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## *Priority Conflicts as a Barrier to Cooperation in Multinational Insolvencies*

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PRIORITY CONFLICTS AS A BARRIER TO COOPERATION IN  
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# Priority Conflicts as a Barrier to Cooperation in Multinational Insolvencies

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Although we have made remarkable progress in the last decade in the management of multinational insolvencies, the fundamental anomaly remains: a global economic crisis must be managed by various national courts. Our judges must act like a team of surgeons, each of whom is able to treat only one part of the patient. This article discusses one of the most important difficulties that arise from that awkward system.

## I. THE PROBLEM OF PRIORITIES

Although insolvency systems around the world share fundamental premises and purposes, there are many variations which present substantial obstacles to cooperation among courts in the insolvencies of multinational corporations. Among the most important of these differences are varying rules governing priorities (preferences) among creditors in the distribution of the value realized in insolvency proceedings, whether liquidation or reorganization. From a broad policy perspective, the differences are not crucial, yet each one represents a contentious result in a particular case because one party or another will be advantaged or disadvantaged. Meaningful cooperation among courts will often require that one or the other priority system prevails. The question is whether a court will feel so bound by the local system so as to prevent cooperation with a foreign court.

This problem did not appear in the old-style territorialist approach to international insolvency. Each court grabbed the assets it could reach and distributed them according to local priority rules. Only when courts try to cooperate to maximize value and fairness in a multinational case does the problem of differing priorities arise. In recent years we have seen the general acceptance of “modified universalism”—a pragmatic, accommodating form of the universalist approach to insolvency that

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seeks to promote cooperation between courts and to produce results as near as possible to the ideal of a single, global proceeding.<sup>1</sup> This approach also permits a meaningful chance for a global reorganization of a business, thus avoiding the serious loss of value almost always associated with piecemeal liquidation. Yet the clash of priority systems presents a serious obstacle to the universalist project.<sup>2</sup>

The differences in priority rules are numerous.<sup>3</sup> In some countries, for example, secured parties enjoy an absolute priority in the proceeds of their collateral, while in others certain creditors may come ahead of the secured party in the distribution of those proceeds. In the latter jurisdictions, those who trump the secured party will vary from the tax collector to the insolvency administrator to the general unsecured creditors. Many countries give their own taxes a special lien or general priority while refusing to distribute anything on account of another country's taxes. Virtually all systems give a priority to moneys owed to workers, but the entitlements protected and the nature and amount of employee preferences vary greatly.<sup>4</sup> These three types of parties—secured parties, tax authorities, and employees—are favored in most systems, but in differing ways and to differing degrees.

These and other differences create a number of difficulties. The obvious one is distribution of proceeds. For example, if a division of a company is sold as a whole, including assets and operations in several countries, how shall the proceeds be allocated and distributed? But the problem goes beyond allocation in distributions. It extends to decisions about the management of the insolvency case. For example, suppose that a higher price can be obtained for the division as a whole, but one of the countries involved could realize more for its priority claimants by separately selling the assets in that country. Does that country's court have the power to cooperate in the maximization of value even if it results in a somewhat lower distribution for the creditors favored by local priorities? Note that nowadays the effect of applying local priority rules

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1. See *HIH Cas. & Gen. Ins. Ltd.*, [2008] UKHL 21, [2008] 1 W.L.R. 852, ¶ 6, available at: <http://www.publications.parliament.uk/pa/ld/ljjudgmt.htm> [hereinafter *HIH*]. The case is also known as "*McGrath v. Riddell*."

2. It should be noted that even the holdouts for territorialism in the academy admit that cooperation is important and cooperation of any kind leads quickly to the kinds of issues discussed in this paper. Lynn M. LoPucki, *The Case for Cooperative Territoriality in International Bankruptcy*, 98 MICH. L. REV. 2216, 2218-20 (2000).

3. 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 (1998).

4. See generally Janis Sarra, *An Investigation into Employee Wage and Pension Claims in Insolvency Proceedings Across Multiple Jurisdictions: Preliminary Observations*, 16 NORTON J. BANKR. L. & PRAC. 835 (2007).

will often *not* be a choice to benefit local creditors over foreigners. In almost all countries, foreigners are given equal treatment and modern communication means that many creditors, especially large multinational creditors, will file in all relevant proceedings. Thus the choice is not between local and foreign creditors but between local and foreign priority systems. The conflicts exist in both liquidation and reorganization cases, but are more subtle and more serious in the latter.

The priority issue is most highly focused when the question is turnover of assets for administration and distribution by a foreign administrator. Under the Model Law on Cross-Border Insolvency, one proceeding is designated as the “main” proceeding for a company.<sup>5</sup> That designation is given to the court in the country that is the center of main interests of the insolvent business. Although the Model Law permits secondary proceedings in each relevant jurisdiction,<sup>6</sup> it also allows turnover of assets to the main proceeding for distribution.<sup>7</sup> Modified universalism’s goal is a single worldwide distribution, which would suggest turnover of all assets to the primary court for distribution under its rules or under some protocol agreed to by the relevant courts. Assuming that a particular court is committed to advancing the universalist goal, is it prevented from doing that because the foreign court will distribute the proceeds in a way different from that commanded by the local court’s statutory priorities? Precisely that question was recently presented to the House of Lords.

## II. THE HIH CASE

HIH, an Australian insurance company, entered insolvency proceedings in Australia. It had substantial assets in the United Kingdom, primarily in the form of reinsurance claims. A provisional liquidation was opened in England and provisional liquidators appointed. The Australian liquidation court sent a letter of request to the English court asking that the English assets be released to the Australian liquidators for distribution in that proceeding. The grant or denial of the request would substantially impact the fortunes of various creditors because of a difference in the priority rules of the two jurisdictions. The

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5. G.A. 52/158, art. 2(b), U.N. Doc. A/RES/52/158 (Jan. 30, 1998), art. 2(b) [hereinafter “Model Law”]. See generally IAN FLETCHER, *INSOLVENCY IN PRIVATE INTERNATIONAL LAW: NATIONAL AND INTERNATIONAL APPROACHES* (2005); CROSS-BORDER INSOLVENCY: A COMMENTARY ON THE UNCITRAL MODEL LAW (Look Chan Ho ed., 2006). The EU Regulation has a similar provision. See Council Regulation 1346/2000, 2000 O.J. (L 160) 1 (EU).

6. Model Law, *supra* note 5, arts. 25-32.

7. *Id.* art. 21(1)(e).

Australian rules gave a priority to claimants under insurance policies over other creditors; the English rules did not.<sup>8</sup>

The lower courts decided that they were bound by the English priority rules and therefore could not release the assets to be distributed under the Australian rules. The House of Lords disagreed. Although the decision was unanimous, there was a sharp split as to the rationale for the result. The wise reader will turn to English experts to understand the full analysis of English law in the various judgments. For the international observer, the key dispute was over the role of universalism in English common law.

Three of the five members of the panel were content to decide that the restraining effect of the English priority system was overcome by the application of an unusual feature of English law, section 426 of the Insolvency Act.<sup>9</sup> That section reflects a special reciprocity in insolvency matters among a small group of jurisdictions, including Australia and England. The panel majority held that section 426 permitted the turnover of assets to the Australian proceeding notwithstanding the resulting change in distributional results.

The judgment of Lord Hoffmann, with Lord Walker's concurrence, took a very different approach. He found that universalism, in a modified and pragmatic form, was "a golden thread" running through English common law in matters of international insolvency. In his view, universalism requires that the English court turn over assets in cooperation with a foreign court as a general rule unless there is some principle of justice or UK public policy that prevents the turnover. Here, there was no such obstacle and thus turnover was required. The application of section 426 was unnecessary.

Two of the remaining three members of the panel squarely disagreed with Lord Hoffmann. Lord Scott and Lord Neuberger would have refused turnover absent the special relationship with Australia under section 426. Thus, it seems clear that these two panel members would have declined to turn over the assets to an American trustee, for example, while Lord Hoffmann and Lord Walker would ordinarily permit turnover.<sup>10</sup> Lord Phillips took a third path, agreeing with the result under section 426 and declining to reach the question of

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8. *HIH*, [2008] UKHL 21, ¶ 51. By the time of the decision in the House of Lords the English system had been altered to give a similar priority to insurance claimants. While the change did not apply to the *HIH* case, the change naturally made it easier to conclude that England had no great policy antagonism to the Australian system.

9. Insolvency Act, 1986, § 426(4)-(5) (Eng.).

10. The United States is not a section 426 nation. For the most part, the insurance industry in the United States is regulated at the state level. The state regulations generally have priority rules similar to the Australian system. *See United States v. Fabe*, 508 U.S. 491, 494 (1993).

universalism. If the same question involving a country that lacks the benefit of section 426 were to come before this panel again, his would be the decisive vote in the case.<sup>11</sup>

Lord Hoffmann pointed out that the rule favored by Lord Scott would mean that turnover would rarely occur except in those few countries where section 426 applies. The differences in detail among priority systems would ensure that result. Lord Neuberger acknowledged that result with some apparent regret.<sup>12</sup> As noted above, such a rule as to priority inevitably impacts other, larger decisions beyond turnover or allocation of proceeds, including decisions about the scope and nature of asset sales and the choice of liquidation versus reorganization. Thus, if local priority systems prevent turnover, they likely prevent many other forms of cooperation as well. For example, a refusal to apply a moratorium on asset seizures to a certain type of creditor based on local practices may doom a global effort at reorganization. For all these reasons, the fact that in Lord Hoffman's thoughtful opinion two of five judges found a form of modified universalism in English common law is the strongest and most important support for that concept in any of the modern cases.

### III. THE DISMISSAL SOLUTION

Lord Scott's position in *HIH* rested ultimately on the mandatory effect of English statutory rules in a pending "winding up" proceeding. It is not clear what rules would apply had the foreign liquidators sought possession of the assets through an appropriate civil action in the absence of an English insolvency case. The advantage to acting without opening an insolvency proceeding would be that the priority rules and other statutory constraints in the English statute would presumably not come into effect. Even if an English winding-up were pending, might it be possible to reach the same result by moving to dismiss the English proceeding on the ground of comity, while ordering the transfer of the assets?

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11. The European Regulation has no provision similar to section 426.

12. *HIH*, [2008] UKHL 21; [2008] 1 W.L.R. 852, ¶ 76.

The idea that dismissal of the “secondary” proceeding<sup>13</sup> solves the technical problem of local rules constraining cooperation has taken root in the United States. Since the adoption of section 304 of the United States Bankruptcy Code in 1978,<sup>14</sup> United States courts have become used to the idea of two different sorts of insolvency cases for foreign companies: a full proceeding and a special “ancillary” proceeding. The full proceeding is of the same sort used for domestic companies. The special “ancillary” proceeding is designed solely for cooperation with a foreign proceeding by way of injunction against creditor action, turnover, discovery, and the like. This special proceeding does not have rules for claims processing, distribution of proceeds, and other systems characteristic of a regular domestic insolvency case. A companion provision, section 305, gives the courts the authority to dismiss a full insolvency case in the best interests of creditors or in deference to a foreign proceeding. Thus, an American bankruptcy court could resolve the problem presented in *HIH* by dismissing the full United States insolvency case with its constraining rules of priority and procedure, eliminating any conflict between those rules and its discretion to release United States assets to a foreign “main” proceeding.<sup>15</sup>

The replacement of section 304 with the new Chapter 15 points to the same approach. Dismissal as a tool of cooperation following the adoption of Chapter 15 is illustrated by *In re Compañía De Alimentos Fargo, S.A.*,<sup>16</sup> although that case did not involve a priority issue as such.<sup>17</sup> In that case an involuntary insolvency proceeding was

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13. The idea of a full local insolvency case as a “secondary” proceeding permeates the EU Regulation. See, e.g., 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); IAN F. FLETCHER, *INSOLVENCY IN PRIVATE INTERNATIONAL LAW* 246 (1999); Manfred Balz, *The European Union Convention on Insolvency Proceedings*, 70 AM. BANKR. L.J. 485, 489 (1996); Wolfgang Lueke, *The New European Law on International Insolvencies: A German Perspective*, 17 BANKR. DEV. J. 369, 395 (2001); Robert Wessels, *European Union Regulation On Insolvency Proceedings*, 20 AM. BANKR. INST. J. 24, 26 (2001). The Model Law also contemplates local full bankruptcy proceedings, but does not call them “secondary.”

14. Section 304 was the predecessor to Chapter 15 of the Bankruptcy Code governing cooperation with foreign insolvency proceedings. Chapter 15 essentially adopts the Model Law.

15. See, e.g., *In re Axona Int’l Credit & Commerce, Ltd.*, 88 B.R. 597 (Bankr. S.D.N.Y. 1988), *aff’d*, 115 B.R. 442 (Bankr. S.D.N.Y. 1990), *appeal dismissed*, 924 F.2d 31 (2d Cir. 1991) (following U.S. preference recovery, U.S. case dismissed and assets transferred to Hong Kong proceeding).

16. 376 B.R. 427 (Bankr. S.D.N.Y. 2007). See also *In re Bd. of Dirs. of Multicanal S.A.*, 314 B.R. 486 (Bankr. S.D.N.Y. 2004), *rev’d on other grounds* *Argentianian Recovery Co. LLC v. Bd. of Dirs. of Multicanal S.A.*, 331 B.R. 537 (S.D.N.Y. 2005).

17. No Chapter 15 case was filed in *Fargo*. For a case that did involve Chapter 15, see *In re Bd. of Dirs. of Telecom Argentina, S.A.*, 528 F.3d 162 (2d Cir. 2008) (Chapter 15 case in which approval of reorganization not barred by differences in rules).

commenced against an Argentinean company, Fargo, by certain of its United States creditors despite the pendency of a reorganization proceeding in Argentina. The creditors claimed the foreign proceeding was being conducted unfairly if not corruptly. In particular, the petitioning creditors were concerned that a major secured creditor in the case had too much leverage because the Argentinean stay did not apply to secured parties. Although there were few assets to administer in the United States, they apparently hoped the United States moratorium would apply to the secured party and thus level the playing field. The bankruptcy court refused to fall in with this plan and dismissed the United States case in deference to the Argentinean one, after finding that Argentinean insolvency law was generally fair.

Aside from claims of corruption and complaints about procedure, the petitioners drew the judge's attention to important differences between the United States and Argentinean systems. For example, Argentina does not provide for "equitable subordination" of claims, nor does it grant broad discovery to unhappy creditors. The court was not persuaded that these differences were fundamental enough to justify a parallel proceeding in the United States. Note that these and other differences in procedure might well have as much practical impact in a multinational case as a difference in priority.

#### IV. OBSTACLES TO THE DISMISSAL SOLUTION

I do not know in which jurisdictions the dismissal solution can be employed, but certainly in a number of countries the similar problem of parallel civil litigation is resolved by the dismissal of the local action where the law requires deference to the foreign one. In common law countries, such a dismissal might be pursuant to the concept of *forum non conveniens* or simple abstention.<sup>18</sup> In civil law countries, the fact that the foreign action was filed first may give rise to a dismissal *lis pendens*. Perhaps the same concepts should be available in the bankruptcy context where the foreign proceeding deserves deference.

The main substantive difficulty is a sort of vested rights theory, a notion that a creditor has a right to a certain distribution of those funds that come under control of a given court.<sup>19</sup> A related argument is that the application of local law to the claims filed in each jurisdiction yields

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18. See AMERICAN LAW INSTITUTE, TRANSNATIONAL INSOLVENCY: COOPERATION AMONG THE NAFTA COUNTRIES 76-82 (2003) (Procedural Principle 23 and 24). See generally RUSSELL J. WEINTRAUB, INTERNATIONAL LITIGATION AND ARBITRATION: PRACTICE AND PLANNING 211-70 (5th ed. 2006); ANDREAS F. LOWENFELD, INTERNATIONAL LITIGATION AND ARBITRATION 300-49 (3d ed. 2003).

19. See Lynn M. LoPucki, *Cooperation in International Bankruptcy: A Post-Universalist Approach*, 84 CORNELL L. REV. 696, 709-13 (1999).

more predictable results. This idea might have had some basis when bankruptcy laws were oriented to the protection of local creditors, but nowadays many creditors file in each local proceeding around the world.<sup>20</sup> The amount to be distributed by a particular court in a territorial system is a free-floating function of a) the assets of the debtor that happen to be in its jurisdiction at the moment when those assets become subject to the local moratorium or dispossession order and b) the number and amount of the claims that may be filed in that court by both local and international creditors. The amount to be distributed is therefore often impossible to predict even at the start of the local case, much less at the time credit was extended. Even secured creditors, unless they have a mortgage on real property, are subject to the rapid movement of personal property and its proceeds from one jurisdiction to another, a mobility that may make a mockery of “situs” choice-of-law rules.

Therefore, it would seem that a notion of vested rights or creditor reliance will often be implausible and impractical in the application of distribution rules, while making cooperation impossible in many cases for the reasons explained earlier. If we are to have a workable system of international cooperation, we have to choose a single priority system for distribution that reflects these realities. In most cases, the approach that will produce the most predictable and generally fair result—although by no means highly predictable or completely fair—will be to distribute assets through the main proceeding or under its distribution rules. If we become dissatisfied with the current approach to determining which proceeding is the main one,<sup>21</sup> then we should focus our efforts on developing a better one, because there is no other solution that shows promise.

It is hard to see how international creditors—banks, investment funds, large international suppliers, and the like—could object to such an approach. However, there is a legitimate concern about small, local creditors, including employees and suppliers. These creditors cannot be expected to be sophisticated in planning for insolvency risks or able to protect themselves in distant proceedings. It is for that reason that we should have a system of claims facilities in any jurisdiction where there are a substantial number of such creditors. Such a facility, operating through the courts or through a system of arbitration, could permit these creditors to make and prove their claims at home and in their own languages. If there are too few creditors to justify such a system in a

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20. See Jay Lawrence Westbrook, *A Global Solution to Multinational Default*, 98 MICH. L. REV. 2276, 2292 (2000).

21. That is the “center of main interests” test. See generally *Case C-341/04, In re Eurofood IFSC Ltd.*, 2006 E.C.R. I-3813; *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, 389 B.R. 325 (S.D.N.Y. 2008).

given country, it would be sensible to pay them in full from local assets before the assets are transferred to the main proceeding. Such a system has been recommended by the American Law Institute's Transnational Insolvency Project.<sup>22</sup>

There is a second group of claims that require special attention in this context: tax and other public claims. The problem here is that many insolvency laws refuse to enforce such claims in favor of foreign tax authorities. It is probably essential to international cooperation to pay such claims locally before transferring property to a main jurisdiction that has such laws. Neither fairness nor public reaction could abide permitting a foreign corporation to hoodwink local taxing authorities or otherwise milk the local public purse and then whisk away the local assets without payment of these public claims.

Finally, there is the question of claims in tort (delict). This sort of claim has the potential to create concern about universalism, especially in common law countries with rules relatively favorable to tort claimants. The concern would be that these claimants would not receive fair treatment in a primary jurisdiction where claims of that sort are not favored.<sup>23</sup> On the other hand, cases dealing with such claims have managed to find acceptable compromises. The most notable example is the Dow Corning (silicone implant) case in the United States.<sup>24</sup> Furthermore, it is important to note that no country offers a priority to tort claimants generally, so the policymakers have not indicated a special concern for those claimants. Whatever the proper solution, this area is another one that may require some special rules once we have enough litigation to better understand the issues presented.

## V. CONCLUSION

Modified universalism has received a strong impetus from the eloquent opinion of Lord Hoffman in *HIH*. It is one of several major steps forward that we have taken in the effort to match the reach of insolvency laws to the boundaries of a global market. Yet we have far to go. An important obstacle to cooperation and the ultimate ideal of a single, worldwide proceeding is the presence of so many varying rules

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22. AMERICAN LAW INSTITUTE, PRINCIPLES OF COOPERATION IN TRANSNATIONAL INSOLVENCY CASES AMONG THE MEMBERS OF THE NORTH AMERICAN FREE TRADE AGREEMENT Procedural Principle 22 (2003).

23. The pendency of tort claims in the United States and claims by another group of sympathetic parties, pensioners, in the United Kingdom was a major factor hindering cooperation in the Federal Mogul multinational bankruptcy.

24. See, e.g., *Roberts v. Picture Butte Municipal Hospital*, [1999] 4 W.W.R. 443 (A.Q.B.) (staying a Canadian tort action in deference to a global settlement in an United States Chapter 11 proceeding).

concerning the distribution of the values realized by insolvency proceedings. The way forward in some jurisdictions may be found in the dismissal solution combined with sensitivity to the special treatment that may be appropriate for certain types of claims.