duty is to its shareholders; placing the burden of mitigating security issues with respect to critical infrastructure that encompasses bridges and flu vaccinations places too much burden on private capital. *See* J. Michael Littlejohn, *Using all the Kings Horses for Homeland Security: Implementing the Defense Production Act*

*C. Does the Senate Bill Enhance National Security?*

On balance, the new bill shifts the existing paradigm, at minimum, by bringing the national security principle on par with, if not elevating it over, the open investment principle. In contrast, in the existing paradigm, the national security principle is often subordinate to the open investment principle, while allowing discretion as needed. This paradigm shift finds symbolic and substantive manifestation in the appointment of the Secretary of Defense as the Vice-Chair for CFIUS.<sup>168</sup> Because the bill risks that American businesses may have greater difficulty courting foreign investors, with the consequence that over time, flows of FDI could be reduced, the question becomes whether the Senate bill accomplishes this result with appreciable benefits for national security. The application of the two different paradigms to the DPW and Smartmatic deals helps illustrate the different schema in action.

With respect to the DPW transaction, the principle concerns were that CFIUS failed to subject the transaction to the second-stage forty-five day review required by existing law, and that even if it had, CFIUS failed to properly consider the larger geo-political context of the deal, especially as related to national security risks to ports within the United States.<sup>169</sup> Under the new paradigm, the corporate entity owned by the UAE would be required to notify CFIUS of the deal, and under the expanded reporting requirements, Congress would also be notified, allowing it to ensure that the second-stage forty-five day investigation was conducted as required by both the new bill and existing law.<sup>170</sup> However, the mitigation agreement negotiations that occurred during the first-stage review of the DPW acquisition would probably not have been materially different, although the negotiations may have been accomplished without the furor that surrounded the transaction and perhaps avoiding the related public pressure that eventually scuttled the U.S. portions of the deal.<sup>171</sup>

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*for Disaster Relief and Critical Infrastructure Protection*, 36 PUB. CONT. L.J. 1, 2 (2006) (observing the important role of the private sector, the negative publicity where risks to infrastructure are identified, how this may operate as a disincentive to effective collaboration with the private sector, and identifying the legal framework for government authority to compel cooperation from the private sector in the event of natural disaster or terrorist attack).

168. S. 3549 § 2(c)(3); Byrne, *supra* note 108, 909 (arguing that maintaining the Department of Treasury as chair ensures primacy of open investment policy while allowing agencies with different mandates adequate authority to ensure that national security concerns are addressed; changing the chairmanship risks upsetting this balance without real national security benefit).

169. See Hufbauer, *supra* note 52; Kaplan, *UAE Purchase*, *supra* note 3.

170. S. 3549 § 2(j)(1)–(2).

171. BBC NEWS, *supra* note 60.

It is unclear how CFIUS' consideration of the mandatory country assessments in evaluating the risks presented by the transaction would affect the review; it is possible that the UAE's track record as a conduit for arms and money to terrorists and rogue states would force CFIUS to recommend blocking the deal at the conclusion of the second-stage investigation.<sup>172</sup> Because it is unlikely that the national security mitigation agreements would have been materially different, it is not clear that any appreciable security benefit would be attained by the more disciplined minimum threshold paradigm reflected in the bill. At minimum, the issue would be brought to the President, including any dissenting views, and on the facts of this case, the deal would probably have been allowed to proceed.<sup>173</sup> In this case, as the President noted defending his approval of the transaction,<sup>174</sup> the factual misconception that was the kernel of the controversy is two-fold: the nature of the property interest in the ports (here merely leases), and the security responsibilities entailed by that interest.<sup>175</sup> For example, it is common place in the United States for foreign corporations to own and operate U.S. ports.<sup>176</sup> Port security remains a primary responsibility of the U.S. Coast Guard, and the U.S. Customs and Border Protection supervises security for cargo, and U.S. citizens staff most ports.<sup>177</sup> Consequently, risks relating to ports as a conduit for foreign personnel and cargo, including terrorists or bombs, remain under the purview of the U.S. government irrespective of who manages vessels and ports.<sup>178</sup> Thus, the security risks specifically implicated by the transaction were likely mitigated by the agreement, and those that were not were well beyond the power of DPW to mitigate.<sup>179</sup> The principle concerns raised by critics were symptomatic of larger concerns regarding U.S. vulnerability in ports at large and not specific to DPW. Regardless

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172. S. 3549 § 2 (c)(7) (mandatory country assessments).

173. 31 C.F.R. § 800.504 (regulation requiring presentation of dissenting views to President).

174. Major Garrett et al., *Bush Says He Will Veto Any Bill to Stop UAE Port Deal*, FOX NEWS, Feb. 22, 2006, <http://www.foxnews.com/story/0,2933,185479,00.html> (describing Bush Administration's defense of President's approval of the DPW transaction).

175. JOHN FRITTELLI, *TERMINAL OPERATORS AND THEIR ROLE IN U.S. PORT AND MARITIME SECURITY*, CRS RL33383 (Apr. 20, 2006) (providing a comprehensive overview of the operation and security of U.S. ports).

176. State-owned Singaporean shipping company, Neptune Orient Lines, operates U.S. ports. Kaplan, *UAE Purchase*, *supra* note 3.

177. *See generally* FRITTELLI, *supra* note 175; *see also* Kaplan, *UAE Purchase*, *supra* note 3.

178. Kaplan, *UAE Purchase*, *supra* note 3.

179. Bilkey, *Testimony*, *supra* note 56, 59 and accompanying text (itemizing concessions, including, of specific relevance here, the provision of personnel files to DHS).

of the outcome of this particular transaction, the security vulnerability of U.S. ports remains.<sup>180</sup>

The consequences for the Smartmatic deal are slightly different. The Smartmatic deal concerned the acquisition of a relatively small, privately held concern, Sequoia Voting Systems, based in Oakland, California, which, as discussed, never underwent CFIUS review.<sup>181</sup> The principle concern with the Smartmatic deal was that the transaction implicated the government of Venezuela and that electronic voting systems are too central to U.S. national interests and too vulnerable to tampering.<sup>182</sup> Whether the new minimum threshold paradigm proposed by the Senate would be more likely to bring the Smartmatic deal under review by CFIUS depends on a few different factors. If the Venezuelan government had an interest in the transaction, either itself or a person acting on its behalf, the parties to the deal would be required to file with CFIUS (under both paradigms).<sup>183</sup> However, because the deal involved neither the government of Venezuela, nor a person acting on behalf of Venezuela, it is not clear that this acquisition would have been brought to the attention of CFIUS.<sup>184</sup> Two principle possibilities remain. Given the expansive definition of critical infrastructure, whether the transaction would be submitted for review under the new paradigm depends on whether voting systems would be considered critical infrastructure.<sup>185</sup> The second possibility under the new paradigm is if the Secretary of Defense determined Venezuela constituted a regional threat.<sup>186</sup> If the deal were notified to CFIUS through either mechanism, under the new paradigm, Congress would have been alerted to the occurrence of the transaction.

In contrast, under the existing paradigm, CFIUS would neither be required to nor precluded from consideration of this transaction. In addition, under the existing law, if the transaction were notified to CFIUS, both the Department of Defense or the DHS (both currently represented on CFIUS) could review the transaction and conclude that foreign ownership of a voting systems manufacturer constituted a potential impairment of national security. In this case, any security concerns could be addressed through mitigation agreements, without the need to subject the

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180. As reflected in the enactment of broad port security legislation following the DPW controversy. See discussion *infra* notes 208–209 and accompanying text.

181. See discussion, *supra* Part III.B.

182. See SVS Oct. 29, 2006 Press Release, *supra* note 73; GAO Elections, 2007, *supra* note 78.

183. S. 3549 § 2(b)(5) (mandatory notice requirements for foreign governments); see *supra* note 93.

184. See Golden, *supra* note 1.

185. S. 3549 § 2(g)(1).

186. *Id.* § 2(g)(6)(B).

transaction to the enhanced scrutiny required by the additional factors in the Senate bill. Under both the existing law and the proposed law, the larger policy concern regarding the vulnerability of electronic voting systems, like the larger problem with ports following the scuttled DPW deal, remains.

Thus, the new paradigm may have some impact in increasing the number of investigations notified to CFIUS for review, but without appreciably enhancing national security, and potentially at significant long-term cost.

#### V. RESOLVING THE EXON-FLORIO PROBLEM

As illustrated above, the existing paradigm strikes a preferable balance between open investment and national security, and preserves the substance of the principle underlying open investment, which maintains that aligning economic interests in the long term provides greater stability, and ultimately, security.<sup>187</sup> Despite its preferable balance of open investment and national security values, the analysis above reveals several critical and interrelated problems in the current review and investigation process: 1) CFIUS does not necessarily follow the review process mandated by law;<sup>188</sup> 2) CFIUS failure to keep Congress abreast of its review process may create a volatile mix of congressional and public lack of confidence that results in divestment despite lack of any credible evidence of a threat to national security;<sup>189</sup> and 3) CFIUS failure to inform Congress may also result in an inappropriate focus on security risks created by a specific transaction, diverting focus from the larger security issue of which the transaction is but a part.<sup>190</sup>

While the proposed bill seeks to address these concerns, it does so at great cost by creating categorical presumptions as to who and what present national security concerns at risk of alienating foreign investments and governments, which could redound to the detriment of the American economy in the long run.<sup>191</sup> Deterring investment in U.S. companies means capital will flow elsewhere and alienates private and government parties with whom the United States would gain the most by cooperat-

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187. See Kaplan, *Foreign Ownership*, *supra* note 11.

188. See Mostaghel, *supra* note 150, at 620 (CFIUS failed to conduct the forty-five day investigation of the DPW transaction as required by the existing law).

189. See *id.* at 622 (describing the partisan melee on Capital Hill over the DPW deal).

190. See Byrne, *supra* note 108, at 902–05.

191. “There are those who would broaden Exon-Florio to include threats to national objectives such as industrial competitiveness, but that sort of inclusiveness would basically cover exactly those nations with whom technological cooperation has the most to offer for U.S. objectives.” Bobrow & Kudrle, *supra* note 11, at 90.

ing.<sup>192</sup> On the other hand, failing to address the problems implicated by lack of congressional and public confidence in the CFIUS review process may implicate similar long-term costs by subjecting specific transactions to unwarranted and partisan scrutiny.<sup>193</sup>

Alienation of private sector and government foreign interests presents very real costs.<sup>194</sup> For example, concessions regarding access to employment records in the final stages of the DPW deal represents a missed opportunity to obtain inside information about global shipping, and as a result, for law enforcement and intelligence agencies to gain insight into global smuggling of terrorists and weapons.<sup>195</sup> Furthermore, encouraging the deal would have helped ensure DPW instituted practices compliant with U.S. security standards in U.S. ports as well as abroad, notably the port in Dubai.<sup>196</sup> Similarly, enlisting the cooperation of Smartmatic in developing electronic voting systems standards and in ensuring that Smartmatic units meet these standard would likely result in the diffusion of these standards to elections in Venezuela, if for no other reason than economies of scale.<sup>197</sup>

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192. Nowak, *supra* note 10, at 1030–31.

193. In the controversy following the DPW deal, it was observed that congressional case-by-case review of commercial transactions at large would generate untenable uncertainties and potential delays for foreign investors with a chilling effect, but this is equally true whether the scrutiny is de jure or de facto. See C. Fred Bergsten, Op-Ed., *Avoiding Another Dubai*, WASH. POST, Feb. 28, 2006, available at <http://www.iie.com/publications/opeds/oped.cfm?ResearchID=603>; see also *Bush Threatens Veto in Ports Row*, BBC NEWS, Feb. 22, 2006, <http://news.bb.co.uk/go/pr/fr/-/2/hi/americas/4737940.stm>.

194. The private sector and foreign governments are identified as critical partners in the *National Strategy for Homeland Security*. See NATIONAL STRATEGY, *supra* note 5, at 33–35.

195. Block, *supra* note 56.

196. DPW, with the \$6.8 billion purchase of P&O, became the third largest port operator in the world. Kaplan, *UAE Purchase*, *supra* note 3; see also LARSON & MARCHICK, FOREIGN INVESTMENT, *supra* note 7, at 20; King, Jr., *supra* note 59. The significance of DPW's willingness to assume responsibility for purchasing, deploying and maintaining radiation detection systems cannot be underestimated. At this stage, although there are serious questions as to the efficacy and value of next-generation systems, DHS figures estimate an increase of over \$320,000 per unit to up-grade existing security, a process that would not be complete at all U.S. ports until 2013. A recent report indicated these costs could be well below actual cost. GAO, COMBATING NUCLEAR SMUGGLING: DHS'S DECISION TO PROCURE AND DEPLOY THE NEXT GENERATION OF RADIATION DETECTION EQUIPMENT IS NOT SUPPORTED BY ITS COST-BENEFIT ANALYSIS, GAO-07-581T, Mar. 14, 2007 (Testimony of Gene Aloise).

197. For example, the results of the widely criticized 2004 election in Venezuela were eventually audited. The Carter Center participated in the audit and attested that the Smartmatic voting machines operated "flawlessly." Juan Forero, *Opposition Rejects Au-*

Alienating the government of UAE would have further concrete costs. The Dubai government runs the Middle East's biggest airline, Emirates Air, just one of a several UAE government-owned companies with substantial investments worldwide, including in the United States.<sup>198</sup> Despite its mixed record supporting U.S. foreign policy, the UAE gave \$100 million to assist victims of Hurricane Katrina.<sup>199</sup> In addition, in a "symbol that the United States trusted the UAE and took the UAE seriously," the UAE government was permitted to purchase 80 F-16 fighter jets in a \$6.4 billion deal in 2000.<sup>200</sup> Following criticism that funds funneled through its hub financed the terrorist attacks of September 11, 2001, the UAE bolstered its anti-money laundering and terror-financing laws and generally increased oversight.<sup>201</sup> The UAE was also the first country to implement the U.S. Cargo Security initiative to pre-screen containers at foreign ports and hosts five U.S. Customs Officials.<sup>202</sup> Finally, the Jebel Ali Port is an important global host to the U.S. Navy, more so than any other foreign port.<sup>203</sup> The DPW acquisition was part of the UAE's overall plan to develop a stable, international financial center based in Dubai, transforming oil wealth into longer term investments, diversifying the economy and increasing the region's integration into the global economy.<sup>204</sup>

Instead of burdening the influx of much-needed foreign capital with broad-based U.S. security concerns, the central problems of the Smartmatic and DPW deals should be addressed. Namely, reform should seek to increase congressional confidence that a thorough review has been conducted,<sup>205</sup> while providing a mechanism to identify and address larger security vulnerabilities that may be exposed in the CFIUS review process. As the GAO noted, "[t]hese questions need to be addressed at a higher policy-making level and in a broader context than the case-by-

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*dit Plan in Venezuela Recall Vote Dispute*, N.Y. TIMES, Aug. 19, 2004, at A5. On the emerging controversy, see Juan Forero & John Schwartz, *Venezuelan Recall Is In Dispute Even Before the Vote*, N.Y. TIMES, June 11, 2004, at A3; Brian Ellsworth, *A Crucial Vote for Venezuela and a Company*, N.Y. TIMES, July 20, 2004, at W1.

198. Spindle et al., *supra* note 3 (these companies purchased major historic hotels and landmarks in New York, San Francisco, and London).

199. Joel Brinkley and Craig S. Smith, *Storm and Crisis: Foreign Aid: Offers Pour In, But the U.S. Is Unprepared*, N.Y. TIMES, Sept. 8, 2005, at A25.

200. Spindle et al., *supra* note 3.

201. *Id.*

202. *Id.*

203. *Id.*

204. Spindle & El-Rashidi, *supra* note 27.

205. See LARSON & MARCHICK, FOREIGN INVESTMENT, *supra* note 7, at 25–26.

case approach presently afforded by CFIUS.”<sup>206</sup> What is striking about the DPW and Smartmatic controversies is that while both represented lost opportunities for the United States to collaborate with the private sector to implement national security policy on a global scale,<sup>207</sup> one positive parallel development was the drafting of legislation to address the larger security concerns implicated in the transactions. In 2006, Congress enacted laws to address the unique security concerns raised in ports.<sup>208</sup> In the following year, bills were introduced to Congress to secure electronic voting systems, but as of the time of publication, none has yet passed.<sup>209</sup> The costs of these security concerns should not be assessed on each individual transaction, but by legislation to address the larger vulnerability that may emerge from the inquiry. The value of congressional oversight in this context is not only to ensure that CFIUS appropriately implements presidential authority to review transactions,<sup>210</sup> but more importantly to provide oversight on the second prong of the Exon-Florio test: where existing laws provide the President insufficient authority to protect national security.<sup>211</sup> As illustrated by the Smartmatic and DPW deals, the goal of congressional oversight should be to focus attention on specific security vulnerabilities that may not be adequately addressed through mitigation agreements in recognition of the fact that the identifiable risks that emerge from a particular transaction are in many cases only a small part of a given vulnerability.

To the extent that greater congressional oversight is required or desirable, it should be strictly circumscribed to avoid the partisan melee that ultimately alienated the investors in the DPW and Smartmatic deals. As one author notes, although “Congress has a role in forming U.S. foreign and national security policy, . . . its role is more appropriately a secondary one of oversight and review.”<sup>212</sup> While the proposed bill purports to

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206. GAO Feb. 1991, *supra* note 95, at 10.

207. See Stephen Flynn & Daniel B. Prieto, Op-Ed., *Capitalizing on the Private Sector to Protect the Homeland*, WASH. POST, Apr. 28, 2006.

208. Security and Accountability For Every Port Act of 2006, Pub. L. No. 109-347 (codified in scattered sections of 9 U.S.C and 46 U.S.C.).

209. Vote Integrity and Verification Act of 2007, S. 559, 110th Cong. (2007); Voter Confidence and Increased Accessibility Act of 2007, H.R. 811, 110th Cong. (2007).

210. *Cf.* Mostaghel, *supra* note 150, at 620–22 (rejecting any change to the existing law and suggesting CFIUS do a better job following it).

211. See 50 U.S.C. app. § 2170(e).

212. Russell J. Bruemmer, *Intelligence Community Reorganization: Declining the Invitation to Struggle*, 101 YALE L.J. 867, 880 (1992). As Bruemmer notes, where national security and foreign relations are concerned, the executive powers are at their constitutional apex. In fact, the executive branch will have the best and most accurate information both about the geo-political context of a particular transaction and the degree to

maintain confidentiality, its notice and reporting mechanisms are sure to embroil transactions in partisan domestic politics, introducing a substantial risk to the transactions concerned.<sup>213</sup> Furthermore, the bill provides no specific measures for ensuring confidentiality, while injecting sensitive national security information and proprietary corporate information into the partisan and political arena of Congress.<sup>214</sup>

At most, the annual reports proposed in the new bill should permit sufficient oversight to ensure that Congress is confident CFIUS conducts a thorough review and to alert Congress to the larger security issues that emerge out of a particular transaction; any expanded notice and reporting requirements should be rejected.<sup>215</sup> In the event that further scrutiny demonstrates a need for enhanced oversight, a committee modeled after the Senate's Select Committee on Intelligence provide may a viable solution.<sup>216</sup>

The Select Committee emerged relatively recently, in 1976, at around the same time a committee to review FDI was first considered.<sup>217</sup> The interests at stake are similar; the oversight responsibilities implicate national security and core executive branch activity, with a strong need for confidentiality. To implement its oversight responsibilities, the Senate created an oversight committee with limited membership, strict voting procedures and rules governing confidentiality of information, and imposed consequences for failure to comply. More specifically, membership in the Senate Select Committee on Intelligence is cooperative through appointment by the President based on recommendations of the Senate leadership; membership must represent members from both political parties.<sup>218</sup> Any disclosure of confidential information by the Committee requires first, that the Committee vote, and if a majority agrees that disclosure is in the public interest, the Committee must notify the President, who may object that the threat to the national interest posed by such disclosure outweighs the public interest in that confidential information, whereupon the Committee may vote to refer to the question of

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which it presents a threat to national security; the President is also the party on whom failure will be most prominently visited. *Id.* at 878–80 (analyzing the roles of the executive and legislative branches with respect to intelligence community reform).

213. The mandatory notification to state governors, S. 3549 § 2(h)(2), and case-by-case notice to Congress, *id.* § 2(j).

214. *See id.* § 2(h)(1) (information filed with CFIUS shall be exempt from disclosure, but instituting no mechanisms or penalties).

215. LARSON & MARCHICK, FOREIGN INVESTMENT, *supra* note 7, at 29.

216. On reporting requirements introduced in the new bill, see *id.* § 2(j).

217. S. Res. 400, 94th Cong. (1976) (establishing the Senate Select Committee on Intelligence); see also Breummer, *supra* note 212, at 873–4.

218. S. Res. 400, 94th Cong. app. A, § 2(a)(1) & (a)(2) (1976).

disclosure of such information to the Senate at large in closed session.<sup>219</sup> Aside from this procedure for disclosure, all other information is confidential, and any individual that discloses information in violation of these procedures may be subject to censure, including removal from office.<sup>220</sup> In so doing, the regulations address the need for oversight while remaining cognizant of the importance of confidentiality and the vulnerability of congressional oversight to inappropriate politicization. As applied to CFIUS, a similar model would provide specific measures to ensure that congressional oversight is employed only to ensure the law is followed and where executive review reveals inadequacy in presidential authority to address national security exigencies. Limiting the purview of oversight in this way, combined with the introduction of strict procedural requirements to ensure that any such committee is bipartisan and the enforcement of confidentiality with concrete penalties limits the risk of politicization of particular transactions and the disclosure of confidential information (whether related to national security or to the interests of the parties to the transaction), while achieving the objective of oversight: that Congress receives timely notice of larger security risks where the President's authority is inadequate. This, in turn, would ensure the primacy of traditional principles of U.S. open investment policy.

## VI. CONCLUSION

The DPW deal precipitated a controversy that resulted in renewed scrutiny of the role of FDI in the United States. The legislative reform of the CFIUS review process proposed in the wake of this controversy represents a dramatic shift in traditionally open U.S. investment policy. In particular, the minimum threshold paradigm for FDI review introduced by the new bill limits CFIUS discretion with respect to the interpretation of who and what represent national security risks, without tangible security benefit. At the same time, the new bill sends a hostile message, a shot across the bow, to foreign investors. The DPW and Smartmatic transactions and their subsequent divestiture represent a paradigmatic failure to advance U.S. strategic interests on a global scale through partnership with corporations operating worldwide. Furthermore, the proposed bill risks that individual transactions will be burdened with broader national security concerns. To maintain the primacy of U.S. open investment policy, it may be necessary to expand congressional oversight to restore congressional and public confidence in the post-September 11 era of heightened security concern. To the extent such oversight is neces-

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219. *Id.* § 8(a) & (b).

220. *Id.* § 8(c)–(e).

sary, it should be strictly circumscribed. In this context, oversight is required to ensure that CFIUS applies the existing law appropriately and to ensure Congress may respond with legislation specific to any larger security vulnerability revealed in the review process. Furthermore, any expansion of congressional review should include confidentiality requirements enforced by strict procedures and penalties that resemble the procedures of the Senate Select Committee on Intelligence.

## VII. EPILOGUE

As this Note was prepared for publication, the Foreign Investment and National Security Act of 2007 was signed into law by President Bush.<sup>221</sup> While a complete review of the new law is beyond the scope of the Note at this late date, some preliminary observations are in order.

The new law reflects many of the characteristics of the minimum threshold paradigm proposed in the bill analyzed in this Note. In particular, the new law changes CFIUS membership, expands CFIUS' scope of review while reducing its discretion, and substantially increases congressional oversight.

Under the new law, the most notable new CFIUS members are the Secretary of Labor and the Director of National Intelligence.<sup>222</sup> In addition, unlike the bill analyzed above, which threatened to subordinate the open investment principle to that of national security by designating the Secretary of Defense as Vice Chairperson of CFIUS,<sup>223</sup> the new law retains the Secretary of the Treasury as the sole chairperson of CFIUS.<sup>224</sup> The addition of the Secretary of Labor remains troubling, however, in that it may signal a shift from a narrow national security focus to one that may also entail broader national security concerns like the preservation of domestic jobs.<sup>225</sup>

As in the minimum threshold paradigm analyzed above, the new law creates a presumption that foreign control of critical infrastructure creates a national security risk.<sup>226</sup> In the new law, when an investment by a foreign entity could result in control of critical infrastructure and any security risks remain unmitigated, a second-stage, forty-five day investi-

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221. Foreign Investment and National Security Act of 2007, PL 110-49 (HR 556), 121 Stat. 246 (2007) (to be codified in 50 U.S.C. app § 2170). The new law establishes CFIUS, which was formed by delegation of authority via executive order, by statute. *Id.* § 3(k)(1).

222. Both are nonvoting, ex officio members. *Id.* § 3(k)(2)(H) & (k)(2)(I).

223. See *supra* note 168 and accompanying text.

224. *Id.* § 3(k)(3).

225. *Id.* § 3(k)(2)(H).

226. See discussion *supra* Part IV.B.

gation is required.<sup>227</sup> In addition, critical infrastructure is incorporated into the law's definition of national security and into the list of factors for consideration by CFIUS, expanding the scope of CFIUS review at least as much as the minimum threshold paradigm.<sup>228</sup> In marked contrast to the minimum threshold paradigm, however, the potentially unlimited sweep of this expansion is ameliorated by the requirement that the Secretary of the Treasury shall publish "guidance on the types of transactions that the Committee has reviewed and that have presented national security considerations . . . ."<sup>229</sup>

The new law also expands the scope of CFIUS review to include evaluation of the country of origin's track record of compliance with non-proliferation regimes and its "relationship" with the United States.<sup>230</sup> These factors are the same factors that the bill analyzed in the body of this Note characterized as "Assessments of Foreign Countries."<sup>231</sup> The new law limits consideration of these additional factors for review to those investments by or on behalf of a foreign government.<sup>232</sup> Thus, on its face and in contrast to the minimum threshold paradigm discussed above, this expansion of CFIUS' scope of review does not by its terms require CFIUS to consider this evidence when evaluating the security risk posed by a non-government affiliated private foreign investor.<sup>233</sup> On the other hand, the new law requires any mitigation agreement be "based on a risk-based analysis, conducted by the Committee, of the threat to national security of the covered transaction."<sup>234</sup> "Risk-based analysis" is not a defined term; however, the new law's definition of national security incorporates "issues relating to 'homeland security.'"<sup>235</sup> The combination of these elements in the new law, like in the minimum threshold paradigm analyzed in the body of this Note, present a risk that individual

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227. 121 Stat. 246 § 2 (b)(2)(B)(i)(III). On the timing requirements for investigations, see *id.* § 2 (b)(2)(C).

228. "The term 'national security' shall be construed so as to include those issues relating to 'homeland security', including its application to critical infrastructure." *Id.* § 2(a)(5). Critical infrastructure is also incorporated into the factors for CFIUS consideration. *Id.* § 4 (f)(4). The inclusion of a definition of "national security" for the purposes of CFIUS review is itself a significant change. See *supra* note 120.

229. 121 Stat. 246 § 2 (b)(2)(E).

230. *Id.* § 4(4).

231. See discussion *supra* Part IV.B.

232. In the chapeau to the subsection, 121 Stat. 246 § 4(4), the new law states "as appropriate, and particularly with respect to transactions requiring an investigation under subsection (b)(1)(B)," i.e. those instances where CFIUS "determines that the covered transaction is a foreign government-controlled transaction . . . ." *Id.* § 2(b)(1)(B).

233. See discussion *supra* Part IV.B.

234. 121 Stat. 246 § 5(l)(1)(B).

235. *Id.* § 2(a)(5)

transactions, whether they involve government or private foreign investors, may be required to internalize the costs of broad homeland security issues in order to secure CFIUS approval.<sup>236</sup>

The lack of tracking for drop-outs from the review process and lack of enforcement authority for mitigation agreements noted as problems in the law prior to amendment<sup>237</sup> have also been addressed in the new law.<sup>238</sup> While these were addressed in the unadopted bill analyzed above, the new law strikes a better balance by allowing CFIUS to promulgate its own methods for evaluating compliance and by ensuring that compliance with any mitigation agreements will not place “unnecessary burdens on a party to a covered transaction.”<sup>239</sup>

Finally, like the minimum threshold paradigm, the new law expands congressional oversight of CFIUS’ reviews and investigations.<sup>240</sup> The new law requires case-by-case notice to Congress.<sup>241</sup> However, unlike the minimum threshold paradigm, the new law does not require notice at the initiation of reviews and investigation, and instead, limits these notices to certifications at the completion of the first-stage review and second-stage investigation.<sup>242</sup> In addition, unlike the minimum threshold paradigm, the new law does not require CFIUS to notify the governor when a transaction involves critical infrastructure in that governor’s state.<sup>243</sup> The new law, like the bill analyzed above, also modifies the current law’s quadrennial report requirement to include an annual report.<sup>244</sup> By limiting notices to Congress to the concluding stage of the review and investigation and by removing the requirement to notify state governors, the new law strikes a better balance than the bill analyzed above by achieving increased public and congressional confidence in the thoroughness of review while limiting the potential for the damaging consequences of unnecessary publicity and politicization.<sup>245</sup>

In conclusion, the new law bears a striking resemblance to the minimum threshold paradigm introduced by the bill analyzed in the body of this Note. The new law contains some important differences however, and as a consequence, it strikes a better balance between national security and the principle of open investment. In particular, the provisions

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236. See discussion *supra* Part V.

237. See discussion *supra* Part IV.B.

238. 121 Stat. 246 § 5(l)(1)–(3).

239. *Id.* § 5(l)(3)(B)(ii) & (l)(3)(B)(ii)(II).

240. *Id.* § 2(b)(3) (certifications to Congress) & § 7 (increased oversight by Congress).

241. *Id.* § 2(b)(3).

242. *Id.*

243. See discussion *supra* Part IV.C.

244. 121 Stat. 246 § 7(b).

245. See discussion *supra* Part IV.B.

that require the Secretary of the Treasury to provide guidance to investors regarding which transactions typically raise national security considerations may allay the concerns of many foreign investors. On the other hand, the incorporation of homeland defense issues and critical infrastructure into the definition of national security risks burdening individual transactions with the costs of larger U.S. security vulnerability that should be addressed through national security legislation like the ports security act discussed above. Whether the increased oversight by Congress provided in the new law will be sufficient to restore public and congressional confidence while adequately circumscribing congressional involvement so as to avoid a repeat performance of the damaging controversies that resulted in the unnecessary divestment of U.S. interests in both the DPW and Smartmatic transactions remains to be seen.

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# MORALITY V. REALITY: THE STRUGGLE TO EFFECTIVELY FIGHT HIV/AIDS AND RESPECT HUMAN RIGHTS

## INTRODUCTION

The United States considers itself a leader in the worldwide fight against the Human Immunodeficiency Virus (HIV) and the Acquired Immune Deficiency Syndrome (AIDS).<sup>1</sup> This concept of global leadership is evident throughout the United States Leadership Against HIV/AIDS, Tuberculosis, and Malaria Act of 2003 (“U.S. Leadership Act”).<sup>2</sup> This bill represents the United States’ recognition of the severity of the HIV/AIDS pandemic and its dedication to helping reverse the grave trends of this crisis.<sup>3</sup>

However, should a country be considered a true leader of a field in which it is creating policy that departs from internationally recognized best practices? The relevance of this question is significant in light of two recent federal district court cases in which judges held a part of the U.S. Leadership Act to be unconstitutional.<sup>4</sup> It also is important as the approach of the United States to HIV/AIDS prevention and treatment is different than the approaches that many public health experts recommend as well as the approaches other nations have taken who have had measurable success in the field of HIV/AIDS policy development and implementation.

The United States codified its contribution to the struggle against HIV/AIDS with the U.S. Leadership Act based on information and encouragement from the United Nations.<sup>5</sup> The United Nations declared a strategic plan in 2001 to encourage its members to create policies and pledge aid to fight HIV/AIDS worldwide.<sup>6</sup> This declaration called for comprehensive and timely efforts geared towards the prevention, treat-

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1. According to the United States Agency for International Development (USAID), “the U.S. government is the world leader in responding to the global pandemic of AIDS.” USAID Health: HIV/AIDS, Overview, [http://www.usaid.gov/our\\_work/global\\_health/aids/](http://www.usaid.gov/our_work/global_health/aids/) (last visited Apr. 15, 2007). *See also* George W. Bush, President of the United States, Statement Upon Signing H.R. 1298, 2003 U.S.C.C.A.N. 726 (May 27, 2003).

2. United States Leadership Against HIV/AIDS, Tuberculosis, and Malaria Act of 2003, Pub. L. No. 108-25, 117 Stat. 711 (2003).

3. *Id.* at 712–18.

4. *Alliance for Open Society Int’l v. U.S. Agency for Int’l Dev.*, 430 F.Supp. 2d 222 (S.D.N.Y. 2006); *DKT Int’l v. U.S. Agency for Int’l Dev.*, 435 F.Supp. 2d 5 (D.D.C. 2006), *rev’d*, 477 F.3d 758 (D.C. Cir. 2007).

5. 117 Stat. 711.

6. G.A. Res. S-26/2, U.N. Doc. A/RES/S-26/2 (June 27, 2001).

ment, and collaboration needed to not only immobilize, but also begin to reverse, the worldwide HIV/AIDS pandemic.<sup>7</sup> On May 27, 2003, the United States Congress passed the U.S. Leadership Act and officially became a part of the strategy of the United Nations to fight HIV/AIDS worldwide.<sup>8</sup> However, examination of the declaration of the United Nations and the subsequent strategies of other States reveal significant differences between the priorities of the United States and the priorities of other parties involved in the global struggle against HIV/AIDS.

These priorities must be examined in light of the fact that state actors have an internationally recognized obligation to “ensure the free and full exercise” of human rights by protecting its citizens from known or foreseeable harms.<sup>9</sup> These human rights include the right to the “enjoyment of the highest attainable standard of physical and mental health...[including] [t]he prevention, treatment and control of epidemic, endemic, occupational and other diseases[.]” as well as the right “[t]o enjoy the benefits of scientific progress and its applications[.]”<sup>10</sup> Moreover, protecting the human rights of all individuals is an obligation *erga omnes* because all States have a legal interest in this protection.<sup>11</sup> Therefore, “national governments bear the responsibility for protecting their citizens from the spread of the HIV epidemic and of mitigating its impact.”<sup>12</sup>

Policies implemented to fulfill these international obligations must be effective and feasible. Especially in the field of public health, policy goals must be realistic and the strategies used to pursue them must be

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7. *Id.*

8. 117 Stat. 711.

9. Velásquez Rodríguez Case, 1988 Inter-Am. Ct. H.R. (ser. C) No. 4, at 166–67 (July 29, 1988). The Inter-American Court of Human Rights stated, in dicta, that States must not only have legal structures in place that make the fulfillment of human rights possible, they must conduct themselves “so as to effectively ensure the free and full exercise of human rights.” *Id.* Specifically, in the Velásquez Rodríguez Case, this obligation led to the conclusion that the State of Honduras was responsible for the kidnapping and murder of Manfredo Rodríguez, even though it claimed to have played no part. *Id.* at 182. The Court held Honduras liable because the government knew about these violations of human rights and did not stop them from occurring. *Id.*

10. International Covenant on Economic, Social, and Cultural Rights, G.A. res. 2200A (XXI), 21 U.N. GAOR Supp. (No. 16) at 49, U.N. Doc. A/6316, Art. 12, 15 (1966), 993 U.N.T.S. 3, entered into force 3 January 1976.

11. Barcelona Traction, Light and Power Co. (Belg. v. Spain), 1970 I.C.J. 3, 32 (Feb 5).

12. Joint United Nations Programme on HIV/AIDS (UNAIDS), Programme Coordinating Board, *Young people and HIV/AIDS: Background discussion paper on the elements of a global strategy*, ¶ 55, U.N. Doc. UNAIDS/PCB(7)/98.3 (Oct. 21, 1998) (hereinafter *Young people and HIV/AIDS*).

proven effective. The differences between the approaches to HIV/AIDS of the United Nations, the United States, and many other countries, such as Brazil, Thailand, and the Netherlands, highlight policy areas that require harmonization in order to make the worldwide effort against HIV/AIDS as effective as possible. The strategies that have proven most realistic and, more importantly, most effective are those that make human rights a priority and utilize the recommendations of international human rights agreements.<sup>13</sup> These strategies, which emphasize personal choice and respect for all individuals, hold the most promise in the fight against HIV/AIDS and should be utilized more in the future.

This Note will review various aspects of the global effort to fight HIV/AIDS in order to provide recommendations for the future. Part I will summarize the current state of the HIV/AIDS crisis and its staggering effects on communities throughout the world. Part II will examine the strategy of the United Nations to create a global framework in the fight against HIV/AIDS, and Part III will discuss the way in which the United States responded to this strategy. Part IV will then consider Brazil's strategy for HIV/AIDS prevention and treatment, and explore the significant differences it presents. Finally, Part V will propose alternative legal strategies for the future of United States policy based on internationally recognized values and human rights.

#### I. STATEMENT OF NEED

Over the past twenty-five years, the HIV/AIDS crisis has developed into "an unprecedented human catastrophe."<sup>14</sup> Only twenty-five years after identifying HIV/AIDS and enabling diagnosis and treatment, the number of people who have been, or are, directly affected<sup>15</sup> by this pandemic is approaching one hundred million.<sup>16</sup> More specifically, more than sixty-five million<sup>17</sup> people have contracted HIV at some point over

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13. G.A. Res. S-26/2, *supra* note 6, at ¶ 16.

14. G.A. Res. 60/262, ¶ 2, U.N. Doc A/RES/60/262 (June 2, 2006).

15. This estimate of those "directly affected" only includes people who either have been diagnosed with, or have died from, HIV or AIDS, and their children. Estimates of people who have been affected by the pandemic in other ways would be infinitely higher.

16. G.A. Res. 60/262, *supra* note 14, at ¶ 2.

17. This number is likely an estimate of infections that have been diagnosed and for which we officially account. A recent study conducted in the United Kingdom showed that 31% of all HIV infections are undiagnosed and therefore not accounted for in certain statistics. Explanations for these undiagnosed cases include the perception many individuals have of immunity from risk, which leads to low rates of voluntary testing. See World Health Org. (WHO) Reg'l Office for Europe, Health Evidence Network, *What is the impact of HIV on families?*, 9 (December 2005) (prepared by P. van Empelen), available at <http://www.euro.who.int/Document/E87762.pdf>. In addition, many people

the last twenty-five years.<sup>18</sup> More than twenty-five million people have died as a result of AIDS-related illness during this time and approximately forty million are currently living with HIV/AIDS globally.<sup>19</sup> HIV/AIDS has become the leading cause of death worldwide for adults aged fifteen to forty-nine, with three million deaths in 2003 alone.<sup>20</sup> The HIV/AIDS pandemic has also ravaged the lives of many children— “[fifteen] million children have been orphaned by AIDS and millions more made vulnerable” by the death or illness of a parent, guardian, or caretaker.<sup>21</sup>

Moreover, the communities most seriously affected by HIV/AIDS have changed over the last twenty-five years in many notable ways, including shifts in the gender, age, and location of many new cases and high concentrations of infections.<sup>22</sup> The world has seen a feminization<sup>23</sup> of the pandemic as “women now represent 50 per cent of people living with HIV worldwide and nearly 60 per cent of people living with HIV in Africa.”<sup>24</sup> In addition, new infections are occurring in much younger age

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throughout the world do not have access to the necessary health care or resources that they need to appropriately diagnose HIV or AIDS. According to the World Health Organization, approximately one billion people are living in extreme poverty worldwide and these people lack access to basic health services. This leads to a situation such as the one found in many nations in Asia and the Pacific, where there are low “prevalence rates,” or diagnosed cases, of HIV/AIDS, but large numbers of infected people. The World Health Organization has found that “India has a prevalence one twentieth that of South Africa yet the same number of people infected.” WHO Regional Office for the Western Pacific, *Fact sheets: Health, poverty, and MDG* (2005), available at [http://www.wpro.who.int/media\\_centre/fact\\_sheets/fs\\_20050621.htm](http://www.wpro.who.int/media_centre/fact_sheets/fs_20050621.htm).

18. G.A. Res. 60/262, *supra* note 14, at ¶ 2.

19. *Id.*

20. WHO Regional Office for the Western Pacific, *supra* note 17.

21. G.A. Res. 60/262, *supra* note 14, at ¶ 2.

22. See Frontline: the age of AIDS: timeline—25 years of AIDS | PBS, <http://www.pbs.org/wgbh/pages/frontline/aids/cron/crontext.html> (last visited Apr. 15, 2007).

23. The original belief about HIV/AIDS was that it predominantly affected men who had sex with men and people who used intravenous drugs. At first, the disease was unofficially known as the Gay-Related Immunodeficiency Syndrome (GRID) and one of the first organizations formed to help address the problems associated with HIV/AIDS was the Gay Men’s Health Crisis (GMHC). However, this perception has changed as it has become very clear that HIV/AIDS does not discriminate: women face similar risks as men, and all people who have unprotected sex face similar risks, regardless of the sex of their partner. *Id.* See also David Jefferson, *How AIDS Changed America*, Newsweek, May 15, 2006, available at <http://www.msnbc.msn.com/id/12663345/site/newsweek/>.

24. G.A. Res. 60/262, *supra* note 14, at ¶ 7. Even though the populations of women and men living with HIV/AIDS worldwide are approximately equal, women are more vulnerable to HIV/AIDS infection and its impact due to gender inequalities and various

groups than ever before, as “half of all new HIV infections occur among children and young people under the age of 25.”<sup>25</sup> Developing nations have become the epicenters of the evolving pandemic and recent statistics estimate that more than ninety-five percent of all people living with HIV/AIDS live in developing nations.<sup>26</sup> Sub-Saharan Africa has also become the part of the world with the largest number, and highest concentration, of people living with, and dying from, HIV/AIDS.<sup>27</sup> According to the United Nations, the HIV/AIDS pandemic “constitutes a global emergency and poses one of the most formidable challenges to the development, progress and stability of our respective societies and the world at large, and requires an exceptional and comprehensive global response . . . .”<sup>28</sup>

## II. STRATEGY OF THE UNITED NATIONS

In 2001, the United Nations made an initial commitment to the fight against HIV/AIDS.<sup>29</sup> The General Assembly passed a resolution, known as the Declaration of Commitment on HIV/AIDS (“Declaration”) and entitled “Global Crisis—Global Action.”<sup>30</sup> The Declaration listed many ways in which Member States could fulfill their own commitments to join this worldwide fight.<sup>31</sup> It stated that prevention is of the utmost im-

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biological factors. WHO, *Women and HIV/AIDS*, [http://www.who.int/gender/hiv\\_aids/en/](http://www.who.int/gender/hiv_aids/en/) (last visited Apr. 15, 2007).

25. G.A. Res. 60/262, *supra* note 14, at ¶ 8; *Young people and HIV/AIDS*, *supra* note 12, at ¶ 2.

26. G.A. Res. 60/262, *supra* note 14, at ¶ 2. At first, concerns about HIV and AIDS were focused on the United States because that is where many of the first cases occurred and the media was covering this fact. Many European countries even banned the import of blood from the United States in the early 1980's. See *Frontline: the age of AIDS: timeline—25 years of AIDS* | PBS, *supra* note 22.

27. See Joint United Nations Programme on HIV/AIDS (UNAIDS): Regions, [http://www.unaids.org/en/Regions\\_Countries/](http://www.unaids.org/en/Regions_Countries/) (last visited Apr. 15, 2007). The United Nations has estimated that while Sub-Saharan Africa contains slightly more than ten percent of the global population, more than sixty percent of all people living with HIV live in Sub-Saharan Africa, with over twenty-five million infections. In 2005 alone, “an estimated 3.2 million people in the region became newly infected, while 2.4 million adults and children died of AIDS.” *Id.*

28. G.A. Res. 60/262, *supra* note 14, at ¶ 3.

29. See G.A. Res. S-26/2, *supra* note 6.

30. *Id.*

31. *Id.* at ¶¶ 37–103. According to the Declaration, these efforts should include eliciting the active participation of civil society, the business community, and the private sector to develop and implement both action and financing plans, constructively confront stigmas and eliminate discrimination, address the effects of gender and age, and

portance, while care, support, and treatment are also crucial aspects of an effective response to the HIV/AIDS crisis.<sup>32</sup> The Declaration called for prevention efforts to “ensure that at least 90 per cent [by 2005], and by 2010 at least 95 per cent of young men and women aged 15 to 24 have access to the information, education, including peer education and youth-specific HIV education, and services necessary to develop the life skills required to reduce their vulnerability to HIV infection. . . .”<sup>33</sup> It also specified the priority that must be given to the most vulnerable populations, including women and children, especially children who have been orphaned by HIV/AIDS.<sup>34</sup>

The United Nations renewed this commitment to the worldwide struggle against HIV/AIDS with a second General Assembly resolution, known as the Political Declaration on HIV/AIDS (“Political Declaration”), which was passed at the High-Level Meeting on AIDS in New York on June 2, 2006.<sup>35</sup> The Political Declaration updated statistics, recognized the efforts that many Member States have already made, encouraged States to renew their own commitments, and reiterated the goals of the United Nations’ global strategy.<sup>36</sup>

Specifically, the United Nations emphasized its commitment to implementing policies that will help prevent the spread of HIV/AIDS in youth populations to try “to ensure an HIV-free future generation.”<sup>37</sup> The Po-

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strengthen health, education and legal system capacity to safeguard “the right to the highest attainable standard of physical and mental health.” *Id.* at ¶ 37.

32. *Id.* at ¶ 17. Prevention efforts should include programs that account for local circumstances as well as cultural values geared towards decreasing high-risk behavior by educating about and encouraging safer-sex practices and increasing the availability of male and female condoms and sterile needles. Efforts should also be made towards early diagnosis and effective treatment to help prevent an infected individual from further spreading the disease. *Id.* at ¶ 52.

33. *Id.* at ¶ 53.

34. *See Id.* at ¶¶ 62–67.

35. *See* G.A. Res. 60/262, *supra* note 14. The High-Level Meeting on AIDS took place on June 2, 2006 after a two-day technical review at the United Nations in New York. 2006 High-Level Meeting on AIDS: Questions and answers, *available at* [http://data.unaids.org/pub/InformationNote/2006/200605\\_HLM\\_QA\\_en.pdf](http://data.unaids.org/pub/InformationNote/2006/200605_HLM_QA_en.pdf). The goals at this meeting were to review the progress that had been made in implementing the Declaration of 2001, consider recommendations on how to reach the stated targets, and renew the commitment of the United Nations and the importance of the Declaration. *Id.* Attendees at the meeting included national delegations led by Heads of States and Governments, organizations and individuals involved in HIV/AIDS programming efforts, world business leaders, HIV/AIDS researchers, people living with HIV/AIDS, and HIV/AIDS advocates from the entertainment industry. *Id.*

36. *See* G.A. Res. 60/262, *supra* note 14.

37. *Id.* at ¶ 26. The United Nations included in its plan “the implementation of comprehensive, evidence-based prevention strategies, responsible sexual behaviour, including

litical Declaration also stated the importance of harm-reduction strategies, especially in the realm of drug use.<sup>38</sup> In addition, the Political Declaration elaborated on the feminization of HIV/AIDS and the need for efforts to eliminate gender inequalities and discrimination based on gender in order to empower women to protect themselves from HIV infection in an environment free from coercion, abuse, and violence.<sup>39</sup> Finally, the Political Declaration made a number of commitments to efforts that the United Nations believes will play a unique role in the fight against HIV/AIDS, including the commitment “to overcoming legal, regulatory or other barriers that block access to effective HIV prevention, treatment, care and support, medicines, commodities and services.”<sup>40</sup>

### III. RESPONSE OF THE UNITED STATES

#### *A. U.S. Leadership Act*

On May 27, 2003, the United States Congress passed the U.S. Leadership Act and pledged a significant amount of funding, resources, and support to assist foreign countries in their struggles against HIV/AIDS, tuberculosis, and malaria, and “to strengthen United States leadership and the effectiveness of the United States response”<sup>41</sup> to these infectious diseases. The U.S. Leadership Act lays out a five-prong strategy for meeting its goals:

- (1) establishing a . . . five-year, global strategy . . . that encompasses a plan for phased expansion . . . and improved coordination . . . between the United States and foreign governments and international organizations;
- (2) providing increased resources for multilateral efforts to fight HIV/AIDS;
- (3) providing increased resources for United States bilateral efforts . . . to combat HIV/AIDS, tuberculosis, and malaria;
- (4) encouraging the expansion of private sector efforts and expanding public-private sector partnerships to combat HIV/AIDS; and
- (5) intensifying efforts to support the development of vaccines and treatment for HIV/AIDS, tuberculosis, and malaria.<sup>42</sup>

The U.S. Leadership Act has tremendous potential to effect positive change in the lives of many individuals, as well as entire communities,

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the use of condoms, evidence-and skills-based, youth-specific HIV education, mass media interventions and the provision of youth-friendly health services.” *Id.*

38. *Id.* at ¶ 22.

39. *Id.* at ¶ 30.

40. *Id.* at ¶ 24.

41. 117 Stat. 711, 717.

42. *Id.* at 717–18.

struggling with the problems associated with HIV/AIDS.<sup>43</sup> In many countries struggling with HIV/AIDS throughout the world, the major obstacles to treatment and prevention include poverty and underdevelopment, which compound the problem and impede support and prevention strategies.<sup>44</sup> The U.S. Leadership Act pledges over sixteen billion dollars in aid to HIV/AIDS programs all over the world.<sup>45</sup> Given this enormous financial commitment, the U.S. Leadership Act could be the legal framework of an excellent opportunity for the United States to use its resources in an effective way in order to help reverse the trends of the HIV/AIDS pandemic.

However, the U.S. Leadership Act differs from the declarations of the United Nations and the strategies of other States in significant ways. These variations reflect different views about how to properly address the HIV/AIDS problem worldwide. The United Nations encourages the use of proven effective methods of prevention, while the United States places great emphasis on methods that are morally driven, rather than objectively-based. The Political Declaration speaks at length about different forms of comprehensive sexual health education, which have shown to be very effective in various contexts.<sup>46</sup> Nevertheless, the U.S. Leadership Act emphasizes the teaching of abstinence as a primary focus of education efforts.<sup>47</sup> There is minimal, if any, evidence that abstinence-only education helps to prevent the spread of sexually transmitted diseases (STDs), such as HIV/AIDS.<sup>48</sup> This is just one example of the problems within the U.S. Leadership Act's current framework.

### *B. Encroachments of Free Speech and Impediments to Prevention Efforts*

Another problem with the U.S. Leadership Act developed into a recent pair of cases in federal district courts in the Southern District of New

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43. *Id.* at 715–16.

44. G.A. Res. S-26/2, *supra* note 6, at ¶ 11.

45. The Act authorizes the appropriation of three billion dollars per year for five years, beginning in fiscal year 2004 and continuing through fiscal year 2008. 117 Stat. 711, 745. The Act also authorizes a one billion dollar contribution to the Global Fund in 2004 and commits to contribute “such sums as may be necessary for the fiscal years 2005–2008.” *Id.* at 724–25. The Global Fund was established in January 2002 as an international AIDS trust fund and the International Bank for Reconstruction and Development serves as its initial collection trustee. *Id.* at 724.

46. See Naomi Starkman & Nicole Rajani, *The Case for Comprehensive Sex Education*, 16 AIDS Patient Care and STDs 313 (2002).

47. 117 Stat. 711, 718, 729.

48. Deborah M. Roffman, *Abstain, Yes. But With Your Eyes Wide Open*, in TAKING SIDES: CLASHING VIEWS ON CONTROVERSIAL ISSUES IN HUMAN SEXUALITY 4, 6 (8th Ed. McGraw-Hill/Dushkin 2002).

York and the District of Columbia.<sup>49</sup> The plaintiffs in these cases, Alliance for Open Society International, Inc. (“AOSI”), Pathfinder International (“Pathfinder”), and DKT International, Inc. (“DKT”) are “United States-based non-profit organizations actively participating in the worldwide effort to limit the spread of HIV/AIDS.”<sup>50</sup> These plaintiffs alleged that part of the U.S. Leadership Act’s funding eligibility requirement,<sup>51</sup> which stated that organizations may only receive funding through the Act if they “have a policy explicitly opposing prostitution,”<sup>52</sup> was an unconstitutional violation of the First Amendment and their right

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49. Alliance for Open Society Int’l, 430 F.Supp. 2d 222; DKT Int’l, 435 F.Supp. 2d 5.

50. Alliance for Open Society Int’l, 430 F.Supp. 2d at 230; DKT Int’l, 435 F.Supp. 2d 5. AOSI is an integral part of a worldwide effort to implement a number of “initiatives to promote open society by shaping government policy and supporting education, media, public health, and human and women’s rights, as well as social, legal, and economic reform.” Alliance for Open Society—Main Page, [http://www.aosi.kz/index\\_eng.htm](http://www.aosi.kz/index_eng.htm) (last visited Apr. 15, 2007). Specifically, AOSI has been involved in utilizing a grant from the United States Agency for International Development (USAID) to implement a drug and HIV/AIDS reduction program, known as the Drug Demand Reduction Program, in Central Asia. *Id.* Pathfinder International partners with local government and grassroots organizations in over twenty developing countries throughout the world to support family planning, reproductive health services, prevention and treatment of HIV/AIDS and care for women suffering from complications of unsafe abortions. Pathfinder International: About Us, <http://www.pathfind.org/site/PageServer?pagename=AboutUs> (last visited Apr. 15, 2007). DKT International is a charitable organization that implements international social marketing programs, which focus on family planning and HIV/AIDS prevention. DKT International, <http://www.dktinternational.org/default.htm> (last visited Apr. 15, 2007). One example of DKT’s work is its condom use program, which is modeled on other successful condom use campaigns, and promotes one-hundred percent condom use in non-traditional outlets, such as “red light areas, [k]araoke bars, motels, and other establishments located near high-risk sexual activity.” *Id.*

51. It is important to note that the statute’s funding eligibility requirement regarding sex work has two parts. 117 Stat. 711, 734. The first part dictates that funding from the Act may not be used to promote sex work or advocate for its legalization. *Id.* The second part states that funding may not be provided to any organization that has not explicitly stated an opposition to sex work. *Id.* The plaintiffs in these cases only challenged the second of these two parts of the funding eligibility requirement. *See* Alliance for Open Society Int’l, 430 F.Supp. 2d at 229; DKT Int’l, 435 F.Supp. 2d at 14. They did not challenge any restriction on the use of government funds. *Id.*

52. 117 Stat. 711, 734; 22 U.S.C. §7631(f). This requirement is regulated by USAID, which is responsible for awarding grants pursuant to the U.S. Leadership Act, by compelling all applicants to submit specific provision with their grant application entitled the “Prohibition on the Promotion or Advocacy of the Legalization or Practice of Prostitution or Sex Trafficking.” DKT Int’l, 435 F.Supp. 2d at 7. USAID was created by executive order in 1961 and it is an “independent agency that provides economic, development, and humanitarian assistance around the world in support of the foreign policy goals of the United States.” Alliance for Open Society Int’l, 430 F.Supp. 2d at 231.

to freedom of speech.<sup>53</sup> Specifically, they challenged the notion that the government may dictate their speech as well as control what they do with alternative private funding, by requiring them to adopt organization-wide policies and practices that align with what the government believes about sex work<sup>54</sup> and about what is appropriate for these organizations and the work they do.<sup>55</sup>

The plaintiffs are all engaged in important work to counter the effects of HIV/AIDS and to help enhance prevention efforts worldwide.<sup>56</sup> As such, they work with many individuals in different high-risk populations, including sex workers.<sup>57</sup> Pathfinder has stated that it wants to continue using its private funding to work with sex workers in India and community organizations in Brazil that address the legal issues surrounding sex work.<sup>58</sup> Pathfinder has also stated its desire to engage policymakers in a

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53. See Alliance for Open Society Int'l, 430 F.Supp. 2d at 229; DKT Int'l, 435 F.Supp. 2d at 14.

54. There is a difference in terminology used throughout these cases that reflects a larger point of contention. As the court points out in *Alliance for Open Society*, the plaintiffs used the term "sex work," while the defendants used the term "prostitution." Alliance for Open Society Int'l, 430 F.Supp. 2d at 230. The court ultimately decides to use "prostitution" because that is the term used throughout the U.S. Leadership Act. *Id.* However, the court notes that there is a difference of opinion regarding these terms as plaintiffs explain that "sex work" tends to be prevalent in the public health and international relief fields but many amici took offense to the notion of "sex" as work. *Id.* The term "sex work" is sometimes used to reflect the notion that people should have the right "to control their own bodies, including the right to exchange sexual favors for money." WILLIAM J. TAVERNER, *TAKING SIDES: CLASHING VIEWS ON CONTROVERSIAL ISSUES IN HUMAN SEXUALITY* 244-45 (8th Ed. McGraw-Hill/Dushkin 2002). This Note will use the term "sex work," except when providing a direct quote in which "prostitution" was previously used.

55. Alliance for Open Society Int'l, 430 F.Supp. 2d at 234. Maurice Middleberg, the Vice President of EngenderHealth, which is another organization involved in successful HIV/AIDS programs in Africa and Asia, recently summarized this argument well by stating that these organizations "shouldn't have to agree with the Administration policy in order to do the work of saving lives." Esther Kaplan, *Just Say Não*, THE NATION, May 30, 2005, available at <http://www.thenation.com/doc/20050530/kaplan>. A logical response to such a statement is that the organizations do not need to agree with the Administration in order to *do* their work. Rather, according to the statute, they must agree with the Administration in order to *receive funding* from the United States to do their work. 117 Stat. 711, 734. Therefore, this has been a crucial issue for organizations that rely on the United States to fund their HIV/AIDS programs.

56. See *supra* note 50.

57. AOSI's Drug Demand Reduction Program in Uzbekistan, Tajikistan, and Kyrgyzstan involves working with sex workers and Pathfinder's work in India includes organizing sex workers to agree to engage in HIV/AIDS prevention methods. Alliance for Open Society Int'l, 430 F.Supp. 2d at 230.

58. *Id.* at 238-39.

“thoughtful policy debate on the appropriate legal regime for prostitution.”<sup>59</sup> DKT has stated that it does not have a policy “either opposing or supporting prostitution” and it will not adopt a policy that states an opposition to prostitution.<sup>60</sup> DKT believes that such a policy would hinder the progress of their condom distribution work by “stigmatizing and alienating many of the people vulnerable to HIV/AIDS—the sex workers.”<sup>61</sup>

In *Alliance for Open Society*, the District Court for the Southern District of New York held that “the Government’s viewpoint based restriction is . . . offensive to the First Amendment as it improperly compels speech by affirmatively requiring Plaintiffs to adopt a policy espousing the government’s preferred message.”<sup>62</sup> Similarly, in *DKT International*, the District Court for the District of Columbia concluded that the second part of the Act’s funding eligibility requirement is an unconstitutional violation of the First Amendment because it constitutes a viewpoint based restriction on freedom of speech and is not narrowly tailored to further a compelling government interest.<sup>63</sup> The Second Circuit Court of Appeals is currently reviewing the *Alliance for Open Society* case, while a three-judge panel of the District of Columbia Circuit Court of Appeals recently reversed the District Court’s *DKT International* decision.<sup>64</sup>

However, reports have already shown that this restriction in the U.S. Leadership Act and other similar “legislative actions have resulted in reduced distributions of condoms and other contraceptive supplies, lessened spending on programs to prevent HIV/AIDS transmission, heightened allocations of AIDS relief funding to faith based organizations that traditionally support abstinence-only means of HIV/AIDS prevention and protection, and eliminated funding to international family planning programs that provide legal abortions or abortion counseling in addition

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59. *Id.* at 239.

60. DKT Int’l, 435 F.Supp. 2d at 12.

61. *Id.*

62. *Alliance for Open Society Int’l*, 430 F.Supp. 2d at 274.

63. DKT Int’l, 435 F.Supp. 2d at 35.

64. *Alliance for Open Society Int’l v. U.S. Agency for Int’l Dev.*, No. 06-4035-cv (2d Cir. filed Aug. 2006); *DKT Int’l v. U.S. Agency for Int’l Dev.*, 477 F.3d 758 (D.C. Cir. 2007). In reversing the district court’s decision, the District of Columbia Court of Appeals panel held that “[t]he Act does not compel DKT to advocate the government’s position on prostitution and sex trafficking; it requires only that if DKT wishes to receive funds it must communicate the message the government chooses to fund.” *DKT Int’l*, 477 F.3d at 764. The three-judge panel of the appellate court found that this does not violate the First Amendment and therefore reversed the district court, however DKT may *Seek en banc* review. *Id.*; OMB Watch, <http://www.ombwatch.org/articleview/3758/> (last visited Apr. 15, 2007).

to HIV/AIDS prevention programs.”<sup>65</sup> This kind of exclusive legislation limits the participation of certain communities in the United States’ fight against HIV/AIDS and “can also have the domino effect of provoking otherwise unaffected actors to ‘opt out’ of engagement.”<sup>66</sup> The extremely strong stance of the United States against sex work, and its effort “to export its perspective abroad,” forces other actors to essentially “pick sides,” and privileges those who agree while completely excluding those who do not.<sup>67</sup> This divisive policy-making is counterproductive and serves as an injustice to potentially life-saving work by “severely undermin[ing] the transnational interactive process.”<sup>68</sup>

### *C. Exclusive Abstinence and Morally-Based Distinctions*

An additional problem with the U.S. Leadership Act is encompassed within its policy goals regarding educational programs.<sup>69</sup> The Act states that the priority of any program’s prevention efforts must be the reduction of high-risk behaviors, which should be accomplished by “promoting abstinence from sexual activity and substance abuse, encouraging monogamy and faithfulness, promoting the effective use of condoms, and eradicating prostitution, the sex trade, rape, sexual assault and sexual exploitation of women and children.”<sup>70</sup> While some of these policy goals may be valid, they also present a problem with their narrow focus on the encouragement of abstinence from certain activities rather than a more broad and inclusive expansion of knowledge and increase in overall awareness.<sup>71</sup>

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65. Nina J. Crimm, *Toward Facilitating a Voice for Politically Marginalized Minorities and Enhancing Presidential Public Accountability and Transparency in Foreign Health Policymaking*, 39 VAND. J. TRANSNAT’L L. 1053, 1077 (2006).

66. Janie Chuang, *The United States as Global Sheriff: Using Unilateral Sanctions to Combat Human Trafficking*, 27 MICH. J. INT’L L. 437, 491-92 (2006) (evaluating these legislative restrictions within the context of anti-trafficking efforts).

67. *Id.* at 492.

68. *Id.*

69. 117 Stat. 711, 718.

70. *Id.*

71. This is one of the problems that the Human Rights Caucus raised at the United Nations High-Level Meeting on AIDS. Statement by the Human Rights Caucus at the High Level Meeting on HIV and AIDS, New York (2 June 2006), available at [http://www.reproductiverights.org/pdf/ww\\_HUMAN.RIGHTS.CAUCUS.HIVAIDS.pdf](http://www.reproductiverights.org/pdf/ww_HUMAN.RIGHTS.CAUCUS.HIVAIDS.pdf). Simply telling people to abstain from high-risk activity without teaching them about what the risks are and how to best avoid them if they do choose to participate in such activities is neither effective nor appropriate. A human rights-based approach involves the affected communities in their own prevention and treatment. *Id.* Individuals have the right to make their own choices about their behavior and empowering them with the information necessary to ensure that those choices are informed decisions is more respectful and effi-

This trend exists throughout the U.S. Leadership Act and it appears again in the Bilateral Efforts section, where the Act states that efforts to prevent the transmission of HIV/AIDS shall not focus on providing comprehensive information about reducing one's risk or raising awareness generally about safer methods of sexual activity or drug use.<sup>72</sup> Instead, the Act dictates that prevention efforts shall have the "exclusive purpose" of encouraging individuals to avoid behavior that places them at risk of HIV infection by using methods such as "delaying sexual debut, abstinence, fidelity and monogamy, reduction of casual sexual partnering, reducing sexual violence and coercion, including child marriage, widow inheritance, and polygamy, and where appropriate, use of condoms."<sup>73</sup>

This section begins to reflect the tone of moral judgment that permeates through the entire Act.<sup>74</sup> There is a heavy emphasis on avoiding activities deemed to be "wrong" without much discussion of comprehensive education about safer ways to take part in these activities or lower risk alternatives.<sup>75</sup> There is a clear distinction between victims of HIV/AIDS that the U.S. government perceives to be innocent and those who essentially are perceived to have brought it on themselves.<sup>76</sup> The U.S. Leadership Act gives great prominence to the more universally-acceptable types of victims, such as women who contract HIV unknowingly from unfaithful spouses and children who contract it from their mothers, while implying that other individuals with HIV or AIDS, such as sex workers, drug users, individuals with early sexual debut, or indi-

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cient than trying to dictate what appropriate behavior is or should be. The Human Rights Caucus "consists of individuals from the following organizations and institutions: Action Aid International, Amnesty International, Human Rights Watch, Center for Women's Global Leadership, Center for Reproductive Rights, Human Rights Program/Harvard Law School, Program on International Health and Human Rights/Harvard School of Public Health, Arc International, International Women's Health Coalition." *Id.*

72. *See* 117 Stat. 711, 729.

73. *Id.*

74. *See Id.*

75. *See Id.* For example, this section encourages programs to promote the delay of sexual debut, thereby implying that having sex at a young age is inappropriate behavior. *See Id.* The Act never discusses the promotion of comprehensive education for young people to allow them to make their own decisions about sex. *See* 117 Stat. 711. This section also encourages the reduction of casual sexual partnering, which implies that sex outside of a serious relationship, such as marriage, is also inappropriate. *See Id.* at 729. The Act never mentions the promotion of, or education about, various safer sex methods or practices in the general population to help ensure that people who have sex outside of serious relationships will do so safely. *See Id.* Rather, it continually emphasizes abstinence and monogamy as the tools that people should use to prevent HIV/AIDS. *See* 117 Stat. 711.

76. *See Id.* at 729.

viduals who have sex outside of serious relationships, are irresponsible risk-takers who deserve less support.<sup>77</sup> This approach runs contrary to what many public health organizations recommend as best practices<sup>78</sup> and it raises the question of whether this is a valid distinction for the United States to make in allocating resources.<sup>79</sup>

#### IV. SUCCESS IN BRAZIL

The narrow focus of the U.S. Leadership Act becomes more apparent after comparing it to the strategy of Brazil, which takes a very different approach to HIV/AIDS prevention and treatment. First, Brazil views sex work and those who take part in it very differently than the United States, as evidenced by the fact that sex work is legal in Brazil while it is not legal in the United States.<sup>80</sup> Brazil is not only unwilling to oppose sex work generally, but its programs also incorporate sex workers into their own policy development and implementation.<sup>81</sup> Brazil's AIDS Commissioner, Pedro Chequer, even stated that sex workers "are our partners" and his commission could not ask them to "take a position against themselves."<sup>82</sup>

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77. *See Id.* The Act includes a substantial discussion regarding "Assistance to Children and Families." *Id.* at 740–43. At the same time, the Congressional findings include the assertion that "prostitution and sex trafficking are 'causes and factors in the spread of the HIV/AIDS epidemic.'" Alliance for Open Society Int'l, 430 F.Supp. 2d at 232, citing 711 Stat. 716.

78. A recent report of the World Health Organization recommended that "policymaking should be directed at laws that protect the human rights of HIV-infected people, regardless of their behavior (such as drug use) or place of origin, so that acceptance, care and support increase for people and families affected by HIV." WHO Reg'l Office for Europe, *supra* note 17, at 20.

79. This distinction becomes increasingly important to analyze as more members of Congress present plans to further restrict how United States funding may be used. It has been reported that "Representative Henry Hyde is seeking to withdraw funds from groups that object to pushing abstinence, while Representative Mark Souder is leading a campaign to match the anti-prostitution pledge with one condemning needle exchange." Kaplan, *supra* note 55.

80. *See* David Salyer, *President Bush's War on...Prostitution?*, SURVIVAL NEWS, July/August 2005, available at <http://www.thebody.com/content/art32399.html>.

81. Kaplan, *supra* note 55.

82. *Id.*; Alliance for Open Society Int'l, 430 F.Supp. 2d at 232. Statements such as these show a much more respectful approach to HIV/AIDS prevention and support. The Brazilian AIDS Commission has recognized that sex workers do not deserve to be marginalized or stigmatized by inherently discriminatory policies. *Id.* The Brazilian AIDS Commission has also implemented many human rights-based practices and forged a productive working relationship with sex workers in order to work towards what is clearly a mutual goal—the reduction of HIV/AIDS infection in the population as a whole. *Id.*

Brazil also places a greater value than the United States on comprehensive forms of sex education.<sup>83</sup> After Brazil insisted that USAID negotiate directly with the Brazilian AIDS Commission, rather than the individual Brazilian non-governmental organizations (NGOs), the AIDS Commission, under Chequer's leadership, persuaded USAID to remove much of its emphasis on abstinence from the proposed grant agreement.<sup>84</sup>

As a result, in May of 2005, Chequer made a strong statement against the restrictive ways in which the United States distributes funding to aid programs engaged in the fight against HIV/AIDS.<sup>85</sup> When faced with a choice between signing a statement opposing sex work and turning down forty million dollars of funding for AIDS work from the United States, Chequer chose what he felt was the only ethically responsible and non-discriminatory option.<sup>86</sup> He decided not to accept any funding from the United States and explained that the goal of his commission is to "reach every segment of society, with no discrimination."<sup>87</sup> The Brazilian strategy in the fight against HIV/AIDS places great value on the importance of human rights and Chequer was unwilling to sacrifice these rights in order to comply with the irresponsible policies of the United States.<sup>88</sup>

The Brazilian AIDS commission, which is comprised of seven seats filled by different government ministries, supported Chequer's decision and voted unanimously to find alternative sources of funding for the country's vital AIDS programs, which have proven quite successful in the past decade.<sup>89</sup> Experts had predicted in the early nineties that Brazil would see 1.2 million HIV infections by the year 2000.<sup>90</sup> However, the country's effective programs, which include HIV/AIDS treatment, large-scale condom distribution, and detailed HIV/AIDS education, have halted the progress of HIV/AIDS and resulted in half as many infections as were expected.<sup>91</sup> The HIV/AIDS prevention and treatment pro-

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83. Kaplan, *supra* note 55.

84. *Id.*

85. *Id.*

86. *Id.*

87. *Id.*

88. See Michael M. Phillips & Matt Moffett, *Brazil refuses U.S. AIDS funds, rejects conditions*, WALL STREET JOURNAL, May 2, 2005, at A3.

89. Kaplan, *supra* note 55.

90. *Id.*

91. *Id.* See Monte Reel, *Where Prostitutes Also Fight AIDS: Brazil's Sex Workers Hand Out Condoms, Crossing U.S. Ideological Line*, WASHINGTON POST, Mar. 2, 2006, at A14, available at [http://www.washingtonpost.com/wp-dyn/content/article/2006/03/01/AR2006030102316\\_pf.html](http://www.washingtonpost.com/wp-dyn/content/article/2006/03/01/AR2006030102316_pf.html). Brazil's progress in HIV/AIDS work over the past two decades has been one of the few success stories in the developing world. Kaplan, *supra* note 55. During a time period when many other nations

grams in Brazil “are considered by the United Nations to be the most successful in the developing world.”<sup>92</sup>

#### V. ALTERNATIVE STRATEGIES FOR THE FUTURE

These successful prevention efforts prove that leaders can make a difference and effect positive change even in the context of a grave crisis such as HIV/AIDS. Leaders in this fight must be realistic in their analysis of various prevention approaches because the global struggle with HIV/AIDS is a very personal issue. The commitments that nations make must realize the realities of people’s lives and how these plans will affect the individuals who are an integral part of any successful strategy. Incorporating human rights-based approaches will help develop realistic policies and progressive strategies, supported by social science research. These types of HIV/AIDS prevention strategies include two vital components, the use of comprehensive sex education and the legalization, and therefore involvement and regulation, of the sex work industry, which incorporate proven effectiveness and the importance of human rights.

##### *A. Comprehensive Sex Education*

Comprehensive forms of sex education have been continuously proven to serve as effective and realistic means of helping to prevent the transmission of sexually transmitted diseases, such as HIV/AIDS.<sup>93</sup> The World Health Organization conducted a study in 1993 and, by reviewing the evaluations of thirty-five sex education programs, it found that the most effective programs in reducing sexual risk-taking were comprehensive programs that include information about abstinence, contraception, and the prevention of sexually transmitted disease.<sup>94</sup> Implementing comprehensive forms of education about sexuality, which include teaching methods of safer sex practices, is a realistic aspect of HIV/AIDS prevention policy because it provides individuals with the information necessary to make informed decisions about their sexual lives.<sup>95</sup>

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were allowing, unintentionally or not, HIV and AIDS to spiral out of control, Brazil was actually bringing it under control. *Id.*

92. Reel, *supra* note 91.

93. Starkman & Rajani, *supra* note 46.

94. *Id.* at 314–15.

95. *Young people and HIV/AIDS*, *supra* note 12, at ¶¶ 19–20. The paper also states that “young people who know about the risks of HIV, who have been able to develop the skills to act upon that knowledge and who have access to the services that meet their needs can become an important resource in slowing the continuing spread of HIV.” *Id.* at ¶ 6.

The U.S. Leadership Act's emphasis on abstinence education represents the misguided notion of the United States, and especially the current administration, about how best to prevent the spread of sexually transmitted disease.<sup>96</sup> Relying on abstinence education is essentially ignoring the realities of the world in which we live, where people experiment with sexual activities, even if they are encouraged to do otherwise.<sup>97</sup> Without the appropriate knowledge to make informed decisions about sexual issues, those who are sexually active become extremely vulnerable to a variety of negative consequences, including HIV infection.<sup>98</sup> Teaching people simply to abstain from sex outside of marriage or other serious and/or monogamous relationships is not an adequate way to help them avoid high-risk behavior and has not been proven effective.<sup>99</sup>

In countries where programs have been implemented that work with young people to help them reduce the risks involved in their sexual behavior, positive trends have been reported.<sup>100</sup> In Thailand, young men who visited sex workers reported much higher levels of condom use in 1995 than in 1991: ninety-three percent and sixty-one percent, respectively.<sup>101</sup> These men had "half as many STD infections and a third fewer HIV infections than had been recorded among [a similar age group] four years earlier."<sup>102</sup> In Senegal, approximately forty percent of women and sixty-six percent of men under twenty-five reported using condoms with non-regular partners in 1997, while less than five percent had reportedly done so earlier in the decade.<sup>103</sup>

Policymakers are often hesitant to raise issues such as comprehensive sex education for many reasons, including the general lack of public discussion about safer sex and the common misunderstandings about what

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96. See Debra Hauser, *Five Years of Abstinence-Only-Until-Marriage Education: Assessing the Impact*, available at <http://www.advocatesforyouth.org/publications/stateevaluations.pdf>.

97. Starkman & Rajani, *supra* note 46, at 313.

98. *Young people and HIV/AIDS*, *supra* note 12, at ¶ 9.

99. *Id.* at ¶ 20.

100. *Id.* at ¶ 4.

101. *Id.* Private companies became involved in increasing condom accessibility and social marketing in the mid-1990's in Thailand, and, as a result, use of condoms doubled among young people. *Id.* at ¶ 13. In 1997, a national survey recorded that eighty-seven percent of men in their early twenties in Thailand reported using a condom every time they visited a brothel sex worker. *Id.*

102. *Id.* at ¶ 5.

103. *Id.* at ¶ 4.

effective sex education entails.<sup>104</sup> Certain people feel that raising the topic of sex in any way, even in the context of safer sex and pregnancy or disease prevention, will lead to an increase in sex among young people or a decrease in the age of sexual debut, which will automatically lead to an increase in negative sexual consequences.<sup>105</sup> However, many studies have shown that comprehensive sexual health programs do not encourage additional sexual experimentation.<sup>106</sup> On the contrary, these programs help people to make their own informed decisions and can help to delay sexual debut as well as decrease the rates of STD infections among those young people who are already sexually active.<sup>107</sup>

Comprehensive forms of sexual health education are not only proven to be an effective and realistic way to help prevent the spread of HIV/AIDS, but they align with many international human rights standards. The Universal Declaration of Human Rights, which the General Assembly of the United Nations adopted in 1948, states that all people have the right to education, which “shall be directed to the full development of the human personality and to the strengthening of respect for human rights and fundamental freedoms.”<sup>108</sup> The Covenant on Economic, Social, and Cultural Rights, adopted by the United Nations General Assembly in 1966, elaborates on this right by including that a person’s education must enable them to “participate effectively in a free society [and] promote understanding. . . .”<sup>109</sup> Individuals also have the right to “life, liberty and the security of person.”<sup>110</sup> In addition, all people are entitled to realize the social and cultural rights “indispensable for his dignity and the free development of his personality.”<sup>111</sup> These rights all contribute to the duty to provide adequate education about sexual health

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104. *Id.* at ¶¶ 14, 19. In addition to a general lack of public discourse about sex, “policy makers, leaders, and parents are often reluctant to admit that large numbers of young people have sex” at all. *Id.* at ¶ 21.

105. *Id.* at ¶ 19.

106. *Id.*

107. *Id.* “Youth programmes in many countries have begun to focus on personal capacity building to assess personal risk, decision making and negotiations skills. When the full range of safer options is provided, young people tend to choose the one most suitable to them according to the stage in their lives. An interesting formula has been devised in Tanzania and other parts of Africa, where ‘Fidelity’, ‘Abstinence’ and ‘Condoms’ are pictured as three life boats – the message being that people may switch from one to another according to their life circumstances, as long as they are safely in one boat.” *Id.* at ¶ 20.

108. Universal Declaration of Human Rights, G.A. Res. 217A (III), at 71, U.N. Doc A/810, Art. 26, (Dec. 10, 1948).

109. Covenant on Economic, Social, and Cultural Rights, *supra* note 10, at Art. 13.

110. Universal Declaration of Human Rights, *supra* note 108, at Art. 3.

111. *Id.* at Art. 22.

and safer sex practices.<sup>112</sup> Individuals have the right to a full education that enables them to freely and safely make decisions about their own lives in order to fulfill their desired development, and Members of the United Nations have a duty to work towards this goal together.<sup>113</sup>

### *B. Legalization of Sex Work*

Sex work is currently completely legal in a number of nations and other jurisdictions.<sup>114</sup> There are also nations where sex work itself is legal, however certain activities that relate or contribute to sex work are illegal and advocates are working towards complete legalization.<sup>115</sup> Studies in certain legalized nations and jurisdictions have shown that HIV/AIDS rates within populations of sex workers and their clients are low in comparison to nations and jurisdictions where sex work is prohibited.<sup>116</sup> In the Netherlands, for example, where sex work is legal and regulated, “non-IV-drug-using female sex workers and their male clients were found to have an extremely low incidence of HIV.”<sup>117</sup> Other nations where sex work is legal have been able to keep the spread of HIV/AIDS to a much lower threshold than would be expected. Brazil, for example, has had half as many HIV/AIDS infections over the last fifteen years as

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112. States may subject these rights to limitation, but only if the limitation will further the “general welfare [of the population] in a democratic society.” Covenant on Economic, Social, and Cultural Rights, *supra* note 10, at Art. 4.

113. Universal Declaration of Human Rights, *supra* note 108.

114. For example, sex work is legal in Germany and the Netherlands and it was legalized in New Zealand in June 2003 with the passage of the New Zealand Prostitution Reform Act 2003. See TAVERNER *supra* note 54, at 245; Working Group on the legal regulation of the purchase of sexual services, *Purchasing Sexual Services in Sweden and the Netherlands: Legal Regulation and Experiences*, 25-6 (Oct. 8, 2004). See also Prostitution Reform Act 2003, 2003 S.N.Z. No. 28, available at <http://rangi.knowledgebasket.co.nz/gpacts/public/text/2003/an/028.html>.

115. Canadian HIV/AIDS Legal Network, *supra* note 114, at 3, 19. Also, advocates in Canada are lobbying for the repeal of the different sections of the Canadian Criminal Code that criminalize activities related to sex work. Canadian HIV/AIDS Legal Network, *Sex, work, rights: Changing Canada's criminal laws to protect sex workers' health and human rights*, 18 (2005). According to the Canadian Criminal Code, the act of “exchanging sex for money and other things of value” is legal, however almost everything related to this act is illegal, which makes it very difficult to be a sex worker and not break the law. *Id.* at 3. Illegal acts include running a brothel, taking or directing a person to a brothel, procuring a sex worker, and communicating for the purposes of sex work. *Id.*

116. Luis Scaccabarozzi, *Sex Workers and HIV*, 15 ACRIA Update 1 (Winter 2005/06), available at [http://www.acria.org/treatment/treatment\\_edu\\_winterupdate2005\\_2006\\_workers.html](http://www.acria.org/treatment/treatment_edu_winterupdate2005_2006_workers.html).

117. *Id.*

experts originally expected.<sup>118</sup> Additionally, a study that compared brothel workers in the areas of Nevada where brothels are legal to sex workers who had been arrested in those areas in the state where sex work is completely prohibited found that none of the legal workers had HIV/AIDS, while six percent of the illegal workers did.<sup>119</sup>

Additionally, there are many jurisdictions where sex work is technically illegal, however regulations or programs have been implemented, recognizing that sex work occurs, that have helped to prevent the spread of HIV/AIDS among sex workers and clients. In Vienna, for example, sex workers are registered and consistently tested for various sexually transmitted diseases, including HIV/AIDS.<sup>120</sup> Studies have shown that HIV/AIDS prevalence rates in communities of sex workers in Vienna are comparable to the population as a whole, which, in Europe, is generally low.<sup>121</sup> Another good example of effective government regulation of sex work is Thailand.<sup>122</sup> The Thai government began working with the owners of brothels in the early nineties to enforce a policy of 100% condom use.<sup>123</sup> The government provided free condoms to the owners of these brothels who, in turn, instructed the sex workers to insist that they be used with clients.<sup>124</sup> The government enforced this policy by closing any brothels that allowed unprotected sex.<sup>125</sup> The results were very impressive with the use of condoms in brothels increasing from fourteen percent in 1989 to over ninety percent by 1994.<sup>126</sup> This time period also saw a large decrease in the number of new cases of sexually transmitted infections treated at government clinics as well as decreases in HIV/AIDS infection rates in certain populations.<sup>127</sup>

This raises questions about the effectiveness of the U.S. Leadership Act's funding eligibility requirements.<sup>128</sup> The district courts in *Alliance for Open Society* and *DKT* both held that the U.S. Leadership Act's provision that limits funding to groups or organizations that "have a policy

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118. Kaplan, *supra* note 55.

119. James Bovard, *Safeguard Public Health: Legalize Contractual Sex*, in *TAKING SIDES: CLASHING VIEWS ON CONTROVERSIAL ISSUES IN HUMAN SEXUALITY* 246, 249 (8th Ed. McGraw-Hill/Dushkin 2002).

120. *See* Scaccabarozzi, *supra* note 116.

121. *Id.*

122. *Id.*

123. *Id.*

124. *Id.*

125. *Id.*

126. *Id.*

127. *Id.*

128. *Alliance for Open Society Int'l*, 430 F.Supp. 2d 222; *DKT Int'l*, 435 F.Supp. 2d 5.

explicitly opposing prostitution”<sup>129</sup> is unconstitutional,<sup>130</sup> and it also may be extremely impractical.<sup>131</sup> The success in the fight against HIV/AIDS in nations where sex work is legal suggests that a more realistic form of social policy advancement is advocating for the legalization of all sex work worldwide, rather than against it.<sup>132</sup>

The U.S. Leadership Act specifically prohibits using funds made available through the Act “to promote or advocate the legalization or practice of prostitution.”<sup>133</sup> However, ignoring the fact that people will engage in sex work, both as sex workers and clients, even if they are encouraged not to, is very similar to ignoring the realities of sexual activity in general.<sup>134</sup> Various people are going to engage in various sexual practices, whether they are legal or not.<sup>135</sup> Even if an individual or organization does not feel it is appropriate to *encourage* a certain type of behavior, an appropriate public health goal would be to maximize the possibility that this sexual behavior is undertaken in as safe a manner as possible. In order to realistically work to help prevent the spread of sexually transmitted diseases, policymakers must face the reality of the world in which they live, and draft appropriate social policy for that world, rather than trying to change the behavior of others.<sup>136</sup>

Legalizing sex work would allow public health agencies to better regulate conditions in the sex industry and could lead to increased levels of

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129. 117 Stat. 711, 734; 22 U.S.C. §7631(f).

130. Alliance for Open Society Int’l, 430 F.Supp. 2d at 274; DKT Int’l, 435 F.Supp. 2d at 35.

131. See Chuang, *supra* note 66, at 491-92.

132. The term “sex work” has a fairly broad meaning, including commercial sex, stripping, phone sex lines, and pornography. These activities carry various legal statuses in different countries throughout the world. In this note, a reference to the “legalization of sex work” means legalizing all consensual forms of sex work that are currently illegal in a country.

133. 117 Stat. 711, 733-34.

134. Bovard, *supra* note 119, at 249.

135. See Scaccabarozzi, *supra* note 116. This researcher found that “[t]here is little evidence that prohibitive legislation affects the amount of commercial sex available.” *Id.* Moreover, others have found that “[c]ommercial sex never can and never should be abolished.” W. Kopp & S. Mayerhofer, *Commercial sex – past and present*, 12 Acta Dermatoven APA 47, 50 (2003).

136. According to a recent report on the legal regulation of sex work in Sweden and the Netherlands, the Dutch government believes that legislation against any aspect of sex work will not eradicate the practice because sex work “is part of life and will always be so.” Working Group on the legal regulation of the purchase of sexual services, *supra* note 114, at 27. It also believes that political leaders are responsible for protecting sex workers from exploitation and abuse in order to ensure that individuals may become employed as sex workers if that is what they want to do. *Id.*

protection and decreased levels of transmission of sexually transmitted diseases.<sup>137</sup> This goal can be accomplished by removing criminal sanctions on the sex work itself and placing specific sanctions on individuals who do not promote safety in the sex work industry. New Zealand, for example, passed the Prostitution Reform Act in 2003 for the purpose of decriminalizing sex work, promoting the human rights and social and economic welfare of sex workers, and enhancing public health.<sup>138</sup> This law placed certain restrictions on the operators of “businesses of prostitution,” sex workers, and clients.<sup>139</sup> These parties are required to “take all reasonable steps to ensure that no commercial sexual services” are undertaken without utilizing appropriate safer sex methods.<sup>140</sup> Operators are also required to “take all reasonable steps to give health information (whether oral or written) to sex workers and clients.”<sup>141</sup> The sanctions for violating these parts of the law are fines up to ten thousand dollars for operators and fines up to two thousand dollars for sex workers and clients.<sup>142</sup> As a result, the HIV/AIDS prevalence rates in New Zealand are extremely low, even when compared to other industrialized nations.<sup>143</sup>

Improving regulation of the sex work industry, although potentially very effective and important, is not the only factor with which governments should be concerned. Legalizing sex work could also help to remove much of the stigma that currently surrounds the industry.<sup>144</sup> This could lead to improvements in HIV/AIDS prevention and treatment because it would help bring sex work out from the underground industry that it generally is today.<sup>145</sup>

It is important to note that sex work is very different than human sex trafficking. The U.S. Leadership Act combines these two issues in both

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137. Bovard, *supra* note 119, at 248.

138. Prostitution Reform Act 2003, 2003 S.N.Z. No. 28, § 3 (a-c).

139. *Id.* at § 8–9.

140. *Id.* at § 8(1)(a).

141. *Id.* at § 8(1)(b). Health information includes “information on safer sex practices and on services for the prevention and treatment of sexually transmitted infections.” *Id.*

142. *Id.* at § 8(2), § 9(4).

143. According to UNAIDS statistics, the HIV/AIDS prevalence rate for adults aged fifteen to forty-nine in New Zealand is 0.1%, while these rates in the United States and Spain are 0.6%, and the rates in France and Italy are 0.4% and 0.5%, respectively. See UNAIDS Country Data, [http://www.unaids.org/en/Regions\\_Countries/Countries/default.asp](http://www.unaids.org/en/Regions_Countries/Countries/default.asp) (last visited Apr. 15, 2007).

144. Canadian HIV/AIDS Legal Network, *supra* note 114, at 14, 18.

145. *Id.* at 18. Alliance for Open Society Int'l, 430 F.Supp. 2d at 232. (“Stigma and discrimination push people in high risk groups...underground, making them difficult to reach through prevention and thus creating more opportunities for HIV/AIDS to spread to the general population.”)

parts of its funding eligibility requirement,<sup>146</sup> however sex work and sex trafficking are not the same activity. Sex work is a mutually consensual activity while trafficking is an exploitative and non-consensual activity. Trafficking is essentially involuntary sex work. Some people may believe that both sex work and sex trafficking are wrong, however legalizing sex work is not the same as allowing, or even just condoning, sex trafficking.

Legalizing sex work and involving sex workers in the regulation of their industry is a human rights issue. According to the International Covenant on Economic, Social and Cultural Rights, individuals have the right to self-determination, which includes the right to “freely pursue their economic, social and cultural development.”<sup>147</sup> The Universal Declaration of Human Rights states that all people have the “right to work, to free choice of employment, to just and favourable conditions of work and to protection against unemployment.”<sup>148</sup> All people have a right to choose how they earn a living, and, as long as this choice is made free from coercion, governments should protect each person’s individual decision as long as it does no harm to other people.

The Human Rights Caucus at the High Level Meeting on AIDS of the United Nations released a statement outlining the aspects of a human rights-based approach to HIV/AIDS prevention, treatment, and care for the future.<sup>149</sup> This statement notes that human rights abuses occur in nations all over the world in the context of the HIV/AIDS pandemic and policymakers need to recognize this fact in order to effectively work towards a solution.<sup>150</sup> According to the Human Rights Caucus, human rights-based approaches “require ensuring the participation of affected communities, non-discrimination in program delivery, attention to the

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146. The first limitation states that no funding from the Act may be used “to promote or advocate the legalization or practice of prostitution or sex trafficking.” 117 Stat. 711, 733–34. The second limitation adds that the funding also may not be used “to provide assistance to any group or organization that does not have a policy explicitly opposing prostitution and sex trafficking.” *Id.*

147. Covenant on Economic, Social and Cultural Rights, *supra* note 10, at Art. 1.

148. Universal Declaration of Human Rights, *supra* note 108, at Art. 23. The Covenant on Economic, Social and Cultural Rights also states that everyone has a right “to gain his living by work which he freely chooses or accepts[.]” Covenant on Economic, Social and Cultural Rights, *supra* note 10, at Art. 6.

149. Human Rights Caucus, *supra* note 71.

150. Human rights abuses that are mentioned in this statement include “acts perpetrated and/or tolerated by governments such as restrictions of movement, gender-based violence, discrimination, police harassment, threats to privacy and freedom of assembly.” They also include denial of care, treatment, education, and access to basic health and social services. Human Rights Caucus, *supra* note 71.

legal and policy environment in which interventions take place, and accountability for what is done, and how it is done.”<sup>151</sup> The statement recommends comprehensive strategies that heavily emphasize human rights principles.<sup>152</sup>

First, members of the affected communities must be involved in the creation of policy and the implementation of programs.<sup>153</sup> This means, among many things, that people living with HIV/AIDS should be involved in decisions about treatment and care, and people in high risk populations, including sex workers, should be involved in decisions about prevention.<sup>154</sup> Second, prevention and treatment efforts should be implemented with equal access for all.<sup>155</sup> This requires the elimination of stigmas attached to certain communities, such as sex workers, in order to allow efficient and effective resource distribution. Lastly, policymakers must pay attention to the legal and political environment in which programs are being implemented.<sup>156</sup> This includes considering the human rights implications of policies, including the legal status of sex work.

If necessary, governments may restrict internationally recognized human rights, but “solely for the purpose of promoting the general welfare in a democratic society.”<sup>157</sup> Sex work does little to no harm to the welfare of the general public or society as a whole. In any event, sex work is a part of society and legislating against it does nothing but make the industry more dangerous for those involved.<sup>158</sup> Even though the criminalization of sex work may be furthering legitimate policy goals, the policies are overbroad and may be accomplished in ways that cause less damage.<sup>159</sup> Legalizing sex work promotes the human rights of sex workers and their clients by enabling better regulation of the industry, which results in more effective disease prevention.

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151. *Id.*

152. These human rights principles include “specific, measurable and time-bound targets,” as well as an emphasis on “universal access to treatment, prevention, care and support” and “protection and empowerment of vulnerable groups[,] harm reduction and substitution therapy[,] sexual and reproductive health and rights[,] and] comprehensive, evidence-based sexuality education.” *Id.*

153. *Id.*; Alliance for Open Society Int’l, 430 F.Supp. 2d at 232.

154. Alliance for Open Society Int’l, 430 F.Supp. 2d at 232. (“Involving individuals from the particular target community – sex workers, for example – in delivering the message gives credibility, reduces fear and stigma, and makes it more likely that people hearing the message will follow through with specific behaviors.”)

155. Human Rights Caucus, *supra* note 71.

156. *Id.*

157. Covenant on Economic, Social and Cultural Rights, *supra* note 10, at Art. 4.

158. Canadian HIV/AIDS Legal Network, *supra* note 114, at 16.

159. *Id.*

The legalization of sex work has been recognized as good policy and “[s]everal international guidelines about HIV/AIDS and human rights recommend that criminal laws that increase the health and safety risks (including the risk of HIV infection) of sex workers should be repealed.”<sup>160</sup> Therefore, Congress should remove both funding eligibility requirements regarding sex work from the U.S. Leadership Act, and consider encouraging the legalization of sex work in order to involve sex workers in the fight against HIV/AIDS and to better regulate the industry.

#### VI. CONCLUSION

Ensuring that all people may completely exercise their internationally recognized human rights without restriction is an obligation that national governments must take very seriously. These rights, which include the right to physical and mental health, prevention of disease, adequate education, and personal liberty, are essential to “promote social progress and better standards of life.”<sup>161</sup> Therefore, national governments and other state actors must take responsibility for protecting its citizens from HIV/AIDS by implementing effective and realistic prevention programs and ensuring equality in access to treatment, care, and support.<sup>162</sup>

The United States is one of the most powerful nations in the world. It is in a prime position to effect extremely positive change in the lives of individuals struggling with HIV/AIDS and to make great strides in helping countries all over the world to fight this global pandemic. However, the current U.S. Leadership Act will not bring the United States to the position of leadership for which it was created. Policymakers, in the United States and worldwide, must focus on progressive and effective approaches to prevention, treatment, and support in order to create the changes we need to reverse the grave trend of HIV/AIDS. The United States can be an effective leader in this sense by creating policy that reflects the reality of the HIV/AIDS pandemic and the communities who most need aid.

To this end, policymakers worldwide must ensure that HIV/AIDS prevention programs are based on comprehensive sexual health education strategies. They must also work toward the legalization of sex work to allow members of the sex work industry to fully participate in the fight

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160. *Id.* at 17.

161. Universal Declaration of Human Rights, *supra* note 108, at Preamble, Art. 26; International Covenant on Economic, Social, and Cultural Rights, *supra* note 10, at Art. 12, 13.

162. *Young People and HIV/AIDS*, *supra* note 12, at 55.

against HIV/AIDS. These strategies are sound policy decisions, not only because of their proven effectiveness, but also because they maximize the realization of the human rights of those who are involved and affected.

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# NONREFOULEMENT UNDER THE CONVENTION AGAINST TORTURE: HOW U.S. ALLOWANCES FOR DIPLOMATIC ASSURANCES CONTRAVENE TREATY OBLIGATIONS AND FEDERAL LAW

*“Freedom from torture is an inalienable human right . . . . These times of increasing terror challenge the world . . . . But we will not compromise the rule of law or the values and principles that make us strong. Torture is wrong no matter where it occurs, and the United States will continue to lead the fight to eliminate it everywhere.”*

-President George W. Bush<sup>1</sup>

## INTRODUCTION

Before the September 11<sup>th</sup> terrorist attacks on the U.S. and the ensuing “war on terror,” the word “torture” still carried the stigma of pre-Enlightenment hysteria, from the Spanish Inquisition to witch hunts in Italy, France, and Germany.<sup>2</sup> The United States, founded on the post-torture, Enlightenment concept of inalienable natural rights, has never been stained with this medieval blood.<sup>3</sup> Yet, today, the United States faces intense criticism, both abroad<sup>4</sup> and at home, for its methods of fighting terrorism.<sup>5</sup> The question of whether preventing terrorist acts justifies torturing suspects to obtain information has become a topic of

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1. President’s Statement on United Nations International Day in Support of Victims of Torture, 2003 WL 21471582 (White House)(June 26, 2005), *also available at* <http://www.state.gov/g/drl/rls/45738.htm#annex2>.

2. See John H. Langbein, *The Legal History of Torture*, in TORTURE: A COLLECTION 93 (Sanford Levinson ed., 2004); RICHARD S. DUNN, THE AGE OF RELIGIOUS WARS (1559-1715) 129, 132—133 (2d ed., 1979) (1970).

3. While America experienced its own witch hunts in Salem, in 1692, New England law followed the Anglo common law judicial system, which, having replaced the ordeal system of proof with the jury trial, did not investigate under torture. See Langbein, *supra* note 2, at 99. *But see* Jerome H. Skolnick, *American Interrogation: From Torture to Trickery*, in TORTURE: A COLLECTION, *supra* note 2, at 105 (asserting that torture *is*, contrary to popular belief, a feature of American heritage, evidenced by lynchings and use of “the third degree” in police interrogation).

4. See “Court Issues European Arrest Warrants for 22 CIA Agents,” *Los Angeles Times*, December 23, 2005; “Europe Fears Linger on US Torture,” *CNN.com*, December 9, 2005, <http://edition.cnn.com/2005/WORLD/europe/12/09/rice.europe.ap> (last visited December 24, 2005).

5. See, e.g., Bob Herbert, “Dangerous Territory,” *New York Times*, December 19, 2005.

enormous public outrage, controversy, and discourse in the United States. Convictions (and photos) of American soldiers torturing detainees at the Abu Ghraib military prison<sup>6</sup> have thrust the American public into a roiling debate over the role of torture and international law in the U.S.'s war on terror.<sup>7</sup> The debate has risen to the level of congressional investigations<sup>8</sup> and legislation,<sup>9</sup> fueled by reports of prisoner abuse at Guantanamo<sup>10</sup> and accounts of secret "extraordinary renditions"<sup>11</sup> to countries

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6. See Seymour Hersh, "The Gray Zone," *The New Yorker*, May 24, 2004; Seymour Hersh, "Torture at Abu Ghraib," *The New Yorker*, May 10, 2004. See also, "Prisoner Abuse Scandal: Full Coverage of the Investigations into the Mistreatment of Detainees by U.S. Soldiers in Iraq and Afghanistan," *Baltimore Sun*, <http://www.baltimoresun.com/news/nationworld/iraq/bal-prisonerabuse,0,382271.storygallery?coll=bal-iraq-storyutil> (last visited April 4, 2007); Edward Alden and Dmitri Sevastopulo, "One Year On, Public Disquiet on Abu Ghraib Reverberates," *Financial Times*, April 27, 2005; "All But One Top Officer Cleared on Abu Ghraib," *International Herald Tribune*, April 25, 2005.

7. See, e.g., *NewsHour with Jim Lehrer: Debating the Efficacy of Torture in Interrogation* (PBS television broadcast Dec. 2, 2005) (transcript available at [http://www.pbs.org/newshour/bb/military/july-dec05/torture\\_12-02.html](http://www.pbs.org/newshour/bb/military/july-dec05/torture_12-02.html)).

8. See, e.g., Committee on Oversight and Government Reform, Chairman Henry A. Waxman, 110<sup>th</sup> Congress, "Investigations, Abu Ghraib Prison Abuses," <http://oversight.house.gov/investigations.asp?Issue=Abu+Ghraib+Prison+Abuses> (last visited April 4, 2007); "Abu Ghraib: Congressional Investigation," SourceWatch, a project for the Center for Media & Democracy, [http://www.sourcewatch.org/index.php?title=Abu\\_Ghraib:\\_Congressional\\_Investigation#Congressional\\_Calls\\_for\\_Action](http://www.sourcewatch.org/index.php?title=Abu_Ghraib:_Congressional_Investigation#Congressional_Calls_for_Action) (last modified June 4, 2005).

9. See Torture Outsourcing Prevention Act, H.R. 952, 109<sup>th</sup> Cong. (2005) ("Markey Bill"), reintroduced, H.R. 1352, 110<sup>th</sup> Cong. (2007); The Convention Against Torture Implementation Act, S. 654, 109<sup>th</sup> Cong. (2005) ("Leahy Bill"). The Leahy Bill would supersede Section 2242 of the Foreign Affairs Reform and Restructuring Act of 1998, Pub.L. No. 105-277, §2242, 112 Stat. 2681-761, 2681-822 (codified at 8 U.S.C. §1231)[hereinafter *FARRA*] and make written or verbal diplomatic assurances against torture, *infra* notes 22 and 23, insufficient to relieve the prohibition against returning a person to a place where there are substantial grounds to believe that he will be tortured. The Markey Bill would amend, not supersede, Section 2242 of FARRA, to require an independent judicial process whereby a person can challenge any diplomatic assurances against torture, and, specifically in the immigration context, to make the sole reliance on such assurances an insufficient basis for believing the person would not be tortured if removed to the country in question.

10. See Dan Eggen and R. Jeffrey Smith, "FBI Agents Allege Abuse of Detainees at Guantanamo Bay," *Washington Post*, December 21, 2004. See also, Eric Schmitt and Tim Golden, "Force-Feeding at Guantanamo is Now Acknowledged," *New York Times*, February 22, 2006; "Prisoner Abuse Scandal," *Baltimore Sun*, *supra* note 6.

11. Extraordinary rendition, as defined by a European Parliamentary committee in its investigation of CIA counterterrorism activities in Europe, is an "extra-judicial practice which contravenes established international human rights standards and whereby an individual suspected of involvement in terrorism is illegally abducted, arrested and/or trans-

with documented instances of state torture such as Egypt, Morocco, and Syria, and secret prisons.<sup>12</sup> The U.S. war on terrorism has also served as an impetus to tighten immigration laws and to interlock them with anti-terrorism measures.<sup>13</sup> Not long after the attacks of September 11<sup>th</sup>, President George W. Bush issued a statement titled, “Combating Terrorism through Immigration Policies,”<sup>14</sup> and the Immigration and Naturalization Service was made part of the newly created Department of Homeland Security.<sup>15</sup> Still, Congress has recognized that while there may exist an

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ferred into the custody of US officials and/or transported to another country for interrogation which, in the majority of cases, involves incommunicado detention and torture.” European Parliament, Temporary Committee on the Alleged Use of European Countries by the CIA for the Transportation and Illegal Detention of Prisoners, *Report on the Alleged Use of European Countries by the CIA for the Transportation and Illegal Detention of Prisoners*, ¶36, Doc A6-0020/2007 (January 30, 2007). Or, as one anonymous American official put it, “We don’t kick the [expletive] out of them. We send them to other countries so *they* can kick the [expletive] out of them.” Dana Priest and Barton Gellman, “U.S. Decries Abuse but Defends Interrogations,” *Washington Post*, December 26, 2002, A1. See also Guy Dinmore, “US Tries to Assure Allies that Extraordinary Renditions are Over,” *Financial Times*, December 27, 2006; Craig Whitlock, “Probe of Detainee Transfers Finds Many CIA Flights,” *Washington Post*, April 27, 2006, A20.

12. See Jane Mayer, “Outsourcing Torture,” *The New Yorker*, February 7, 2005. See also Demetri Sevastopulo, Guy Dinmore, Christopher Condon, “Brussels to Probe Claims of Secret CIA Jails,” *Financial Times*, November 3, 2005; Bob Herbert, “Our Friends, the Torturers,” *New York Times*, February 18, 2005; “Rice is Challenged in Europe over Secret Prisons,” *New York Times*, December 7, 2005.

13. Post September 11<sup>th</sup>, changes to immigration laws have been proposed and enacted as part of security and anti-terrorism bills. The REAL ID Act not only made changes to admission procedures at points of entry but also eliminated district courts’ jurisdiction over removable aliens’ habeas claims. REAL ID Act of 2005, Pub. L. No. 109-13, Div. B, §106, 119 Stat. 302 (*amending* 8 U.S.C. 1252(B)(4))[hereinafter *REAL ID Act*]. *But see* *Enwonwu v. Chertoff*, 376 F.Supp. 2d 42, 67 n.20 (D.Mass. 2005) (where alien habeas petitioner challenged the constitutionality of the government’s order of removal under substantive due process, the federal district court affirmed that “[d]espite the language of section 1252(g), federal courts retain ‘subject matter jurisdiction over habeas petitions brought by aliens facing removal to the extent that those petitions are based on colorable claims . . . that an alien’s statutory or constitutional rights have been violated’” (internal citation omitted). Most recently, the House of Representatives passed the Border Protection, Antiterrorism, and Illegal Immigration Control Act of 2005, which further amends the immigration regulations. H.R. 4437, 109<sup>th</sup> Congress, 1<sup>st</sup> Session. See also Margaret D. Stock, “United States Immigration Law in a World of Terror,” National Security White Papers, the Federalist Society, 2003, available at <http://www.fed-soc.org/Publications/Terrorism/immigration.htm>.

14. Presidential Directive on Combating Terrorism Through Immigration Policies, 37 PUB. PAPERS 44, Nov. 5, 2001), also available at <http://www.whitehouse.gov/news/releases/2001/10/20011030-2.html>.

15. See WHITE HOUSE, DEPARTMENT OF HOMELAND SECURITY, (2002), <http://www.whitehouse.gov/deptofhomeland/book.pdf>.

important nexus between immigration and terrorism,<sup>16</sup> the government must still provide aliens with due process and fairness.<sup>17</sup> It has, in addition, along with the President's Office and the judiciary, affirmed the United States' obligation and commitment under domestic and international law to stand against and prohibit torture under any circumstances.<sup>18</sup>

Numerous international organizations, human rights groups, and legal scholars<sup>19</sup> have voiced concern that diplomatic assurances from countries that an alien will not be tortured do not adequately guarantee the right to be free from torture.<sup>20</sup> Under current immigration regulations, the U.S. cannot remove, or deport, an alien to a country where he faces a substan-

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16. But see Hearing Before the Subcommittee on Immigration, Border Security, and Claims of the House Comm. on the Judiciary: Immigration Relief Under the Convention Against Torture For Serious Criminals and Human Rights Violators, 108<sup>th</sup> Congress. 3 (2003) (statement of Rep. Sheila Jackson Lee, Ranking Member of the House Subcommittee on the Judiciary), available at <http://judiciary.house.gov/legacy/88220.pdf> [hereinafter Immigration Relief Hearing] ("I always remind my colleagues that immigration does not equate to terrorism").

17. See War on Terrorism: Immigration Enforcement Since September 11, 2001: Hearing Before the Subcommittee on Immigration, Border Security, and Claims of the Committee on the H. Comm. on the Judiciary, 108<sup>th</sup> Congress (2003), available at <http://judiciary.house.gov/media/pdfs/printers/108th/86954.pdf> [hereinafter War on Terrorism Hearing Report].

18. See *Sosa v. Alvarez-Machain*, 542 U.S. 692 (2004); *Filartiga v. Pena-Irala*, 630 F.2d 876 (2<sup>nd</sup> Cir. 1980) [hereinafter *Filartiga I*]; *Second Periodic Report of the United States of America to the Committee Against Torture* (2005), available at <http://www.state.gov/g/drl/rls/45738.htm>; see also Reuters, "House Passes Torture Ban, War Funding," *Washington Post.com*, December 19, 2005, <http://www.washingtonpost.com/wp-dyn/content/article/2005/12/19/AR2005121900801.html>.

19. The Secretary General, Interim Report of the Special Rapporteur of the Commission on Human Rights, delivered to the General Assembly, U.N. Doc A/60/316 (Aug. 30, 2005); The Association of the Bar of the City of New York, Torture by Proxy: International and Domestic Law Applicable to "Extraordinary Renditions," 60 *The Record* 13, 47 n.100 (2005) [hereinafter ABCNY report]; MICHAEL JOHN GARCIA, CONGRESSIONAL RESEARCH SERVICE REPORT FOR CONGRESS, RENDITIONS: CONSTRAINTS IMPOSED BY LAWS ON TORTURE (2005), <http://www.fas.org/spp/crs/natsec/RL32890.pdf>; Human Rights Watch report, Empty Promises: Diplomatic Assurances No Safeguard Against Torture, Vol. 16, No. 4D, April 2004, also available at <http://hrw.org/reports/2004/un0404/diplomatic0404.pdf> (last visited December 24, 2005) [hereinafter HRW Report].

20. See Breffni O'Rourke, "Rice Defends Terror Practices as Europe Faces Tough Questions," *RadioFreeEurope Radio Liberty*, December 6, 2005, <http://www.rferl.org/featuresarticle/2005/12/3fc7f75f-e6a8-4fe3-ab7f-833336b06ac2.html>; see also Michael John Garcia, *supra* note 19.

tial risk of torture.<sup>21</sup> However, if the Secretary of State obtains diplomatic assurances from such a country that the alien will not be tortured and forwards the assurances to the Attorney General, then the alien may be removed without further administrative review.<sup>22</sup> In addition, the diplomatic assurances may not be reviewed in federal courts.<sup>23</sup>

This note will argue that the U.S.'s current use of diplomatic assurances must—but fails to—comply with Convention Against Torture

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21. Implementation of the Convention Against Torture, 8 C.F.R. §208.18 (2005). The regulations implemented FARRA, *supra* note 9, congressional legislation enacting CAT. Section 2242(a) states:

It shall be the policy of the United States not to expel, extradite, or otherwise effect the involuntary return of any person to a country in which there are substantial grounds for believing the person would be in danger of being subjected to torture, regardless of whether the person is physically present in the United States.

22. Diplomatic Assurances Against Torture Obtained by the Secretary of State, 8 C.F.R. §208.18(c) (2005)[hereinafter *Diplomatic Assurances*].

(1) The Secretary of State may forward to the Attorney General assurances that the Secretary has obtained from the government of a specific country that an alien would not be tortured there if the alien were removed to that country.

(2) If the Secretary of State forwards assurances described in paragraph (c)(1) of this section to the Attorney General for consideration by the Attorney General or her delegates under this paragraph, the Attorney General shall determine, in consultation with the Secretary of State, whether the assurances are sufficiently reliable to allow the alien's removal to that country consistent with Article 3 of the Convention Against Torture. The Attorney General's authority under this paragraph may be exercised by the Deputy

Attorney General or by the Commissioner, Immigration and Naturalization Service, but may not be further delegated.

(3) Once assurances are provided under paragraph (c)(2) of this section, the alien's claim for protection under the Convention Against Torture shall not be considered further by an immigration judge, the Board of Immigration Appeals, or an asylum officer.

23. The Attorney General and Secretary of State determine whether diplomatic assurances against torture safeguard removal in compliance with CAT, 8 C.F.R. §§208.17(f), 208.18(c), (e) and such discretion is non-reviewable. Judicial Review of Orders of Removal, 8 U.S.C. §1252(a)(2)(B)(ii) ("no court shall have jurisdiction to review any other decision or action of the Attorney General or the Secretary of Homeland Security the authority for which is specified under this subchapter to be in the discretion of the Attorney General or the Secretary of Homeland Security. . .").

("CAT")<sup>24</sup> treaty obligations and customary international law.<sup>25</sup> Under the *Charming Betsy* doctrine,<sup>26</sup> the Supreme Court has long held that treaties, like statutes, are the "law of the land,"<sup>27</sup> and that subsequent laws cannot violate them without express Congressional intent.<sup>28</sup> Congress has *not* expressly stated any intention to derogate from its *nonrefoulement* obligations under CAT;<sup>29</sup> in fact, recent bills and congressional hearings reaffirm Congress's intent to safeguard CAT's absolute protection against torture.<sup>30</sup> Therefore, current regulations must be amended, for the use of non-reviewable and insufficiently reliable diplomatic assurances, whether or not given in good faith, effectively derogates from CAT's prohibition against torture.<sup>31</sup>

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24. Convention Against Torture and Other Cruel, Inhuman or Degrading Treatment or Punishment, G.A. Res. 39/46, Annex, 39 U.N. GAOR, Supp. No. 51, U.N. Doc. A/39/51 (1984) [hereinafter *CAT*].

25. RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE U.S., §702 (1987). Customary international law, once established by the practice of states that base that practice upon a sense of legal obligation, also binds those states that do not follow that practice and/or have not directly or tacitly expressed their consent to be bound by it. *See, e.g.* the *Lotus Case*, *France v. Turkey*, 1927 P.C.I.J., Ser. A, No. 10 (1926) (construing "principles of international law" as "the principles which are in force between all independent nations.>").

26. *Murray v. The Charming Betsy*, 6 U.S. 64, 2 Cranch 64 (1804).

27. *Foster & Elam v. Neilson*, 27 U.S. (2 Pet.) 253, 314 (1829). *See* U.S. CONSTITUTION art. 3 §2.

28. Courts must interpret federal statutes in a way that avoids violating international law. *See* *Weinberger v. Rossi*, 456 U.S. 25, 32 (1982) (*citing* *Murray v. The Charming Betsy*, 6 U.S. 64, 2 Cranch 64 (1804) and *McCulloch v. Sociedad Nacional de Marineros de Honduras*, 372 U.S. 10, 20-21 (1963)), *cited and followed by* *Ma v. Reno*, 208 F.3d 815, 829 (9<sup>th</sup> Cir. 2000).

29. *CAT*, *supra* note 24, at art. 3. "No State Party shall expel, return ('refouler') or extradite a person to another State where there are substantial grounds for believing that he would be in danger of being subjected to torture."

30. *See, e.g.*, Markey Bill and Leahy Bill, *supra* note 9. *See also* Immigration Relief Under the Convention Against Torture for Serious Criminals and Human Rights Violators: Hearing Before the Subcommittee on Immigration, Border Security, and Claims of the House Comm. on the Judiciary, 108<sup>th</sup> Congress (2003), *available at* <http://judiciary.house.gov/legacy/88220.pdf>.

31. The UN Special Rapporteur Manfred Nowak concluded the following in his 2005 report to the UN General Assembly: "It is the view of the Special Rapporteur that diplomatic assurances are unreliable and ineffective in the protection against torture and ill-treatment: such assurances are sought usually from States where the practice of torture is systematic; post-return monitoring mechanisms have proven to be no guarantee against torture; diplomatic assurances are not legally binding, therefore they carry no legal effect and no accountability if breached; and the person whom the assurances aim to protect has no recourse if the assurances are violated. The Special Rapporteur is therefore of the opinion that States cannot resort to diplomatic assurances as a safeguard against torture and ill-treatment where there are substantial grounds for believing that a person would be

Part I of this note will set forth the international law instruments prohibiting torture and the return of an individual to a substantial risk of torture. It will describe the U.S.'s obligations under international law and the various domestic laws it has implemented in order to fulfill these obligations. Part II will analyze these domestic laws and regulations under the *Charming Betsy* doctrine,<sup>32</sup> the Administrative Procedure Act,<sup>33</sup> and constitutional law principles, ultimately concluding that U.S. law does not implement the U.S.'s international obligations and that they violate the Separation of Powers doctrine and due process.<sup>34</sup> Part III will argue for a judicial review mechanism of diplomatic assurances that fairly balances the various competencies and interests of the judiciary and the executive branch. Such a proposal is informed by current state practices outside the United States.

#### I. INTERNATIONAL LAW PROHIBITING TORTURE

Since World War II, the international community has formally prohibited torture through numerous treaties and declarations,<sup>35</sup> as well as mu-

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in danger of being subjected to torture or ill-treatment upon return.” *Interim Report, supra* note 19. The European Court of Human Rights (ECHR) has held that CAT’s Article 3 prohibition of torture includes the principle of nonrefoulement in *Soering v. The United Kingdom*, [1989] Eur. Ct. H.R. 14038/88. The ECHR has also held that even diplomatic assurances that are given in good faith may be an inadequate guarantee of safety for return to a country where torture is a “recalcitrant and enduring problem.” *Chahal v. The United Kingdom*, [1996] Eur. Ct. H.R. 22414/93 ¶105. Even if the U.S. withdrew from the nonrefoulement provision of CAT, it would still be obligated to prohibit the return to torture under customary international law. Vienna Convention on the Law of Treaties, art. 43, May 23, 1969, 1155 U.N.T.S. 332, 8 I.L.M. 679. The Vienna Convention’s interpretive authority over treaties has been recognized and followed by the U.S. State Department and several federal appeals courts. See Maria Frankowska, *The Vienna Convention Before the United States Courts*, 28 VA. J. INT’L L. 281 (1988).

32. *Charming Betsy* doctrine, *supra* notes 26 and 28.

33. Administrative Procedure Act, 5 U.S.C. §§551-559, 701-706 (2000)[hereinafter *APA*]. The APA ensures that final agency action can be reviewed by the federal courts when no other remedy is available, 5 U.S.C. §704 (2000), except for several specified agencies, such as military agencies during wartime and political party agencies. Immigration agencies are not exempt from the APA.

34. *Infra* Section II(B)(3).

35. See, e.g., Convention Against Torture, *supra* note 24; International Covenant on Civil and Political Rights, G.A. Res. 2200A, U.N. GAOR, 3<sup>rd</sup> Comm., 21<sup>st</sup> Sess., 1496<sup>th</sup> plen. Mtg. at 49, U.N. Doc. A/RES/2200A (XXI), at art. 7 (1966) (providing that “[n]o one shall be subjected to torture or to cruel, inhuman or degrading treatment or punishment.”); Universal Declaration on Human Rights, U.N. GAOR, Supp. No. 16, at 52, U.N. Doc. A/6316, at art. 5 (1948) (providing that “no one shall be subjected to torture or to cruel, inhuman or degrading treatment or punishment”).

nicipal (domestic) constitutions and laws.<sup>36</sup> According to the Restatement 3d of the Foreign Relations Law of the U.S., the prohibition against torture is also customary international law.<sup>37</sup> Finally, torture may also be considered a violation of peremptory international norms (*jus cogens*),<sup>38</sup> as its prohibition is found in “all comprehensive international instruments:”<sup>39</sup> the Geneva Conventions;<sup>40</sup> Universal Declaration of Human Rights;<sup>41</sup> International Covenant on Civil and Political Rights;<sup>42</sup> European Convention on Human Rights;<sup>43</sup> American Convention on Human

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36. See, e.g., in the *United States*, 18 U.S.C. §2340(A); “Torture Victim Protection Act,” 8 C.F.R. §208.18 [hereinafter *TVPA*]; FARRA, *supra* note 9.

37. RESTATEMENT, *supra* note 25. Regarding torture in particular, “[e]ven persons who are not entitled to the protections of the 1949 Geneva Conventions (such as some detainees from third countries) are protected by the “fundamental guarantees” of article 75 of Protocol I of 1977 to the Geneva Conventions. The United States has long considered article 75 to be part of customary international law (a widely supported state practice accepted as law). Article 75 prohibits murder, “torture of all kinds, whether physical or mental,” “corporal punishment,” and “outrages upon personal dignity, in particular humiliating and degrading treatment, . . . and any form of indecent assault.” Human Rights Watch, *Summary of International and U.S. Law Prohibiting Torture and Other Ill-treatment of Persons in Custody*, May 24, 2004, available at <http://hrw.org/english/docs/2004/05/24/usint8614.htm>.

38. *Jus cogens*, or a peremptory norm of international law, is “a norm accepted and recognized by the international community of States as a whole as a norm from which no derogation is permitted and which can be modified only by a subsequent norm of general international law having the same character.” Vienna Convention on the Law of Treaties, *supra* note 31, at art. 53. See also, *Siderman de Blake v. Republic of Argentina*, 965 F.2d 699, 717 (9<sup>th</sup> Cir. 1992)(“Under international law, . . . official torture violates *jus cogens*.”); 48 C.J.S. International Law §2 (2005)(“*Jus cogens* norms are norms of international law that are binding on states, or nations, even if they do not agree to them”).

39. See RESTATEMENT, *supra* note 25, at §702, reporter’s note 5.

40. Geneva Convention for the Amelioration of the Conditions of the Wounded and Sick in Armed Forces in the Field, *opened for signature* Aug. 12, 1949, 6 U.S.T. 3114, 75 U.N.T.S. 31; Geneva Convention for the Amelioration of the Condition of Wounded, Sick and Shipwrecked Members of Armed Forces at Sea, *opened for signature* Aug. 12, 1949, 6 U.S.T. 3217, 75 U.N.T.S. 85; Geneva Convention Relative to the Treatment of Prisoners of War, *opened for signature* Aug. 12, 1949, 6 U.S.T. 3316, 75 U.N.T.S. 135; Geneva Convention Relative to the Protection of Civilian Persons in Time of War, 6 U.S.T. 3516, 75 U.N.T.S. 287.

41. Universal Declaration of Human Rights, article 19, *adopted* Dec. 10, 1948, G.A. Res. 217A (III), U.N. Doc. A/810.

42. International Covenant on Civil and Political Rights, *opened for signature* Dec. 16, 1966, G.A. Res. 2200A (XXI), U.N. GAOR, 21<sup>st</sup> Sess., Supp. No. 16, U.N. Doc. A/6316 (1966), 999 U.N.T.S. 171, art. 7.

43. European Convention for the Protection of Human Rights and Fundamental Freedoms, *opened for signature* Apr. 11, 1950, 213 U.N.T.S. 222, art. 3.

Rights;<sup>44</sup> and the African Charter of Human and Peoples' Rights.<sup>45</sup> Perhaps the most important of the international instruments prohibiting torture, however, CAT permits absolutely no exceptions to the prohibition on torture, stating that not even war or public emergency can justify torture.<sup>46</sup> Additionally, CAT forbids *refoulement*—the return, extradition, or expulsion of a person to another country where “there are substantial grounds for believing that he would be in danger of being subjected to torture.”<sup>47</sup>

President Reagan signed CAT on April 18, 1988 on behalf of the United States, subject to a declaration stating that Articles 1 through 16 were not self-executing<sup>48</sup> and thus required domestic legislation for implementation. The Senate ratified CAT, subject to various declarations and understandings,<sup>49</sup> on October 21, 1994, and the U.S. became a full party to the treaty in November 1994. Congress eventually passed the Foreign Affairs Reform and Restructuring Act (“FARRA”) in 1998,

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44. American Convention on Human Rights, Nov. 22, 1969, 1144 U.N.T.S. 123, art. 5(2).

45. African Charter on Human and Peoples' Rights, *opened for signature* June 27, 1981, O.A.U. Doc. CAB/LEG/67/3 rev. 5, 21 I.L.M. 58, art. 5 (1982).

46. CAT, *supra* note 24, at art. 2(2). “No exceptional circumstances whatsoever, whether a state of war or a threat of war, internal political instability or any other public emergency, may be invoked as a justification of torture.” As of April 19, 2007, there were 74 signatories and 144 parties to CAT. United Nations, *Treaty Series*, vol. 1465, p. 85, available at <http://www.ohchr.org/english/countries/ratification/9.htm>. *But see* James Park Taylor, *Dancing with the Scavenger's Daughter: Torture, Rendition & the United States*, 30-JUL Mont. Law. 10, 38 (2005)(discussing arguments by Alan Dershowitz in favor of a judicial process to authorize limited derogation from CAT, found in WHY TERRORISM WORKS: UNDERSTANDING THE THREAT, RESPONDING TO THE CHALLENGE (2002)).

47. CAT, *supra* note 24, at art. 3.

48. <http://untreaty.un.org/ENGLISH/bible/englishinternetbible/partI/chapterIV/treaty14.asp>; Sen. Exec. Rpt. 101-30, Resolution of Advice and Consent to Ratification, (1990), available at <http://thomas.loc.gov/cgi-bin/ntquery/z?trty:100TD00020>.

49. The United States ratified CAT subject to the following declarations, reservations, and understandings: a declaration that CAT Articles 1 through 16 were not self-executing (and so required domestic legislation for implementation), *id.* at III.(2); a reservation that limited Article 16's binding authority over lesser forms of cruel and unusual punishment to the prohibitions of the U.S. Constitution's Fifth, Eighth, and/or Fourteenth Amendments, *id.* at I.(2); an opting-out of the arbitration provisions of Article 30, *id.* at I.(3); an understanding that acts of torture must be committed by or at the acquiescence of a public official or other person acting in an official capacity, *id.* at II.(1)(b); an understanding that mere noncompliance with applicable legal procedural standards does not automatically constitute torture, *id.* at II.(1)(e); an understanding specifying the “more likely than not” standard to be met in *nonrefoulement*,” *id.* at II.(2).

which implemented CAT's prohibition against torture<sup>50</sup> and *refoulement*.<sup>51</sup> While the U.S. had already prohibited *refoulement* in the context of refugees and asylum seekers,<sup>52</sup> FARRA broadened the class of protected persons, pursuant to CAT, to include individuals who lack a valid asylum claim<sup>53</sup> but who nevertheless are "more likely than not" to face a risk of torture.<sup>54</sup> This class of individuals is not eligible for permanent status in the United States and may be returned to another country on the strength of diplomatic assurances.<sup>55</sup>

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50. As codified in 8 C.F.R. §1208.18, an act of "torture" is defined as "any act by which severe pain or suffering, whether physical or mental, is intentionally inflicted on a person..." Torture "is an extreme form of cruel and inhuman treatment." The definition is consistent with Article 1 of CAT, except for the requirement of intentional infliction, which entered the statute by United States understandings.

51. FARRA, *supra* note 9, at §2242(a): "It shall be the policy of the United States not to expel, extradite, or otherwise effect the involuntary return of any person to a country in which there are substantial grounds for believing the person would be in danger of being subjected to torture, regardless of whether the person is physically present in the United States.

52. Congress acceded to the 1967 United Nations Protocol relating to the Status of Refugees in 1968. G.A. Res. 2198 (XXI) (Nov. 18, 1966), U.N. Econ. & Soc. Council [ECOSOC] Res. 1186 (XLI) (Dec. 16, 1966). In 1980, in order to bring domestic law into compliance with the Protocol, Congress passed the Refugee Act of 1980. Pub.L. No. 96-212, 94 Stat. 102. The Act included a *nonrefoulement* provision, which has since been slightly modified by the Illegal Immigration and Immigrant Responsibility Act of 1996 (IIRIRA) and codified in the Immigration and Nationality Act §241(b)(3), 8 U.S.C. §1231(b)(3)(B).

53. Asylum applicants must prove persecution based on one of five protected grounds: race, religion, nationality, membership in a particular social group, or political opinion in the country in question. 8 U.S.C. §1158(b)(i) (2005).

54. FARRA delegated implementation of the U.S.'s obligations under Article 3 of CAT to "the appropriate agencies." Immigration and Naturalization Service (INS) and Executive Office for Immigration Review regulations interpreted FARRA's "substantial grounds for believing the person would be in danger of being subjected to torture" to require a "more likely than not" burden of proof of the applicant. Regulations Concerning the Convention Against Torture, 8 C.F.R. §208.16(c)(2) (2005).

55. See *Immigration Relief Hearing*, *supra* note 16, at 24 ("It is not and has never been an avenue for permanent residency, the Convention Against Torture relief. Unlike asylum, individuals granted Convention Against Torture relief have no right to remain permanently in the U.S. In fact, I would say that deferral of removal under the Convention Against Torture is the most precarious and restricted immigration relief under the Immigration and Nationality Act, but it has saved lives and it has prevented torture").

## II. DIPLOMATIC ASSURANCES UNDER U.S. LAW

Treaties to which the United States has acceded have equal force of law as federal statutes.<sup>56</sup> In addition, the Supreme Court has long held that wherever possible, subsequent acts of Congress must be construed as consistent with treaty obligations.<sup>57</sup> Regulations, which also have the force of federal law, are constrained by the statutes that authorize their promulgation, and by the U.S. Constitution.<sup>58</sup>

Under a constitutional law analysis, regulations which allow diplomatic assurances to block any further administrative or judicial review of a CAT claim overreach their implementing statutory authority and are manifestly contrary to the purpose of FARRA.<sup>59</sup> Also, regulations which grant such blanket discretionary power to the executive branch violate the Constitution's Separation of Powers doctrine and the Fifth Amendment's guarantee of due process.<sup>60</sup>

*A. Current Immigration Procedure for Aliens Fearing Torture*

Under current immigration procedures, individuals fearing torture in their home countries may apply for withholding or deferral of removal under CAT.<sup>61</sup> Unlike asylum applicants, CAT claimants are not barred from relief if they have committed a particularly serious crime or constitute a danger to the community of the United States.<sup>62</sup> However, they are

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56. See U.S. CONSTITUTION art. 3 §2; *Foster & Elam v. Neilson*, *supra* note 27, at 314.

57. See *Charming Betsy* doctrine, *supra* note 28. See also *Cook v. United States*, 288 U.S. 102, 120 (1933) (“[a] treaty will not be deemed to have been abrogated or modified by a later statute, unless such purpose on the part of Congress has been clearly expressed”).

58. See *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

59. *Infra* Section II(B)(2).

60. *Infra* Section II(B)(3).

61. Note that withholding and deferral of removal under CAT are separate from withholding and deferral of removal in the traditional asylum context. An application for withholding or deferral of removal under CAT does not require proof of persecution based on any one of the five protected grounds; rather, the applicant must show that “it is more likely than not that he or she would be tortured if removed to the proposed country of removal.” 8 C.F.R. §§208.16(c), 208.17. From March 1999 through August 2002, the Justice Department processed 53,471 applications for CAT relief, of which less than 3% were granted. *Immigration Relief Hearing*, *supra* note 16, at 1, 9.

62. REGINA GERMAIN, AILA'S ASYLUM PRIMER: A PRACTICAL GUIDE TO U.S. ASYLUM LAW AND PROCEDURE 80 (4<sup>th</sup> ed., 2005) *citing* 8 U.S.C. §§1158(b)(2)(A)(ii) and 1231(b)(3)(B)(ii). Section 241(b)(3)(B) of the Immigration and Nationality Act of 1952, Pub. L. No. 82-414, 66 Stat. 163 [hereinafter *INA*] set forth mandatory bars to the granting of CAT withholding of removal where:

only eligible for deferral of removal, which can be terminated more easily than withholding of removal.<sup>63</sup>

Under immigration regulations, not the statutory language of FARRA itself,<sup>64</sup> the Secretary of State and Attorney General have, respectively, the power to seek and validate “diplomatic assurances” against torture from the country where a CAT applicant fears torture<sup>65</sup> and to thereby cut short further consideration of the CAT claim in the administrative channel. In other words, if the Secretary of State obtains reliable assurances and forwards them to the Attorney General, then the alien’s CAT claim cannot be further considered by any asylum officer, immigration judge, or the Board of Immigration Appeals.<sup>66</sup> Thus, while an alien can typically appeal a denial of his application for withholding or deferral of removal and obtain a *de novo* hearing with an immigration judge or the Board of Immigration Appeals,<sup>67</sup> once diplomatic assurances are accepted by the Attorney General, an alien has no further recourse, unless

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(i) the alien ordered, incited, assisted, or otherwise participated in the persecution of an individual because of the individual’s race, religion, nationality, membership in a particular social group, or political opinion;

(ii) the alien, having been convicted by a final judgment of a particularly serious crime is a danger to the community of the United States;

(iii) there are serious reasons to believe that the alien committed a serious non-political crime outside the United States before the alien arrived in the United States; o

(iv) there are reasonable grounds to believe that the alien is a danger to the security of the United States.

8 U.S.C. §1231(b)(3)(B).

63. GERMAIN, *supra* note 62, at 227. Deferral of removal does not grant an alien permanent legal status, nor does it confer derivative rights upon family members. Furthermore, it only prohibits the alien’s return to the country of risk, not to other non-risk countries. 8 C.F.R. §1208.17 (2005).

64. FARRA itself sets forth strong policy but leaves the details of actual regulations to “the heads of the appropriate agencies,” *supra* note 9, at §2242(b). The INS enacted implementing regulations in March 1999, creating withholding and deferral of removal and incorporating the Act’s restrictions on judicial review. 8 C.F.R. §§208.16-18.

65. Diplomatic Assurances, *supra* note 22.

66. 8 C.F.R. §208.18(c)(3).

67. The Department of Justice’s Executive Office of Immigration Review (EOIR) has adjudicatory authority over certain removal and detention decisions made by the Department of Homeland Security, the executive agency charged with the daily implementation and enforcement of immigration regulations. See ABCNY Report, *supra* note 19, at 47 n.100.

he can raise a constitutional law issue, or a question of law concerning his final order for removal.<sup>68</sup>

Diplomatic assurances—their negotiation, reliability, sufficiency—are not subject to judicial review, for the initial determination of reliability or validity lies wholly in the protected discretion of the Secretary of State and the Attorney General.<sup>69</sup> The courts have upheld this non-reviewability of diplomatic assurances.<sup>70</sup>

Although FARRA seems to achieve its goal of protecting those who may be ineligible for traditional asylum or withholding but nevertheless face a substantial risk of torture, its implementing regulations, which allow “diplomatic assurances” to summarily end any alien’s CAT claim, fatally undermine the statute’s purpose. Furthermore, the non-reviewability of what amounts to a blanket discretionary power of the executive branch effectively constitutes an agency-created exception to FARRA.<sup>71</sup> These two effects of current regulations raise important constitutional issues.

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68. REAL ID Act, *supra* note 13. Since President G.W. Bush signed the REAL ID Act into law on May 11, 2005, the Third, Fifth, Seventh, Ninth, and Eleventh Circuits have issued opinions adopting the interpretation that the Act granted them jurisdiction over errors of law in final removal orders, as well as constitutional claims. *See, e.g.* Papa-georgiou v. Gonzales, 413 F.3d 356 (3<sup>rd</sup> Cir. 2005); Kamara v. Attorney General, 420 F.3d 202 (3<sup>rd</sup> Cir. 2005); Rodriguez-Castro v. Gonzales, 2005 WL 2417048 (5<sup>th</sup> Cir. 2005); Baez v. Bureau of Immigration and Customs Enforcement, 2005 WL 2436835 (5<sup>th</sup> Cir. 2005); Vasile v. Gonzales, 417 F.3d 766 (7<sup>th</sup> Cir. 2005); Hamdan v. Gonzales, 2005 U.S. App. LEXIS 22058 (7<sup>th</sup> Cir. 2005); Fernandez-Ruiz v. Gonzales, 410 F.3d 585 (9<sup>th</sup> Cir. 2005); Chacon-Botero v. Attorney General, 2005 WL 2456877 (11<sup>th</sup> Cir. 2005). Interestingly, the Fourth Circuit made a point of noting in a footnote of its opinion in *Malm v. Gonzales*, 2005 WL 2534194, \*3 (4<sup>th</sup> Cir. 2005), a case that ultimately did not require the court to decide the alien’s due process claim, “[w]e by no means suggest, however, that the REAL ID Act is constitutional in all of its applications by referring to its enactment in the context of deciding this case.”

69. *See* Diplomatic Assurances, *supra* note 22.

70. *See, e.g.*, Lukwago v. Ashcroft, 329 F.3d 157 (3<sup>rd</sup> Cir. 2003); Soliman v. U.S., 296 F.3d 1237, 1242 (11<sup>th</sup> Cir. 2002)(where the Circuit Court noted that it lacked jurisdiction to review the Attorney General’s decision to terminate the petitioner’s deferral of removal after securing diplomatic assurances against torture); Comejo-Barreto v. Seifert, 218 F.3d 1004, 1015 (9<sup>th</sup> Cir. 2000), *related proceeding at* 379 F.3d 1075 (9<sup>th</sup> Cir. 2004), *vacated by, rehearing, en banc, granted by* 386 F.3d 938 (9<sup>th</sup> Cir. 2004), *vacated by* 389 F.3d 1307 (9<sup>th</sup> Cir. 2004); Al-Anazi v. Bush, 370 F.Supp. 2d 188 (where the District Court rejected a Guantanamo Bay detainee’s motion for a preliminary injunction of transfer to foreign countries).

71. Regulations eliminating both administrative and judicial review of certain issues operate on a much larger scope than a jurisdictional statute, which “usually takes away no substantive right but simply changes the tribunal that is to hear the case.” *Landgraf v. Usi Film Prods.*, 516 U.S. 244, 258 (1994).

*B. Due Process Analysis*

The Supreme Court has long held that aliens who have entered the United States have liberty interests under the U.S. Constitution and are “persons”<sup>72</sup> protected by the Fifth and Fourteenth Amendment guarantees of due process,<sup>73</sup> regardless of the legality of their presence in the country.<sup>74</sup> While circuit courts remain split over whether the U.S. Constitution grants aliens the right to judicial review of removal proceedings, they nevertheless unanimously hold that aliens must be given fair administrative hearings.<sup>75</sup> Thus, Congress’s plenary power over immigration

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72. See *Zadyvdas v. Davis*, 533 U.S. 678, 693 (2001) (“[T]he Due Process Clause applies to all ‘persons’ within the United States, including aliens, whether their presence here is lawful, unlawful, temporary, or permanent”); *Plyler v. Doe*, 457 U.S. 202, 210 (1982) (rejecting the argument that illegal aliens are not entitled to equal protection); *Mathews v. Diaz*, 426 U.S. 67, 77 (1976) (affirming that even unlawful aliens have the right to due process to protect against the deprivation of life, liberty, or property). See also *Kwong Hai Chew v. Colding*, 344 U.S. 590, 597 (1953) (regarding illegal aliens, “[a]lthough Congress may prescribe conditions for his expulsion and deportation, not even Congress may expel him without allowing him a fair opportunity to be heard. Indeed, this Court has held that the Due Process Clause protects an alien subject to a final order of deportation . . . though the nature of that protection may vary depending upon status and circumstance . . .”).

73. See *Plyler v. Doe*, 457 U.S. 202 (1982); *Shaughnessy v. Mezei*, 345 U.S. 206, 212 (1953); *Carlson v. Landon*, 342 U.S. 524, 542 (1952); *Wong Wing v. United States*, 163 U.S. 228, 238 (1896); *Yick Wo v. Hopkins*, 118 U.S. 356, 369 (1886).

74. See *Rasul v. Bush*, 542 U.S. 466 (2004); *Zadyvdas*, 533 U.S. 678 (2001); *INS v. St. Cyr*, 533 U.S. 289 (2001); *INS v. Chadha*, 462 U.S. 919 (1983); *Plyler v. Doe*, 457 U.S. 202 (1982).

75. In the past, the circuit courts have split over whether Congressional restrictions on judicial review of deportation orders of criminals under new legislation (AEDPA and IIRAIRA, *infra* note 144) violated due process. The vast majority of the circuits held that fair administrative proceedings were sufficient guarantees of due process. See *Ekasinta v. Gonzales*, 415 F.3d 1188, 1195 (10<sup>th</sup> Cir. 2005); *Hall v. INS*, 167 F.3d 852, 857 (4<sup>th</sup> Cir. 1999); *Duldulao v. INS*, 90 F.3d 396 (9<sup>th</sup> Cir. 1996). However, some among them also noted that their holdings were heavily influenced by the availability to aliens of habeas review. See, e.g., *Goncalves v. Reno*, 144 F.3d 110, 126 (1<sup>st</sup> Cir. 1998) (“In every circuit which has addressed constitutional challenges to this withdrawal of jurisdiction [IIRIRA], the court found that preclusion of all judicial review would present serious constitutional questions, and in every case those questions were avoided by noting the continuing availability of habeas review. Although the cases diverge in their approaches, they all agree on these two basic points—that Congress can constitutionally withdraw jurisdiction over such petitions for review under old INA § 106, but that some jurisdiction remains on habeas.”); *Mansour v. INS*, 123 F.3d 423 (6<sup>th</sup> Cir. 1997) (noting that the circuit courts have managed to avoid fully addressing the constitutional question of whether aliens are entitled to judicial review outside administrative hearings because habeas relief has been assumed). This assumption of the availability of habeas to aliens in removal proceedings is no longer viable under the recently passed REAL ID Act, for the Act expressly stripped the lower courts of habeas jurisdiction and have granted the circuit

law,<sup>76</sup> including its right to restrict judicial review under certain circumstances,<sup>77</sup> is limited by constitutional constraints<sup>78</sup> that are properly addressed by the courts.<sup>79</sup> Similarly, the Executive Branch's foreign policy initiatives, administrative enforcement of federal laws, and the formulation of uniform public policy in immigration matters<sup>80</sup> are subject to judicial review when they violate fundamental individual rights.<sup>81</sup> Even when the nation is at war, for example, and executive powers expand significantly, the Separation of Powers doctrine preserves the role of the courts to ensure that power is not unlawfully "condensed" into a single branch of government.<sup>82</sup>

A due process challenge of the use of diplomatic assurances may argue that immigration regulations' restrictions on administrative and judicial review of those assurances violate due process because they violate the Separation of Powers doctrine. Such a challenge raises the following questions: (1) whether immigration regulations concerning CAT claims are subject to judicial review; (2) whether those regulations granting the Secretary of State and Attorney General non-reviewable discretion to terminate a CAT claim are a reasonable interpretation of FARRA; and (3) whether that discretion is constitutional when it eliminates the possi-

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courts jurisdiction over final orders of removal only on constitutional issues and pure questions of law. The circuit courts now face a new problem: determining whether they can review factual findings underpinning the administrative decisions on matters of law as they could under the old habeas provisions.

76. See *Demore v. Kim*, 538 U.S. 510 (2003); *Zadyvdas v. Davis*, 533 U.S. at 695; *Mathews v. Diaz*, 426 U.S. 67, 79-80 (1983).

77. See *Zadyvdas*, 533 U.S. at 687.

78. *Id.*; see also art. 3, §2 of U.S. Constitution. There is a current controversy over whether Article III §2 authorizes Congress not only to establish lower federal courts but to define courts' jurisdiction. See Erwin Chemerinsky, *CONSTITUTIONAL LAW: PRINCIPLES AND POLICIES* §2.9 at 148 (Aspen Publishers, 2<sup>nd</sup> ed., 2002).

79. See *Zadyvdas*, 533 U.S. at 695, citing *INS v. Chadha*, 462 U.S. at 941-942 ("Congress must choose 'a constitutionally permissible means of implementing' that power"). See also *INS v. St. Cyr*, 533 U.S. at 300 ("...Congress, like this Court, is bound by and swears an oath to uphold the Constitution. The courts will therefore not lightly assume that Congress intended to infringe constitutionally protected liberties or usurp power constitutionally forbidden it").

80. See *Zadyvdas*, 533 U.S. at 700.

81. See *INS v. Chadha*, 462 U.S. at 940 ("the plenary authority of Congress over aliens under Art. I, § 8, cl. 4, is not open to question, but what is challenged here is whether Congress has chosen a constitutionally permissible means of implementing that power"); *Filartiga I*, *supra* note 18; *Enwonwu v. Chertoff*, *supra* note 13, at 67, n.20 (where district court, in reviewing an order for forced removal of alien applicant to Nigeria, affirmed that his life and liberty interests in being free from torture are constitutionally protected). See also *Lynch v. Cannatella*, 810 F.2d 1363, 1375 (5<sup>th</sup> Cir. 1987).

82. See *Hamdi v. Rumsfeld*, 542 U.S. 507, 536 (2004).

bility of further administrative review, and is non-reviewable by an Article III court.

### 1. Jurisdiction over Administrative Acts

The Administrative Procedure Act of 2000 ("APA")<sup>83</sup> creates a presumption of judicial review of agency regulations<sup>84</sup> under existing subject matter jurisdiction-granting statutes or writs,<sup>85</sup> except in two cases: when a statute expressly precludes judicial review; and when agency action has been committed to agency discretion by law.<sup>86</sup> This latter exception is extremely narrow; it applies only to instances where the governing statute offers no meaningful standard or law for the courts against which to hold regulations.<sup>87</sup>

Regulations allowing for diplomatic assurances and precluding judicial review of them are reviewable under the APA, for they do not fall under either of the two APA exceptions. First, FARRA expressly permits judi-

83. APA, 5 U.S.C. §§551-559, 701-706, *supra* note 33.

84. *See* *Abbott Labs v. Gardner*, 387 U.S. 136, 149 (1967), *overruled on other grounds by* *Califano v. Sanders*, 430 U.S. 99 (1977) ("An 'agency action' includes any 'rule,' defined by the Administrative Procedure Act as an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy" *citing* 5 U.S.C. §§551 (4), 551(13)).

85. APA, 5 U.S.C. §703.

The form of proceeding for judicial review is the special statutory review proceeding relevant to the subject matter in a court specified by statute or, in the absence or inadequacy thereof, any applicable form of legal action, including actions for declaratory judgments or writs of prohibitory or mandatory injunction or habeas corpus, in a court of competent jurisdiction. If no special statutory review proceeding is applicable, the action for judicial review may be brought against the United States, the agency by its official title, or the appropriate officer. Except to the extent that prior, adequate, and exclusive opportunity for judicial review is provided by law, agency action is subject to judicial review in civil or criminal proceedings for judicial enforcement.

*See also* *Cornejo-Barreto v. Seifert*, 218 F.3d at 1015.

86. The APA does not guarantee judicial review of agency final actions under the following exceptions: when the governing statute expressly precludes judicial review, APA §701(a)(1); and when agency action has been committed to its discretion by law, APA §701(a)(2).

87. *See* *Cornejo-Barreto v. Seifert*, 218 F.3d at 1013(9<sup>th</sup> Cir. 2000)(finding that FARRA set a clear standard of non-discretionary protection against removal where there is a substantial likelihood of torture). *See also* *Heckler v. Chaney*, 470 U.S. 821, 830 (1985)("The legislative history of the Administrative Procedure Act indicates that it is applicable in those rare instances where 'statutes are drawn in such broad terms that in a given case there is no law to apply.' S. Rep. No. 752, 79th Cong., 1st Sess., 26 (1945)").

cial review of final orders of removal in both the administrative and Article III courts.<sup>88</sup> Second, while FARRA authorized the appropriate agencies to form implementing regulations, it also established a clear standard of law that those regulations must meet:

It shall be the policy of the United States not to expel, extradite, or otherwise effect the involuntary return of any person to a country in which there are substantial grounds for believing the person would be in danger of being subjected to torture, regardless of whether the person is physically present in the United States.<sup>89</sup>

That is, immigration authorities have the non-discretionary duty not to return an alien where he faces a substantial risk of torture.<sup>90</sup> Therefore, the APA presumption of judicial reviewability of immigration regulations<sup>91</sup> stands, and challenges to diplomatic assurances are judiciable.<sup>92</sup>

However, judicial review of executive regulations cannot center on “policy questions”<sup>93</sup> or foreign relations.<sup>94</sup> For example, where a statute

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88. FARRA §2242(d) specifies that judicial review is appropriate under the INA, 8 U.S.C. §1252.

89. FARRA, *supra* note 9, at §2242(a).

90. *Cornejo-Barreto v. Seifert*, 218 F.3d at 1014.

91. *See Singh v. Moyer*, 867 F.2d 1035, 1037 (7<sup>th</sup> Cir. 1989)(citing APA, 5 U.S.C. 701(b)(1)(1982)). A new question raised by the enactment of the REAL ID Act is whether the Act’s prohibition of habeas petitions independent from review of final orders of removal leaves aliens without a statute to confer subject matter jurisdiction over their APA claims. The REAL ID Act specifies that nothing in the provision should be construed to deny judicial review of constitutional claims and questions of law of final orders of removal; therefore, it may be that aliens can claim that the REAL ID Act, or the resulting amended INA itself confers subject matter jurisdiction upon the circuit courts.

92. The Ninth Circuit’s first opinion in *Cornejo-Barreto v. Seifert*, *supra* note 70, a landmark challenge to diplomatic assurances, supports the position that the Secretary of State’s discretionary power under FARRA-enacting regulations are in fact reviewable. While a subsequent, related proceeding overruled that holding, deeming it non-binding dicta, the circuit court voted to rehear the case en banc. However, that grant was vacated, as well the court’s second opinion overruling the holding that is relevant here, for mootness when the foreign government requesting *Cornejo-Barreto*’s extradition withdrew its request.

93. In *Chevron v. Natural Resources*, where plaintiffs challenged Environmental Protection Agency (EPA) regulations, the Supreme Court ruled in favor of deference to the EPA’s interpretation of the key statutory term “source,” because it determined that plaintiffs brought their challenge in order to wage “a specific policy battle,” better left to legislators and administrators, rather than to challenge whether the regulations were a reasonable interpretation of ambiguous statutory language and implied intent. *Chevron*, 467 U.S. at 864. *See also Nixon v. United States*, 506 U.S. 224, 228 (1993)(characterizing the “political question doctrine” as partly concerning whether one political branch of government is constitutionally vested with final authority over a government function).

lacks clear language on an issue but expresses congressional intent, courts will defer to a reasonable administrative interpretation,<sup>95</sup> rather than make a policy determination that is better left to the legislature and executive branches.<sup>96</sup> Here, while FARRA's language is quite broad, it is not ambiguous, and Congress's intent in passing the law is expressly stated in the policy provision of FARRA. Therefore, a court reviewing regulations under FARRA would not have to avoid inappropriate policy-making by deferring to the executive's interpretation of the statute.

Similarly, while courts show the executive and legislature great deference where foreign relations are involved,<sup>97</sup> such as in extradition decisions<sup>98</sup> and "political questions,"<sup>99</sup> appropriate deference would not bar

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94. See, e.g., *Cornejo-Barreto v. Siefert*, 379 F.3d at 1084 (discussing the "rule of non-inquiry," which is premised upon the notion that courts are ill-equipped as institutions, compared to the legislative and executive branches, to judge the workings of other countries' judicial systems).

95. *Chevron*, 467 U.S. at 844.

96. *Id.* at 864.

97. See, e.g., *Zemel v. Rusk*, 381 U.S. 1, 17 (1965) ("because of the changeable and explosive nature of contemporary international relations, and the fact that the Executive is immediately privy to information which cannot be swiftly presented to, evaluated by, and acted upon the legislature. . ."); *Iwanowa v. Ford Motor Co.*, 67 F.Supp.2d 424 (D. N.J. 1999) (where the district court held the plaintiff's World War II-related forced labor claims nonjudicial political questions and deferred to executive interpretation of the international treaty). But see *Hamdi v. Rumsfeld*, 542 U.S. 507 (2004). In *Hamdi*, the Supreme Court rejected the Government's suggestion that courts review enemy combatant determinations under a "very deferential 'some evidence' standard" because of the courts' limited expertise regarding military decision-making). *Id.* at 598.

98. See, e.g., *Cornejo-Barreto*, *supra* note 70.

99. The political question doctrine renders certain issues non-judicial. Its principles were first set forth in *Marbury v. Madison*, 5 U.S. 137, 170 (1803), by Chief Justice Marshall. The doctrine was later expounded in *Baker v. Carr*, 369 U.S. 186, 217 (1962), which traced it to the Constitution's separation of powers. Also, courts often deem political questions non-judicial when foreign relations, entrusted by the Constitution to the President and Congress, are inextricably involved. See *Baker v. Carr*, 369 U.S. at 217 (1962):

Prominent on the surface of any case held to involve a political question is found a textually demonstrable constitutional commitment of the issue to a coordinate political department; or a lack of judicially discoverable and manageable standards for resolving it; or the impossibility of deciding without an initial policy determination of a kind clearly for nonjudicial discretion; or the impossibility of a court's undertaking independent resolution without expressing lack of the respect due coordinate branches of government; or an unusual need for unquestioning adherence to a political decision already made; or the potentiality of embarrassment from multifarious pronouncements by various departments on one question. Unless one of these formulations is inextricable from

review of diplomatic assurance regulations. Deference on political questions is subject to the following constraints:<sup>100</sup> first, whether a non-judicial political question exists must be decided case-by-case;<sup>101</sup> second, political questions that possibly exceed constitutional authority are necessarily judicial;<sup>102</sup> and, third, the political question doctrine does not prescribe deference in the face of unconstitutional action.<sup>103</sup> While immigration regulations do represent a unique nexus of domestic and foreign policies,<sup>104</sup> the mere fact that a CAT-related issue would involve consideration of foreign nationals and governments does not render the issue a political question into which the courts should not inquire.<sup>105</sup> Finally, the courts are clearly authorized to construe treaties and to interpret federal legislation.<sup>106</sup> Indeed, in *Chevron v. NRDC*, the Supreme Court affirmed that “the judiciary is the final authority on issues of statu-

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the case at bar, there should be no dismissal for non-justiciability on the ground of a political question’s presence

*followed by, e.g.,* *Goldwater v. Carter*, 444 U.S. 996 (1979); *Ludecke v. Watkins*, 335 U.S. 160, 168 (1948).

In subsequent cases, the Court has relied primarily on the first two of the Baker criteria alone, considering the remaining criteria “prudential” factors. *Alperin v. Vatican Bank*, 410 F.3d 532, 545-546 (*citing* *Made in the USA Foundation v. U.S.*, 242 F.3d 1300, 1312-19 (11<sup>th</sup> Cir. 2001)).

100. *Baker v. Carr*, 369 U.S. at 211. *See also Zemel v. Rusk*, 381 U.S. at 17 (“This does not mean that simply because a statute deals with foreign relations, it can grant the Executive totally unrestricted freedom of choice”).

101. *Baker v. Carr*, 369 U.S. at 211; *Alperin v. Vatican Bank*, 410 F.3d at 537.

102. *Baker v. Carr*, 369 U.S. at 217 (“The courts cannot reject as ‘no law suit’ a bona fide controversy as to whether some action denominated ‘political’ exceeds constitutional authority”).

103. *Atkins v. U.S.*, 556 F.2d 1028, 1053, *cert denied*, 98 S.Ct. 718 (“[T]he rule of respect is not a prescription for deference in the face of unconstitutional action, which would be little more than an abdication of judicial responsibility.”).

104. Not only is foreign policy implicated in the government’s decision to ratify international treaties, but it has also determined specific domestic legislation. For example, Congress has passed legislation granting temporary protected status, which provides aliens with a temporary stay of removal, as well as work authorization, to aliens from Burundi, El Salvador, Honduras, Liberia, Nicaragua, Somalia, and Sudan. REGINA GERMAIN, *supra* note 62, Appendix 7D at 401.

105. *See Cornejo-Barreto*, 218 F.3d at 1009, n.5 (noting that FARRA “clearly supersedes” the rule of non-inquiry doctrine); *see also Mironescu v. Costner*, 2007 U.S. App. LEXIS 6622, at \*25 (4<sup>th</sup> Cir. 2007)(holding that the district court lacked jurisdiction to review a decision by the Secretary of State that relied on diplomatic assurances to extradite a CAT-protected alien *not* because the rule of non-inquiry barred judicial review on habeas, but because the petitioner challenged his extradition, not removal).

106. U.S. Const. art. 3 §2.

tory construction and must reject administrative constructions which are contrary to clear congressional intent.”<sup>107</sup>

Under *Chevron*, whenever considering the legality of implementing regulations under a governing statute, courts are to determine, first, whether Congress has directly addressed the question at issue, and, second, whether the agency’s interpretation of the statute is reasonable.<sup>108</sup> If Congress has not specifically commented on the question, either in the statute or the legislative history, then courts may rely on the expressed purpose(s) of the statute, the policy concerns that motivated the enactment, and a parsing of the statutory language and history for any discernible congressional “intent.”<sup>109</sup> Only if the regulations are found to be an unreasonable interpretation of the statute—that is, “arbitrary, capricious, or manifestly contrary to the statute”<sup>110</sup>—should a court substitute its own construction of the statute.<sup>111</sup>

## 2. Administrative Acts and Regulations Must Not Be Manifestly Contrary to Congressional Statutes

FARRA and its legislative history<sup>112</sup> are silent on diplomatic assurances or any similar discretionary power to end a CAT application. Therefore, under the *Chevron* rule discussed above, INS regulations concerning diplomatic assurances must fall within a permissible construction of the statute.<sup>113</sup> More specifically, they cannot be “arbitrary, capricious, or manifestly contrary to the statute.”<sup>114</sup> If the regulations cannot be harmonized with the statutory program, they are considered null.<sup>115</sup>

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107. *Chevron*, 467 U.S. at 843 n.9 (1984); followed in *I.N.S. v. Cardozo-Fonseca*, 480 U.S. 421 (1987)(where the Supreme Court declined to defer to BIA regulations that uniformly applied fear of persecution standard to asylum and withholding of removal claims despite clear congressional intent behind the two forms of relief called for distinct standards).

108. *Chevron*, 467 U.S. at 844.

109. See, e.g., *id.* at 862-863.

110. *Chevron*, 467 U.S. at 844.

111. See Kristine Cordier Karnezis, Construction and Application of “Chevron Deference” to Administrative Action by United States Supreme Court, 3 A.L.R. Fed. 2d 25, §11 (2005).

112. Sen. Exec. Rpt. 101-30, *supra* note 48.

113. *Chevron* rule, *supra* note 107.

114. See *Household Credit Services, Inc. v. Pfennig*, 541 U.S. 232, 239 (2004)(quoting *Chevron*, 467 U.S. at 843-44).

115. See *Rulemaking Defined and Distinguished*, 2 Fed. Proc., L. Ed. §2:69, citing *Dixon v. U.S.*, 381 U.S. 68, 74 (1965).

While the *concept* of reliable diplomatic assurances may not be manifestly contrary to FARRA,<sup>116</sup> the *non-reviewability* of such diplomatic assurances appears to be so, for the Act implicitly guarantees full judicial review of final orders of removal in its provisions on “policy” and “review and construction.” First, subsection (d) of the Act provides that there can be no judicial review of the regulations adopted to implement the Act, claims raised directly under CAT or FARRA, or “any other determination made with respect to the application of the policy set forth,” *except* as part of the review of a final order of removal.<sup>117</sup> The very enumeration of what courts *cannot* review outside the context of a final order of removal states what they *can* review in a challenge to a final removal order. The phrase “any other determination made with respect to the application of the policy set forth...” implies a quite broad palette of issues that are subject to judicial scrutiny,<sup>118</sup> one that would include diplomatic assurances as well.<sup>119</sup>

The second area where Congress seems to have expressed the intent to safeguard judicial review of final orders of removal is to be found in subsection (c)—“exclusion of certain aliens.” This provision orders implementing regulations to exclude from the CAT protection of withholding of removal any aliens who have persecuted others, been convicted of a serious crime and who might be considered dangerous to society, been

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116. FARRA, *supra* note 9, at §2242(c), allows the exclusion from CAT protection of aliens who have persecuted others; have been convicted of serious crime and considered dangerous; have been convicted of serious nonpolitical crimes outside the U.S., or threaten national security.

117. FARRA, *supra* note 9, at §2242(d).

118. Before the 1940s, the Supreme Court sought to balance constitutional concerns with the rising administrative state by applying what came to be known as the nondelegation doctrine. *See* *FMC v. S.C. State Ports Authority*, 535 U.S. 743, 773 (2002) (citing *Schechter Poultry Corp. v. United States*, 295 U.S. 495 (1935) for its “nondelegation doctrine”); *Panama Refining Co. v. Ryan*, 293 U.S. 388 (1935). This doctrine forbade Congress from delegating its essential legislative powers to administrative agencies. While Congress could leave the task of dealing with the “host of details with which the national legislature cannot deal directly,” it had to set clear standards and could not entrust policy choices to the agencies. *Panama Refining*, 293 U.S. at 421. In 1935, the Court struck down provisions of the National Industrial Recovery Act in *Panama Refining Co. v. Ryan* and *Schechter Poultry Corp. v. United States* on the strength of the nondelegation doctrine. Erwin Chemerinsky, *supra* note 78, at §3.10, 319-320. These two cases, and the doctrine itself, have never been directly overruled; however, no subsequent legislation has ever been struck down since on the basis of nondelegation.

119. Note that FARRA’s only limitation on judicial review in §2242(d) is that it must be of a final order of removal. It mentions no specific limitation of judicial review over certain *parts* of that order, such as administrative decisions or exercises of discretion; it simply covers “claims raised under the Convention or this section, or any other determination made with respect to the application of the policy set forth...”

convicted of a serious nonpolitical crime outside the U.S., or constitute a danger to national security.<sup>120</sup> Notably, the provision still requires the exclusion to be consistent with CAT, as ratified by the U.S., “to the maximum extent,”<sup>121</sup> and indeed such excluded aliens are not barred from being granted deferral of removal.<sup>122</sup> The U.S. has made no reservation or declaration expressing, or implying, the intent to cut short or qualify the usual administrative hearing process, or to deny federal court review.<sup>123</sup> In light of FARRA’s stated purpose of implementing CAT,<sup>124</sup> these provisions together express a clear congressional intent to guarantee CAT claimants judicial review of final orders of removal and, impliedly, any determination that might result in non-compliance with CAT. Therefore, INS regulations which deny such review run manifestly contrary to FARRA, and constitute an unreasonable statutory construction.

### 3. The Separation of Powers Doctrine and Due Process Protection

Current INS regulations implementing FARRA also raise serious constitutional questions concerning separation of powers and due process, and therefore merit close scrutiny by the courts.<sup>125</sup> The regulations state that “once assurances are provided . . . the alien’s claim for protection under the Convention Against Torture shall not be considered further by an immigration judge, the Board of Immigration Appeals, or an asylum officer.”<sup>126</sup> This provision replaces the administrative hearing process

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120. The exclusion in FARRA §2242(c) is defined by §241(b)(3)(B) of the INA, *supra* note 62.

121. FARRA §2242(c).

122. 8 C.F.R. §208.17

123. *See* Senate Exec. Rpt. 101-30, *supra* note 48. While the Senate Report included a comment that administrative authorities’ determinations would not be subject to judicial review in federal courts because the Convention was not self-executing, *id.* at 17-18, the enactment of FARRA implemented the Convention and did not carve out such an exception to judicial review.

124. Indeed, FARRA’s language mimics CAT in its definitions of key terms and policy statement. *Compare* CAT art. 3 (“No State Party shall expel, return (‘refouler’) or extradite a person to another State where there are substantial grounds for believing that he would be in danger of being subjected to torture”) with FARRA §2242(a) (“POLICY – It shall be the policy of the United States not to expel, extradite, or otherwise effect the involuntary return of any person to a country in which there are substantial grounds for believing the person would be in danger of being subjected to torture, regardless of whether the person is physically present in the United States”).

125. *See Chevron*, 467 U.S. 837. *See also* *Enwonwu v. Chertoff*, 367 F.Supp. 2d at 67, n.20 (stating that removal aliens have a liberty interest in being free from torture).

126. 8 C.F.R. §208.18(c)(3).

that is an alien's minimum due process right,<sup>127</sup> giving the Secretary of State and Attorney General extremely broad discretion to effectively return an alien to a substantial risk of torture. Furthermore, the regulations state that the Attorney General's use of discretion, or "any administrative decision," cannot be reviewed by the appellate courts.<sup>128</sup> Such deprivation of judicial review surpasses FARRA's limitation of judicial review to final orders of removal, and excessively blocks the courts from carrying out their constitutional duty to protect individuals' due process rights—even when the individuals are excludable aliens who are physically in the United States.<sup>129</sup>

Consider the following hypothetical examples:

i. Alien X claims persecution based on membership in a social group—former informants in the Colombian drug trade—as well as fear of torture if he were sent back to Colombia. He asks for a granting of asylum or CAT protection. If the immigration officer denies his asylum claim because he doesn't believe that former drug informants are a valid social group under asylum law, then Alien X will be sent to an immigration judge for consideration of his CAT claim. If the immigration judge believes that Colombia might indeed practice torture generally, but that the evidence fails to show that Alien X, specifically, would be "more likely than not" to face torture if returned to Colombia, then Alien X will be ordered removed. At this point, Alien X may appeal to the Board of Immigration Appeals for a final review.

However, if the Secretary of State seeks and obtains diplomatic assurances, then the Attorney General will consult with the Secretary of State to decide whether these are sufficiently reliable<sup>130</sup> to accept. If the Attorney General accepts the assurances, Alien X will no longer be able to appeal to the Board of Immigration Appeals, where he could have claimed errors of fact or law.<sup>131</sup> Instead, he will only be able to appeal on questions of law or a constitutional claim to the appropriate circuit court, which will be limited to reviewing the established administrative record.<sup>132</sup> The circuit court will review the immigration judge's factual findings for substantial evidence, and any statutory interpretations *de*

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127. See *supra* note 75. See also War on Terrorism Hearing Report, *supra* note 17.

128. 8 CFR §208.18(e). *But see* FARRA §2242(d)(which does *not* mention any restriction or prohibition of judicial review of administrative orders or decisions).

129. See *supra* note 76.

130. 8 CFR §208.18(c)(2).

131. See Germain, *supra* note 62, at 186, 188.

132. 8 U.S.C.A. §1252(b)(4)(A) ("the court of appeals shall decide the petition only on the administrative record on which the order of removal is based"); see also *Grass v. Gonzales*, 418 F.3d 876, 879 (8<sup>th</sup> Cir. 2005).

*novo*.<sup>133</sup> Decisions by the Attorney General are not reviewable under current regulations.<sup>134</sup>

ii. Alien Y is barred from applying for asylum relief because he was a member of a rebel militia in Chechnya, a breakaway province in Russia. He applies for protection under CAT, though, because he fears torture if he is returned to Russia. Suppose that the immigration judge finds that Alien Y would in fact “more likely than not” face torture in Russia and grants him deferral of removal under CAT. If the Secretary of State were to seek and obtain diplomatic assurances from Russia that Alien Y would not be tortured there, the Attorney General could then terminate Alien Y’s deferral of removal. This would constitute a final order of removal, which Alien Y could appeal in a circuit court on the basis of a constitutional claim of a due process violation.<sup>135</sup>

In these scenarios, the Attorney General has the discretionary power to deny what might be appropriate relief or to revoke properly granted relief;<sup>136</sup> however, this kind of discretion to terminate CAT claims has not been authorized directly by statute, unlike that for granting asylum,<sup>137</sup> and appears to be contrary to the agency’s own history. Congress has given the Attorney General broad positive discretion to *admit* aliens through the granting of asylum.<sup>138</sup> In addition, Congress has given the Attorney General power to admit aliens who are otherwise excludable, such as those previously convicted of crimes involving “moral turpitude”

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133. See *INS v. Elias-Zacarias*, 502 U.S. 478, 481 (1992); *Celaj v. Gonzales*, 138 Fed. Appx. 710, 712 (6<sup>th</sup> Cir. 2005); *Sarr v. Gonzales*, 127 Fed. Appx. 815, 816 (6<sup>th</sup> Cir. 2005); *El Himri v. Ashcroft*, 378 F.3d 932, 936 (9<sup>th</sup> Cir. 2004).

134. See *supra* note 23.

135. See *Utah v. U.S. Att’y Gen.*, 192 Fed. Appx. 928, 932 (11<sup>th</sup> Cir.) (holding that although the circuit courts cannot review discretionary decisions by the Attorney General, they still retain jurisdiction over constitutional claims or questions of law).

136. Realistically, these kinds of discretionary decisions are often informed by policy considerations. In the first scenario, for example, the Attorney General and Secretary of State might want to guarantee some measure of protection for aliens who have helped U.S. law enforcement in the war on drugs or, conversely, to expel as many drug-dealing illegal aliens as possible. In the second scenario, the Executive may not want to welcome foreign rebels and possible Islamic terrorists. While acknowledging these political considerations, these do not render a challenge to the Attorney General’s power to make such discretionary decisions non-judicial. (If the question before us was merely to challenge an unpopular exercise of discretion, *that* might be non-judicial.)

137. INA §208(b). See also *INS v. Cardoza-Fonseca*, 480 U.S. 421, 423, 428 (1987). This discretion is non-reviewable unless manifestly contrary to law and abuse of discretion. 8 U.S.C. §1252(b)(4)(D). The Supreme Court has interpreted this standard to mean that a denial of discretionary relief is to be affirmed if it is supported by substantial evidence. *INS v. Elias-Zacarias*, 502 U.S. 478, 481 (1992).

138. INA at §1158(b).

or narcotics, or to cancel removal of inadmissible or removable aliens.<sup>139</sup> In contrast, the Attorney General's discretionary power over CAT claims derives only from regulations, not statute. This newer, broader interpretation of the term "discretion" would not necessarily be impermissible<sup>140</sup> if it was part of a reasonable interpretation of the governing statute.<sup>141</sup> However, for reasons discussed above,<sup>142</sup> such an interpretation is *not* reasonable under FARRA, because CAT protection is not discretionary relief. Therefore, the Attorney General's discretionary power to terminate CAT claims is doubtful, and the courts should be able to review all underlying determinations in the denial of a CAT claim.<sup>143</sup>

Up until recently, aliens whose challenges to denials of discretionary relief such as asylum were rejected by the Board of Immigration Appeals—either in the form of a denial to hear the appeal, or a ruling which upheld the immigration judge's decision—could still bring a habeas suit in the federal courts. While statutes and regulations have periodically limited aliens' rights to judicial review, the Supreme Court has, nevertheless upheld aliens' rights to federal habeas review. In *INS v. Saint Cyr*, the Supreme Court held that legislation that stripped courts of judicial review over petitions by aliens who had been classified as aggravated felons,<sup>144</sup> did not deprive them of habeas jurisdiction, because there was no such clear congressional intent to be found either in the statute or its history.<sup>145</sup> In so deciding, the Court relied on the "plain statement rule,"

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139. See *INS v. Saint Cyr*, 533 U.S. at 293-297.

140. See *Chevron*, 467 U.S. at 863-864. ("The fact that the agency has from time to time changes its interpretation of the term 'source' does not, as respondents argue, lead us to conclude that no deference should be accorded the agency's interpretation of the statute. An initial agency interpretation is not instantly carved in stone. On the contrary, the agency, to engage in informed rulemaking, must consider varying interpretations and the wisdom of its policy on a continuing basis").

141. *Id.* at 866.

142. *Supra* Section II(B)(2).

143. See *Massieu v. Reno*, 91 F.3d 416, 425 (3<sup>rd</sup> Cir. 1996) ("While the asylum claim is within the discretion of the Attorney General, withholding of deportation *shall* be granted if the alien satisfies the relevant standards. 8 U.S.C. §1253(h)(1)").

144. Antiterrorism and Effective Death Penalty Act of 1996, Pub. L. No. 104-132, 110 Stat. 1214 (1996)[hereinafter *AEDPA*]; Illegal Immigration and Immigrant Responsibility Act of 1996, Pub. L. No. 104-208, 110 Stat. 3009 (1996)[hereinafter *IIRIRA*]. AEDPA added a new provision to immigration laws, which stripped courts of judicial review over any final deportation orders based on the alien's having committed one of the laws' specified crimes. AEDPA §440(a), 110 Stat. at 1276. Passed a few months later, IIRIRA similarly stripped courts of appellate jurisdiction over final orders of removal based on an alien's prior commission of certain criminal offenses. IIRIRA §306(a), (codified at INA §242(a)(2)(C)), 8 U.S.C. §1252(a)(2)(C)).

145. *INS v. Saint Cyr*, 533 U.S. 289 (2001).

which requires Congress to unambiguously state any intention to invoke extraordinary constitutional powers—such as Congress’s ability to eliminate judicial review for a certain class—or to eliminate important constitutional protections like due process.<sup>146</sup> The rule is rooted in the strong presumption in favor of judicial review of administrative regulations<sup>147</sup> and Article III of the U.S. Constitution. In addition to the plain statement rule, the Court adhered to the “constitutional avoidance” principle,<sup>148</sup> which requires that, between a statutory interpretation which raises serious constitutional problems and a fairly possible alternative one, the courts must choose the latter.

Most circuit courts have followed the reasoning in *Saint Cyr* in holding that FARRA does not revoke habeas jurisdiction over CAT claims.<sup>149</sup> Congress expressly stripped courts of jurisdiction to review regulations implementing the Act, any decisions made in applying it, and any private CAT-related claim in a suit brought under FARRA—except in the context of a final removal order—but it did not expressly strip any court of habeas jurisdiction, nor did it prohibit *all* judicial review of regulations made pursuant to the Act.<sup>150</sup> FARRA simply stated that judicial review could take place only after administrative hearings had been exhausted.<sup>151</sup>

Since *Saint Cyr*, however, Congress has passed additional legislation that yet again raises separation of powers issues.<sup>152</sup> The REAL ID Act of

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146. *Id.* at 289, 298 (*citing* *Ex Parte Yerger*, 8 Wall. 85, 102 (1869) (“We are not at liberty to except from [habeas corpus jurisdiction] any cases not plainly excepted by law”)).

147. *See* APA, *supra* note 33. The APA ensures that final agency action can be reviewed by the federal courts when no other remedy is available, 5 U.S.C. §704 (2000), except for several specified agencies, such as military agencies during wartime and political party agencies. 5 U.S.C. §701(b)(1). Immigration agencies are not exempt from the APA. *Id.*

148. *INS v. Saint Cyr*, 533 U.S. 289; *followed by* *Ogbudimpka v. Ashcroft*, 342 F.3d 207, 214 (3<sup>rd</sup> Cir. 2003).

149. *See, e.g.,* *Saint Fort v. Ashcroft*, 329 F.3d 191, 201 (1<sup>st</sup> Cir. 2003); *Singh v. Ashcroft*, 351 F.3d 435, 441 (9<sup>th</sup> Cir. 2003); *Ogbudimpka v. Ashcroft*, 342 F.3d at 213-214; *Cadet v. Bulger*, 377 F.3d 1173, 1182 (11<sup>th</sup> Cir. 2004).

150. FARRA §2242(d).

151. *See id.*

152. Real ID Act of 2005, *supra* note 13, at §106(a)(4) (“Notwithstanding any other provision of law (statutory or nonstatutory), including section 2241 of title 28, United States Code, or any other habeas corpus provision, and sections 1361 and 1651 of such title, a petition for review filed with an appropriate court of appeals in accordance with this section shall be the sole and exclusive means for judicial review of any cause or claim under the United Nations Convention Against Torture and Other Forms of Cruel, Inhuman, or Degrading Treatment or Punishment, except as provided in subsection (e)”).

2005 strips district courts of habeas jurisdiction over final orders of removal, and directs all habeas-like challenges to circuit courts instead.<sup>153</sup> The circuit courts are limited to deciding questions of law and constitutional claims and remain, as under pre-REAL ID amendments, prohibited from examining anything other than the administrative record supporting the appealed decision and from reviewing underlying factual findings unless “any reasonable adjudicator would be compelled to conclude to the contrary.”<sup>154</sup> However, REAL ID expressly states that nothing in the Act should be construed to deny the circuit courts of the authority to review questions of law and constitution claims.<sup>155</sup>

Subsequent to the passage of the REAL ID Act, the circuit courts have split over whether the Act would prohibit courts from examining factual findings in the administrative record in deciding issues of law. The Act’s provision that limitations on judicial review are not to be construed “as precluding review of constitutional claims or questions of law” may seem to imply that circuit courts may review factual findings that underlie legal determinations.<sup>156</sup> If so, then the appellate courts may review whether determinations of the reliability of diplomatic assurances are supported by the evidence. However, the administrative record of a final order of removal is often silent on the reliability of forwarded diplomatic assurances, because the Attorney General’s consideration of them with the Secretary of State is not part of the administrative record. Furthermore, even if they were part of the record, such determinations would be non-reviewable, for current regulations preclude any judicial review of the Attorney General’s discretionary decisions or actions, except a granting of asylum.<sup>157</sup> Thus, INS regulations restricting the circuit courts to

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153. *Id.*

154. Scope and Standard of Review, 8 U.S.C.A. §1252(b)(4)(A),(B).

155. Judicial Review of Certain Legal Claims, Real ID Act, *supra* note 13, at §106(a)(1)(A)(iii), amending 8 U.S.C. §1252 by adding a new provision, §1252(a)(2)(D): “Nothing in subparagraph (B) or (C), or in any other provision of this Act (other than this section) which limits or eliminates judicial review, shall be construed as precluding review of constitutional claims or questions of law raised upon a petition for review filed with an appropriate court of appeals in accordance with this section.”

156. This would ensure conformity with the Supreme Court’s holding in *INS v. Chadha*, 462 U.S. at 937-39 that the courts may review a final order of removal and “all matters on which the validity of the final order is contingent.”

157. Courts do not have jurisdiction to review “any other decision or action of the Attorney General or the Secretary of Homeland Security the authority for which is specified under this title [8 U.S.C.S. §§1151 et seq.] to be in the discretion of the Attorney General of the Secretary of Homeland Security, other than the granting of relief under section 208(a) [8 U.S.C.S. §1158(a).” 8 U.S.C.S. §1252(a)(2)(B)(ii). The exception to the general rule of non-reviewability, the Attorney General’s decisions to grant asylum may be re-

the administrative record on which the removal order is based may conflict with REAL ID's intent to safeguard judicial review of constitutional claims and questions of law.

### III. JUDICIAL LIMITATIONS TO AVOID CONSTITUTIONAL INVALIDATION

While the government may legally infringe upon individual rights in certain circumstances,<sup>158</sup> the courts will, wherever possible, construe and even limit a statute in such a way as to avoid ruling on its constitutionality.<sup>159</sup> In keeping with this "constitutional avoidance" principle<sup>160</sup> and the Supreme Court's ruling in *Zadvydas v. Davis*,<sup>161</sup> a constitutional challenge of the Attorney General's discretion over diplomatic assurances and CAT claims would likely trigger a statutory construction analysis of FARRA. Such an analysis would decide whether immigration regulations' interpretation of FARRA raised serious constitutional issues and whether a possible alternate interpretation could be upheld.

In *Zadvydas*, the Supreme Court faced the decision of whether aliens who had been found removable could be held in detention indefinitely or only for a "period *reasonably necessary* to secure the alien's removal."<sup>162</sup> The statute itself specified only that an alien who was ordered removed and "determined by the Attorney General to be a risk to the community or unlikely to comply with the order of removal may be detained *beyond the removal period* and, if released, shall be subject to

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viewed under an abuse of discretion or manifest contrariness to the law standard. 8 U.S.C. §1252(b)(4)(D).

158. The Supreme Court has long held that the government may infringe fundamental rights, including due process, under certain conditions. However, government actions will not go completely unchecked: depending on the government interest that motivates the challenged government action or program, the courts will apply rational, intermediate, or strict scrutiny. Government action that discriminates against aliens generally merits strict scrutiny; in other words, the government must demonstrate an important government interest, and its actions must be narrowly tailored to serving that interest. *See Graham v. Richardson*, 403 U.S. 365, 367 (1971). However, rational scrutiny will apply in several exceptions, such as classifications setting aliens apart in self-government situations and challenges to federal immigration law that has been passed by Congress. In other words, states need only prove that the action has a rational relationship to a valid state interest.

159. *See Crowell v. Benson*, 285 U.S. 22, 62 (1932) ("When the validity of an act of the Congress is drawn in question, and even if a serious doubt of constitutionality is raised, it is a cardinal principle that this Court will first ascertain whether a construction of the statute is fairly possible by which the question may be avoided"), *quoted in Zadvydas*, 533 U.S. at 689.

160. *Id.*

161. *Zadvydas v. Davis*, 533 U.S. 678.

162. *Zadvydas v. Davis*, 533 U.S. at 682 [italics in original].

[certain] terms of supervision.”<sup>163</sup> The Court ultimately ruled that a “reasonable time” limitation applied, to be reviewable by the courts, because the government’s construction of the statute allowing indefinite detention, and promulgated in immigration regulations, would raise serious constitutional issues.<sup>164</sup> Specifically, given the fundamental liberty interest in avoiding indefinite detention, administrative proceedings that lacked “significant later judicial review”<sup>165</sup> for determining whether an alien was dangerous were deemed inadequate due process.<sup>166</sup> In the Court’s words, “the serious constitutional problem arising out of a statute that, *in these circumstances*, permits an indefinite, perhaps permanent deprivation of human liberty without any such protection is obvious.”<sup>167</sup> Thus, in keeping with its “constitutional avoidance” principle,<sup>168</sup> the Court decided the issue of post-removal detention without ruling on the validity of the statute itself.

#### A. Proposal

If Alien Y, *supra*, were to challenge the Attorney General’s power to terminate his CAT claim and protection through diplomatic assurances, he could claim that the government’s interpretation of FARRA violates his due process right to liberty from torture by granting the Attorney General improper discretion and without valid reason. While the government may point out that FARRA gives “the heads of the appropriate agencies” the task of formulating regulations “to implement the obligations of the United States under Article 3 of the United Nations Conven-

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163. *Id.* citing 8 U.S.C. §1231(a)(6)(1994 ed., Supp. V).

164. *Id.* at 690—691. The Supreme Court applied a rational basis standard of review in finding that the government’s regulatory goal of “ensuring the appearance of aliens at future immigration proceedings” was “weak or nonexistent where removal seems a remote possibility at best,” and that its second goal of “[p]reventing danger to the community” was unrelated to an alien’s removable status when there was no accompanying special circumstance like mental illness or proven dangerousness. The Court also found that the administrative hearing process, which required the alien to prove that he was not dangerous, was inadequate protection of removable aliens’ fundamental liberty rights.

165. *Id.* at 692.

166. *Id.* (“This Court has suggested, however, that the Constitution may well preclude granting ‘an administrative body the unreviewable authority to make determinations implicating fundamental rights.’”) (“The Constitution demands greater procedural protection even for property”).

167. *Id.* at 692 (emphasis added).

168. *Id.* at 688, citing *Crowell v. Benson*, 285 U.S. 22, 62, (1932); *United States v. X-Citement Video, Inc.*, 513 U.S. 64, 78; *United States v. Jin Fuey Moy*, 241 U.S. 394, 401 (1916). *Comparing to* *Almendarez-Torres v. United States*, 523 U.S. 224, 238 (1998) (“construction of statute that avoids invalidation best reflects congressional will”).

tion Against Torture,”<sup>169</sup> Article 3 contains no exceptions or overriding state interests to the prohibition of nonrefoulement: “No State Party shall expel, return (“refouler”) or extradite a person to another State where there are substantial grounds for believing that he would be in danger of being subjected to torture.”<sup>170</sup> Also, Article 3 should not be interpreted or implemented in a way that contravenes other Articles in the Convention that the U.S. has ratified without objection.<sup>171</sup> For example, no government interest could justify expelling even suspected terrorists to a country where they would be tortured, for that would violate Article 2(2), which states that “[n]o exceptional circumstances *whatsoever*, whether a state of war or a threat of war, internal political instability or any other public emergency, may be invoked as a justification of torture.”<sup>172</sup>

Even if the government successfully established a valid state interest, it would still have to prove that its process was reasonably necessary to promoting that interest,<sup>173</sup> fell reasonably within the statute’s meaning,<sup>174</sup> and included adequate procedural safeguards of Alien Y’s liberty interest.<sup>175</sup> Failing that, as the Supreme Court ruled in both *Zadvydas* and in *Hamdi v. Rumsfeld*, the courts may impose judicial limitations on the government’s statutory interpretation when necessary to preserve “the proper constitutional balance.”<sup>176</sup> While the legislative and executive branches are constitutionally entrusted with power over war, foreign relations, and immigration policy, that power is “subject to important constitutional limitations.”<sup>177</sup> In cases concerning the indefinite detention of “enemy combatants” at Guantanamo and other U.S. military facilities, the Supreme Court has required the government to provide accused combatants a quasi-judicial forum where they can contest their enemy combatant status.<sup>178</sup>

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169. FARRA §2242(b).

170. CAT art. 3, *supra* note 24. Although Article 3(2) states that “for the purpose of determining whether there are such grounds, the competent authorities shall take into account all relevant considerations including, where applicable, the existence in the State concerned of a consistent pattern of gross, flagrant or mass violations of human rights,” this provision does not amount to a loophole for government policy to override individual protection.

171. Vienna Convention, *supra* note 31, at art. 31.

172. CAT, *supra* note 24, at art. 2(2) (emphasis added).

173. *See Zadvydas*, 533 U.S. at 689.

174. *See id.* at 699-700.

175. *See Hamdi v. Rumsfeld*, 542 U.S. 507 (2004); *Rasul v. Bush*, 542 U.S. 466 (2004); *Zadvydas*, 533 U.S. at 689.

176. *Hamdi v. Rumsfeld*, 542 U.S. at 533—534.

177. *See Zadvydas v. Davis*, 542 U.S. at 695, *citing INS v. Chadha*, 462 U.S. at 941-942.

178. *Hamdi v. Rumsfeld*, 542 U.S. at 533—534.

In the case of the Attorney General's broad discretion over diplomatic assurances and CAT claims, the courts could require the addition of such procedural safeguards as appellate review of the reliability of accepted diplomatic assurances: such review could be conducted *in camera* in order to ensure confidentiality,<sup>179</sup> and the government could benefit from a presumption of reliability, rebuttable by evidence presented by CAT claimants. Judicial review might in fact indirectly *aid* the negotiation of reliable assurances, as emerging standards may serve as an effective baseline and notice. In fashioning such limitations, the courts may find state practices abroad useful reference points.

*B. Models of Judicial Review of Diplomatic Assurances Outside the U.S.*

Numerous courts abroad have affirmed their role in reviewing diplomatic assurances and have demonstrated reluctance to defer absolutely to an executive branch.<sup>180</sup> In the United Kingdom, the High Court of Justice Queens Bench Division ruled in *Youssef v. The Home Office*<sup>181</sup> that while the court "should make allowance for the way that government functions and be slow to second-guess the Executive's assessment of diplomatic negotiations,"<sup>182</sup> it maintains judicial review over such assessments.<sup>183</sup>

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179. In *Mironescu v. Costner*, regarding the Government's concerns about the risk that judicial review of diplomatic assurances would pose to confidentiality and "sensitive communications" between the Executive branch and foreign governments, the Fourth Circuit found "no reason to doubt that district courts can adequately protect the confidentiality of such communications by considering them *in camera*..." *Mironescu v. Costner*, 2007 U.S. App. LEXIS at \*27.

180. See *Youssef v. the Home Office*, 2004 WL 1640250, ¶63 (QBD)(2004); *Agiza v. Sweden*, Judgments Comm. Against Torture, 34<sup>th</sup> session, CAT/C/34/D/233/2003 (2005); *Suresh v. Canada*, 2002 SCC 1, File No. 27790, 2002 CarswellNat 7, also available at [http://www.lexum.umontreal.ca/csc-scc/en/pub/2002/vol1/html/2002scr1\\_0003.html](http://www.lexum.umontreal.ca/csc-scc/en/pub/2002/vol1/html/2002scr1_0003.html). These courts have required the executive to secure agreements regarding systematic monitoring of the removed alien's custody and treatment by the removing state, or independent NGO monitoring.

181. See *Youssef v. the Home Office*, 2004 WL 1640250.

182. *Id.* at ¶63.

183. It is important to note that the government did not claim that the courts should play no role in deciding whether diplomatic assurances are sufficient. In fact, the Home Secretary and Her Majesty's Ambassador cited judicial standards to foreign authorities, as well as the UK Prime Minister, for what could be considered minimum reliable assurances in their negotiations. *Id.* at ¶21 ("The Ambassador re-emphasized to Mr. Al Baz that even if agreement could be reached on a set of assurances, the English courts might not accept them"). See also ¶23.

The court in *Youssef* rejected the government's argument that the High Court should follow the *Wednesbury* standard of review,<sup>184</sup> under which the courts only review the exercise of administrative discretion for unreasonableness.<sup>185</sup> Instead, the court held that, absent compelling reasons against it, the individual's liberty interest at stake warranted full judicial review.<sup>186</sup> In fact, the court examined Home Office, Embassy, and the Office of the Prime Minister correspondence and records in determining whether the government unlawfully detained the petitioner alien where government negotiations with Egypt for diplomatic assurances against torture were drawn-out and ultimately unsuccessful and not relied upon.<sup>187</sup> As a result, the High Court found that Egypt's lack of cooperation on the torture prohibition—namely, its assertions that national sovereignty disallowed UK monitors, and that Egypt's domestic prohibition on torture was sufficient assurance—ultimately failed to meet the Home Office's requisite level of minimum assurances, which were “those that the Home Office had been advised a UK court would expect if a case for deportation were to be reasonably argued.”<sup>188</sup>

Since *Youssef*, the *Wednesbury* standard of reasonableness has been held to violate a claimant's right to an effective remedy under the European Convention of Human Rights. In *R. (Daly) v. Secretary of State for the Home Department*,<sup>189</sup> the House of Lords recognized that proportionality was the appropriate standard to apply where [C]onvention rights are at stake.<sup>190</sup> The *Daly* judgment relied heavily on the recent finding by the European Court of Human Rights in *Smith v. U.K.* that the *Wednesbury*

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184. *Id.* at ¶62.

185. Richard B. Lillich, *The Soering Case*, 85 A.J.I.L. 128, n.16.

186. *Youssef v. The Home Office*, 2004 WL 1640250 at ¶62. The court added that, even under the argued-for *Wednesbury* standard of reasonableness, the government still would have failed to comply with the prohibition against torture: “[T]he Home Secretary's view that there remained after 25 June 1999 a real prospect of being able to remove Mr. Youssef in compliance with Article 3 of the European Convention on Human Rights was a view that was beyond the range of responses of a reasonable Secretary of State.” *Id.* at ¶80.

187. *Id.* at ¶¶72-81.

188. *Id.* at ¶¶14, 27. Pre-*Smith v. U.K.*, [1999] Eur. Ct. H.R. 33985/96, a deportation claim such as Youssef's would have had to meet the *Wednesbury* standard, whereby government action only needed to meet a reasonable standard to justify an infringement of an individual's fundamental right under the European Convention of Human Rights.

189. *Regina (Daly) v. Secretary of State for the Home Department*, [2001] 2 A.C. 532 (HL).

190. *Id.* at 546. See also Nicholas Bamforth, *Understanding the Impact and Status of the Human Rights Act 1998 within English Law*, at vi (Global Law Working Paper, 10/2004), available at [http://www.nyulawglobal.org/workingpapers/documents/GLWP1004Bamforth\\_000.pdf](http://www.nyulawglobal.org/workingpapers/documents/GLWP1004Bamforth_000.pdf).

standard of review inadequately protected individuals' rights to effective remedy under the Convention, suggesting that *Smith* "marked the 'quietus' of the view that proportionality and *Wednesbury* review in a human rights context were 'substantially the same.'"<sup>191</sup> Under the proportionality standard, courts may review not only the reasonableness of the executive branch's assessment of diplomatic assurances, but balance competing factors of deference to the executive branch, legislative authority, and the individual's fundamental rights.<sup>192</sup>

In a Canadian case, *Suresh v. Canada*,<sup>193</sup> the Supreme Court of Canada used what can be thought of as a "balance of convenience" standard—similar to the proportionality standard set out by the U.K. courts and the European Court of Human Rights—in reviewing the government's procedure of acquiring and guaranteeing the reliability of diplomatic assurances in a Sri Lankan refugee's application for a stay of removal.<sup>194</sup> In *Suresh*, the court held that "the [CAT] phrase 'substantial grounds' raises a duty to afford an opportunity to demonstrate and defend those grounds."<sup>195</sup> Therefore, "where the Minister is relying on written assurances from a foreign government that a person would not be tortured, the refugee must be given an opportunity to present evidence and make submissions as to the value of such assurances."<sup>196</sup>

Under current immigration regulations in the United States, once diplomatic assurances are forwarded to the Attorney General, they are determinative and beyond the reach of judicial review of both administrative<sup>197</sup> and federal courts.<sup>198</sup> Although regulations preclude U.S. courts from reviewing diplomatic assurances, the courts may very well interpret those regulations to be constitutional only if they allow a judicial review mechanism: if so, these two international cases discussed above may provide useful models of how courts may uphold the customary law prohibition on torture.

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191. *Regina v. Secretary of State*, *supra* note 189, at 549.

192. *Id.* at 547.

193. *Suresh v. Canada*, *supra* note 180.

194. *Id.*

195. *Id.* at ¶119.

196. *Id.* at ¶123.

197. §208.18(c)(3)

198. Diplomatic Assurances, *supra* notes 22 and 23.

## IV. CONCLUSION

There unfortunately remain a number of countries that still employ torture on a widespread or systematic basis, most often in secrecy,<sup>199</sup> sometimes while paying lip-service abroad, and always in violation of international law.<sup>200</sup> This has led some commentators to question the force and role of international law against human rights violations such as torture, as promulgated by international institutions such as the United Nations,<sup>201</sup> or through customary international law.<sup>202</sup> The courts have emphatically affirmed the force of the international prohibition against torture and rejected inconsistency of rhetoric and action as a basis for dismissing torture claims: as articulated in *Filartiga v. Pena-Irala*, “where a nation’s pronouncements form part of the consensus establishing an international law . . . it does not lie in the mouth of a citizen of that nation, though it professes one thing and does another, to claim that his country did not mean what it said . . . If there be hypocrisy, we can only say with La Rochefoucauld that ‘hypocrisy is the homage which vice pays to virtue.’”<sup>203</sup> Nor must the gap between a state’s public profession of a universal norm, such as the prohibition of torture, and its internal laws and remedies frustrate efforts to fashion a remedy that vindicates the “repugnance of international wrongs”<sup>204</sup> and furthers “the true progress that has been made.”<sup>205</sup>

Where domestic institutions exist to further compliance with the international prohibition against torture, strengthening such institutions can

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199. Many countries that are known to torture routinely deny that they do so. See HRW Report, *supra* note 19, at 4. Also, it is often difficult to ascertain the truth: as a rule, torture is conducted in secret, and prison personnel, ranging from guards to doctors, are often complicit in using sophisticated techniques to leave few external marks on the body. *Id.*

200. Countries that have been criticized by the U.S. State Department in its most recent Human Rights Report for continuing to employ torture include: Egypt, Iran, Iraq, Jordan, Libya, Pakistan, Saudi Arabia, and Syria. 28 U.S. STATE DEPT. COUNTRY REPORTS ON HUMAN RIGHTS PRACTICES-2004.

201. See Peter J. Spiro, “The New Sovereignists: American Exceptionalism and Its False Prophets,” FOREIGN AFF. 9, 12 (November/December 2000). See also, Eric A. Posner and John C. Yoo, “Commentary: Where’s the Old Bolton When We Need Him?” *Los Angeles Times*, April 19, 2005, also available at <http://www.law.uchicago.edu/news/posner-bolton.html>.

202. See Jack L. Goldsmith and Eric A. Posner, “Understanding the Resemblance Between Modern and Traditional Customary International Law,” 40 VA. J. INT’L L. 639, 672 (2000).

203. *Filartiga v. Pena-Irala*, 577 F.Supp. 860, 864 (E.D.N.Y. 1984) [*Filartiga II*].

204. *Tachiona v. Mugabe*, 234 F.Supp.2d at 417.

205. *Filartiga I*, 630 F.2d at 890.

have a “profound impact” on the international ban against torture.<sup>206</sup> The U.S. has these means: a statute criminalizing torture and allowing for the prosecution of alien torturers upon their presence in the U.S.,<sup>207</sup> as well as two civil remedies which similarly allow for a torturer to be brought to justice, even if the torture took place entirely abroad.<sup>208</sup> The United States can do more than provide remedies for torture that has already been suffered, however: it has the structural capability to further *prevent* torture with impunity by ensuring that no individual with a valid claim of fear of torture is sent to face that fear on the strength of mere promises. Meaningful judicial review of diplomatic assurances can be formulated and carried out in a manner that both respects and strengthens the roles of the separate branches of government, allowing the U.S. not only to fulfill its duties under international law, but to reaffirm its founding principles of protecting and promoting the fundamental rights of the individual.

*Jane C. Kim* \*

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206. See Oona Hathaway, “The Promise and Limits of the International Law of Torture,” TORTURE: A COLLECTION, *supra* note 2, at 209.

207. 18 U.S.C.S. §2340A (2005)(creating criminal right of action in connection with U.S. accession to CAT).

208. TVPA, *supra* note 36, at §2; Alien Tort Claims Act, Judiciary Act of 1789, ch. 20, §9, 1 Stat. 73, 77, *codified at* 28 USCS §1350 (2005).

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