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Value Tracing and Priority in Cross-Border Group Bankruptcies: Solving the Nortel Problem from the Bottom up

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I. INTRODUCTION

The *Nortel*[2] bankruptcy case is simultaneously the biggest success and biggest failure in the recent history of cross-border restructuring practice. On the plus side, the coordinated sale of an insolvent telecom firm's key assets created a pool of value worth $7 billion—much larger than could have been accomplished through piecemeal local liquidation of spectrum licenses and intellectual property rights.[3] Indeed, that pool of assets was much more valuable than anybody imagined when the firm filed its bankruptcy petition. On the minus side, the fights over value allocation swallowed up a gargantuan part of that value—an estimated $2.6 billion.[4]

The fights centered on alleged entitlements to priority—upward deviations from equal treatment and *pro rata* distribution. These fights were complicated by Nortel's structure as a global corporate group. The claims were based on, among other things: (1) liens; (2) corporate structure; (3) territorial jurisdiction; and (4) local statutory priorities. Interactions among these claims to priority made it virtually impossible to unscramble the egg.

The court's answer to the problem, dividing the pool of value amongst all proceedings pending for the Nortel group, has been characterized as a partial substantive consolidation and has proven controversial. In our view, the court's solution—*pari passu* distribution by estate—reached the right substantive result but got there by the wrong route. By calling the approach "partial substantive consolidation," the court framed its order as relying on "substantive consolidation," an extraordinary remedy that

[2] In re Nortel Networks Inc., No. 11-53454(KG), 2016 WL 2584092, at *1 (Bankr. D. DE. May 2, 2016).
[3] *Id.* at *1.
[4] Donald L. Swanson, *The Monstrous Costs of Mediation Failures (the Nortel Networks Bankruptcy, Part One)*, AM. BANKR. INST. (last visited Apr. 2, 2020), https://www.abi.org/feed-item/the-monstrous-costs-of-mediation-failures-the-nortel-networks-bankruptcy-part-one.

disrespects the corporate form and is available only when the court finds bad behavior or disrespect of corporate formalities.[5]

What actually happened was something far more mundane—a failure by the various creditors to establish their claims to priority. The outcome in *Nortel* is a natural incident of any rescue case involving an integrated firm. The goal of corporate rescue is to preserve going concern value—the surplus value of the consolidated enterprise. This is precisely the increment of value that cannot be allocated amongst the various entities in a corporate group.

In this paper we propose to rethink the method used to allocate both enterprise value and governance power in rescue cases. Our approach seeks to simplify value allocation in cases like *Nortel* without disrespecting either the corporate form or disturbing property rights. As an added benefit, we seek to correct a "governance" problem that adds expense to the coordinated liquidation of consolidated firms and endangers rescue in cases where a firm hopes to continue in operation.

As we see it, the common error is that creditors frequently assert claims based on a top-down approach to distributional priority that rests on a myth—the single distributional waterfall—that simply does not reflect reality or the law. As we will discuss later, in multinational cases involving corporate groups, claims to priority are plural rather than hierarchical. In cases like *Nortel,* however, when bankruptcy entitlements are mistakenly viewed as hierarchical, uncertainty about the location of firm value and firm assets creates a knot of veto rights that, as a practical matter, inverts the proper legal allocation of governance rights. Under corporate law, governance rights generally run from the bottom up, with power to decide the firm's future lying with the fulcrum security or residual claimant. By contrast distributional property rights run from the top down, with asset-based claims being paid prior to unsecured claims or equity. The higher a claimant's distributional priority the weaker its claim to control over the firm's decisions.

Paradoxically, when a debtor's value is uncertain, and multiple creditors in multiple entities can claim seniority, claims to priority become

[5] Nortel Networks Corp. (Re), [2015] ONSC 2987 (Can. Ont. Sup. Ct.); *see* Michael Barrett, *Substantive Consolidation After Nortel: The Treatment of Corporate Groups in Canadian Insolvency Law*, Insolvency Institute of Canada, *available at* https://www.insolvency.ca/en/whatwedo/resources/SubstantiveConsolidationAfterNortel_TheTreatmentofCorporateGroupsinCanadianInsolvencyLaw.pdf.

veto rights. Multiple nominally senior creditors can use their claims to distributional priority to hold a restructuring hostage, regardless of whether their priority claim is realizable as a practical matter. The right to be paid first becomes the right to decide. But worse, where there are multiple such claims, the right to decide becomes a power to obstruct.

We suggest a simple, perhaps naïve, solution to this problem: a creditor asserting priority should have the burden of establishing the realizable value of its claim. Rather than assuming that the priority of entitlements run from the top down, in rescue cases a claim's priority should be established from the bottom up; any claim to distributional entitlement that exceeds a *pari passu, pro rata* distribution must be traced to particular encumbered assets, or to enterprise value that can be situated in a distinct entity. Further, such claims of priority should be limited to their demonstrable realizable value.

This approach has an important practical benefit for governance purposes; the veto-power associated with a claim of distributional priority is fixed and can be satisfied by payment of the realizable amount. The key move here, however, is not substantive consolidation; it is realization. Opening a proceeding fixes the relative position of creditors and operates as a realization on their collateral. To the extent that rescue increases the value of the firm beyond the value of its component parts, that value is shared. By shifting the burden of establishing priority, our approach ensures that distribution can run from the top down, within entity (and territorial) silos, while governance will run from the bottom up, maximizing the value of the firm.

One feature of this approach is novel, however. Since priority claims are limited to value that can be situated in particular assets or entities, a significant portion of the value of the enterprise may be "homeless." Since the firm is insolvent, this is not "equity" that flows up to the parent. Instead, it is enterprise value that inheres in the corporate group. Corporate law does not, as a formal matter provide a place to put this residual going concern value. Corporate groups are not "entities" in any legal sense. However, the going concern value of a group is an asset of the group as a whole. This pool of enterprise value that cannot be situated in any one asset, entity or country constitutes a rump estate that must be shared. Crucially, this pool of enterprise or going concern value is not extraordinary (as it must be to merit substantive consolidation). Instead, its existence is inherent in any rescue regime. The very essence and purpose of rescue is to preserve firm specific value, in excess of the sum of the parts. To the extent that local assets, entity assets, or liened assets

prove insufficient to satisfy the creditor's claim the deficiency should be assertible against that residuum—the "rump estate." As a practical matter this is what happened in *Nortel but* calling it "substantive consolidation" is a misnomer.

This article proceeds in three steps. First, it describes the current architecture for dealing with the insolvency of corporate groups and the problem posed by cases like *Nortel* and *Lehman.* Second, it details the various types of claims to priority that can exist within a corporate group and explores the nature of priority and develops the concept of "homeless value." Claims to priority may be hierarchical or they may be plural. They may be traceable to assets, countries, or entities, or they may inhere in the group. Regardless, when a firm continues to operate in bankruptcy, (or is sold as a going concern) the relative position of the claimants must be fixed at the outset. Thereafter, subject to respecting the priority of the newly fixed claims, governance should be situated with the variable claimants to this unsituated value—the "rump estate." These are the claimants who will benefit from any increase in value and pay for any decrease. Third, working from the general bankruptcy principal of equal treatment or *pro rata distribution* we suggest an approach to value allocation that would vastly simplify cases like *Nortel,* but which also provides a mechanism to allocate value in rescue cases where the firm continues to operate. The simple point is that priority claimants should have the burden of establishing the realizable value of their priority. This establishes an entitlement floor for, and limits the veto rights of, these priority claimants. As such, it provides a legal default for allocating value in going concern sale cases, and a cram-down standard for restructurings.

II. MODIFIED UNIVERSALISM AND ITS LIMITS: VALUE MAXIMIZATION V. VALUE ALLOCATION

The past thirty years have seen a remarkable development of cross-border practice in insolvency cases. As major global corporate groups have failed, administrators and judges around the globe have explored the limits of their power to coordinate sales and restructurings in global cases. This exploration has occurred largely under the principle of modified universalism, a framework built on comity where local courts recognize the effects of an insolvency proceeding commenced in one jurisdiction

throughout the world.[6] Global recognition allows for a coordinated approach to realization of the value of the firm for the benefit of all creditors, regardless of their respective location. Modified universalism contemplates a single proceeding, pending at the debtor's center of main interest (COMI), that administers the firm and realizes on its value globally. This global proceeding allows the administrator to pursue value-maximizing strategies such as a going-concern sale or a recapitalization of the firm. Modified universalism forms the basis for both the UNCITRAL Model Law on Cross-Border Insolvency, and the European Union Insolvency Regulation. Under both instruments local courts are called upon to recognize and give effect to the orders of the COMI court. There have been some hiccups along the way. For example, coordination is more difficult when the members of a corporate group do not share the same COMI.[7] This has not proven fatal to the overarching vision, however, and the recent promulgation of the UNCITRAL Model Law on the Insolvency of Corporate Groups should help in this regard.[8]

Value maximization has been the key driver of, and the payoff for adopting the modified universalist approach.[9] The legal framework is procedural, but the benefits are substantive. Where global restructurings have worked, they have been held together by the prospect of mutual advantage. This concept of mutual advantage is both a practical corollary and legal prerequisite to global cooperation—each creditor must be made better off (or at least be "adequately protected"). Obtaining creditor support of a collective solution, thus, requires a plan to offer an improvement of position over going it alone—a going concern or coordination surplus.

However, assuring mutual advantage requires an entitlement baseline, both to assure creditors of fair treatment and to prevent creditors from

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[6] *See* Jay L. Westbrook, *A Global Solution to Multinational Default*, 98 MICH. L. REV. 2276, 2299, 2302 (2000); John A. E. Pottow, *Procedural Incrementalism: A Model for International Bankruptcy*, 45 VA. J. INT'L L. 935, 992 (2005). *But see* Lynn M. LoPucki, *Cooperation in International Bankruptcy: A Post Universalist Approach*, 84 CORNELL L. REV. 696, 750 (1998-1999). In previous articles, one of us has staked a claim to a slightly different type of "universalism," "universal proceduralism." *See* Edward Janger, Universal Proceduralism, 32 BROOK. J. INT'L L. 819, 820-21 (2007). For the purposes of this essay, the differences are not relevant. More to the point, the proposals discussed in this essay are consistent with Universal Proceduralism, and in our view represent a necessary extension to Modified Universalism.

[7] See Irit Mevorach, *The 'Home Country' of a Multinational Enterprise Group Facing Insolvency*, ICLQ vol. 57, April 2008 pp 427–448.

[8] *See* text at note 39, *infra*.

[9] *See e.g.*, Irit Mevorach, *The Future of Cross-Border Insolvency*, 14-15 (2018).

overreaching each other and the debtor.[10] Where there is no entitlement baseline, opportunistic use of situational leverage by key suppliers, creditors or trading partners to extract concessions may destroy the ongoing business, and fights over allocating going concern sale proceeds can fritter away any collective benefit. As *Nortel* illustrates, fights over allocating the additional increment of value created by a global insolvency solution can endanger orderly resolution. Unfortunately, modified universalism does not provide a mechanism or a basis for resolving disputes about either how to maximize value (governance) or value allocation (priority). Instead, it sits atop a congeries of corporate governance regimes and systems of territorial priority, buoyed by the hope that the parties and courts will work it out. To accomplish this, modified universalism relies on broad principles like comity and adequate protection. Miraculously, sometimes it works out, but it can get messy (and expensive).

a. *Value allocation and governance: the twin blind spots of modified universalism*

i. Value Allocation and the Empty Core

As noted above, Nortel may serve as the best example for both the success and failure of the modified; universalist approach. Instead of liquidating the assets of the firm separately—as they were spread around the world, Nortel's administrators followed a coordinated strategy and pooled the firm's key assets (spectrum and intellectual property licenses) which allowed them to sell these assets in a single auction. Here, competing bids of major market participants drove the price up to unforeseen levels and generated about $7 billion in cash.[11] Value-maximization happened. The modified universalist idea worked.

Nortel also provides the most vivid demonstration of the weak spot in today's international framework of cross-border insolvency. Modified universalism lacks a global substantive legal framework for allocating the excess value created by resolving the firm as an integrated whole. Once the proceeds of the coordinated sale were locked in an escrow account, the fight over value allocation began on a global scale. In *Nortel*, this fight lasted for more than 8 years and generated costs estimated at $2.6 billion.[12]

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10 Edward Janger, *Silos: Establishing the Distributional Baseline in Cross-Border Bankruptcies*, 9 BROOK. J. CORP. FIN. & COM. L. 180, 181-82 (2014).
11 Nortel, *supra* note 2, at *2.
12 *Id.* at *16.

A significant piece of that fight was due to US bondholders, who hoped to receive larger distributions in the US than their Canadian or European counterparts. After a costly attempt at mediation failed,[13] the Canadian and US courts solved this problem through a mechanism they called partial substantive consolidation.[14] The various estates shared pro rata in the value of the assets of the company. Equality of distribution trumped claims to priority based on nationality.[15]

A second example of the problem of value allocation in cross-border cases arose in the *Lehman* bankruptcy.[16] Lehman Brothers was a complex global business.[17] In order to keep track of its money, it had a centralized cash management system.[18] Operating funds were disbursed to subsidiaries on a daily basis, but overnight they were returned to a central account, managed out of London.[19] When Lehman failed, disputes arose as to whether funds were located in the subsidiaries all over the world, or centralized in the subsidiary in London that operated the cash management system. Significant assets were spent trying to answer the question, but at the end of the day, the result was indeterminate. The money was in the firm, but not in any one subsidiary at any one moment.

The difficulty in both cases was that money could not be distributed to creditors until these disputes over priority were resolved. On the one hand, the cases were successful at liquidating the businesses without disputes over allocation standing in the way. On the other hand, the

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[13] Steven Church, *Nortel Mediation Over Splitting $9 Billion Extended by Judge*, BLOOMBERG (Jan. 22, 2013, 6:51 PM), https://www.bloomberg.com/news/articles/2013-01-22/nortel-mediation-over-splitting-9-billion-extended-by-judge-1-; Donald L. Swanson, *The Monstrous Cost of Mediation Failures (the Nortel Networks Bankruptcy, Part One)*, ABI, https://www.abi.org/feed-item/the-monstrous-costs-of-mediation-failures-the-nortel-networks-bankruptcy-part-one.

[14] *Id.* at *1-2.

[15] Peg Brickley, *Nortel Creditors Fail to Reach Deal on How to Split $7.3 Billion*, WALL ST. J. (Oct. 7, 2016, 5:36 PM), https://www.wsj.com/articles/nortel-creditors-fail-to-reach-deal-on-how-to-split-7-3-billion-1475876175.

[16] Lehman Bros. Special Fin. Inc. v. BNY Corp. Tr. Serv. Ltd. (*In re* Lehman Bros. Holdings Inc.), 422 B.R. 407, 416 (Bankr. S.D.N.Y. 2010).

[17] Richard Herring, *The Challenge of Resolving Cross-Border Financial Institutions*, 31 YALE J. ON REG., 853, 867 (2014).

[18] *Id.* at 870.

[19] *Id.*; *see also* Richard S. Miller et al., *Lessons of the Lehman Brothers Bankruptcy: Global Cash Management v. Legal Provincialism* in Global *Financial Markets – Legal, Policy and Regulatory Analysis*, 1 K & L GATES 1, 6-7 (2008), *available at* http://www.klgates.com/global-financial-markets--legal-policy-and-regulatory-analysis-11-17-2008/#lessons.

absence of a robust set of rules for allocation made it extremely expensive to figure out how to distribute the proceeds.

Nortel and *Lehman* demonstrate that, in global group cases, the increment of untraceable value can be quite large, even when the value is in the form of relatively discrete assets—cash, or the proceeds from the sale of spectrum licenses. For many firms much of the firm's value will inhere in income generated by operations—the "going concern value" of the firm. The increment of extra value that is generated by continuing the operation of the business will often, by definition, be impossible to allocate to a particular piece of property or to situate in a particular subsidiary or country. When there are multiple claims to an undifferentiated pot of money, then it is worth fighting over. And, when there is no principled basis for distributing that pot, the allocation is necessarily arbitrary. Moreover, negotiations among multiple claimants about "dividing the dollars" frequently end in what game theorists call an "empty core," with the various stakeholders caught in an endless cycle of negotiation.[20]

ii. Governance and Situational Leverage

The value allocation questions in both *Nortel* and *Lehman* arose after the estate had realized on the value of the various businesses. This is not always the case. Allocation questions may also arise in the midst of efforts to keep the business afloat. The confounding of governance and allocation is made worse when the claims of entitlement are used opportunistically to hold a restructuring hostage to a reordering of the bankruptcy priority scheme. In the US, a common issue is the need to pay "critical vendors."[21] Sometimes a key supplier or trading partner will refuse to do business with the reorganizing debtor unless prepetition debts are paid in full. Technically, this is a violation of the automatic stay, but the need to preserve the trading relationship will often override the protection of the stay. A similar example arises when airlines wish to honor their frequent flyer mile program, or stores wish to honor their gift certificates in order to maintain and preserve customer goodwill. As a practical matter, courts routinely approve payments to such creditors. The basis for doing so is unclear. Some US courts rely on 11 U.S.C. 105 and the so-called "doctrine

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[20] *See generally* Kenneth A. Shepsle, ANALYZING POLITICS: RATIONALITY, BEHAVIOR, AND INSTITUTIONS (2d. ed. 2010) (explaining the idea about empty core and the divide of the dollars claim); *see* Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L.J. 648, 687-98 (2010). Edward J. Janger, *The Costs of Liquidity Enhancement: Transparency Cost, Risk Alteration, and Coordination Problems*, 4 BROOK. J. CORP. FIN. & COM. L. 39 (2009).

[21] *See, e.g.*, In re Kmart Corp., 359 F.3d 866, 868–72 (7th Cir. 2004).

of necessity."[22] Other courts rely on 11 U.S.C. 363(c) and the power to use and sell property of the estate in the "ordinary course."[23] Neither rationale is particularly satisfying, but, again, the practice is common. Courts in other jurisdictions follow a similar line.[24]

Situational leverage is often a feature in the negotiation of debtor-in-possession financing. For example, in the *Lyondell* case, the court approved a post-petition financing order under which, for each dollar loaned on a secured basis, a dollar of unsecured prepetition debt would also be rolled into the secured claim. [25] In other words, for each dollar loaned, the debtor put up two dollars in collateral, one of which secured the new money, and the other of which secured a previously unsecured loan. The terms were extraordinarily generous, and the willingness of the debtor to make such a promise flowed from the debtor's acute need for cash during the early stages of the case. [26]

Debtor and judicial acquiescence to situational leverage also play a role in cross-border restructurings. As Judge Gropper has pointed out, "The usual practice is for U.S. debtors to pay all foreign creditors, not merely priority creditors."[27] In other words, when a multinational enterprise files for bankruptcy in the US and there is a desire to keep the business operating, instead of relying on the protection of the automatic stay the usual practice is simply to keep paying the foreign creditors, notwithstanding that this prefers their prepetition claims over other creditors who are not being paid.

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[22] In re Just for Feet, Inc., 242 B.R. 821, 824–25 (Bankr. D. Del. 1999).

[23] In re Kmart Corp., 359 F.3d 866, 868–72 (7th Cir. 2004); In re Lehigh and New England Ry. Co., 657 F.2d 570, 581 (3d Cir. 1981); In re Penn Cent. Transp. Co., 467 F.2d 100, 102 (3d Cir. 1972); In re Just for Feet, Inc., 242 B.R. 821, 823–25 (Bankr. D. Del. 1999); In re Columbia Gas Sys., Inc., 171 B.R. 189, 191–92 (Bankr. D. Del. 1994).

[24] *See e.g.*, Bundesgerichtshof [BGH] [Federal Court of Justice] Apr. 11, 2004 – IX ZR 22/03 (Ger.) Enabling such payments based on a test of them being beneficial for the overall estate similar to the "doctrine of necessity."

[25] Final Order (I) Authorizing Debtors (A) To Obtain Postpetition Financing, (B) To Utilize Cash Collateral and (C) To Purchase Certain Assets and (II) Granting Adequate Protection to Prepetition Secured Parties at 62, *In re Lyondell Chem. Co.*, Case No. 09-10023 (REG) (Mar. 1, 2009) [docket no. 1002]; *see also*, Shapiro v. Saybrook Mfg. Co., 963 F.2d 1490 (11th Cir. 1992); Texlon (couldn't find cite to case).

[26] Nicole M. Stephansen, *Roll-up Financing Gains Prominence*, LEXOLOGY (June 15, 2010), https://www.lexology.com/library/detail.aspx?g=cf36dbad-7ef5-4c72-a87c-2cdce2840e85.

[27] Hon. Allan Gropper, *The Payment of Priority Claims in Cross-Border Insolvency Cases*, 46 TEX. INT'L L.J. 559, 571 (2011).

Further, as one of us has noted in a previous article, secured creditors frequently use their leverage to force a quick going concern sale. Such sales often allocate all of the sale proceeds to the secured creditor claiming a blanket lien, even where a more time consuming recapitalization of the firm might have produced more value, and careful attention to procedure and entitlements might have allowed value to flow through to the other creditors.[28] Indeed, the US Supreme Court has recently recognized that it is problematic when critical vendor motions, sales, structured dismissals and other devices operate as end runs around the prescribe process for confirming a plan of reorganization.[29]

iii. Process v. Substance

In sum, modified universalism provides a procedure for coordinating a case, but leaves decision-making and value allocation as open questions. The principle of adequate protection nods in the direction of substantive fairness,[30] but the concept leaves many questions open. To what extent can stakeholders insist on claims to priority as a baseline for their entitlement? What law governs priority? How should claims to priority be valued, and how should competing claims of priority be ordered?

b. Adequate protection and the problem of value allocation in rescue

For the modified universalist, and particularly for the court hosting the main proceeding in a cross-border case, understanding the relationship between the entitlement floor for and the likelihood of international recognition is crucial. The concept of adequate protection used by the UNCITRAL Model Law on Cross Border Insolvency (the "MLCBI")[31] leaves at least two crucial questions unanswered, however: (1) should the forum court apply its own priorities to distributional disputes or the priorities that would apply to the claim; and (2) how should these priorities be applied in rescue?

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[28] Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862 (2014) (discussing the transactional leverage of secured creditors to disadvantage other claimants).
[29] Czyewski v. Jevic Holding Corp., 137 S. Ct. 973, 984-86 (2017).
[30] Modified universalism also contemplates mechanisms for coordination, access and participation. These build out the procedural framework, while adequate protection assures that the process remains fair, and does not fundamentally disturb substantive rights.
[31] G.A. Res. 52/158, Model Law on Cross-Border Insolvency, (May 30, 1997); 11 U.S.C. §§ 1501-1532.

i. Territoriality and Allocation

Historically, insolvency law's approach to value allocation has relied on two defaults: liquidation and territorialism. Value has been allocated to claims based on the location of the assets generating value and distributed to the creditors able to assert their claims in the proceeding. In a piecemeal liquidation, all value that is generated can easily be traced to the asset sold. There is no extra value. The location of an asset may therefore easily work as the (only) determinant for allocation of the value received from its sale. Territorial insolvency proceedings would claim and distribute the value of assets in their territory to creditors with a claim against the debtor firm. The European Insolvency Regulation (EIR) provides for this exact rule in its original art. 2(g)[32] and maintained this baseline rule in its recast art. 2 (9) (vii).[33]

Such rules for allocation of assets are often local rules, though sometimes they have regional character (as art. 2 EIR).[34] In a global dispute about allocation, however, they cannot govern the outcome of the dispute for all participants. In addition, such rules have not yet been developed for all kinds of assets, and even where they address specific assets classes (e.g. Art. 2 (9) with different rules applied to registered assets, financial instruments, cash, intellectual property, tangible property and claims), they were not designed to be applied in a group scenario where gaming these rules is easy.[35] Lacking any coherent global standard, the international practice has required the parties to negotiate a distribution scheme by themselves. However, such a contract amongst more than two parties is not easy to negotiate.

Global rescue challenges both the liquidation and the territorial paradigm. Because the debtor continues in operation, the value of assets conceptually (but not legally) merges into the value of the firm. Because the enterprise is global, the territorial approach is disrupted by the reallocation of assets both before and after commencement of main proceedings abroad, especially in a group context. Assets may be moved from one jurisdiction to another for financial or tax reasons. They also may

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[32] Commission Regulation, 1346/2000 of 29 May 2000, On Insolvency Proceedings, O.J. (L 160) 1, 5 (EC).

[33] Commission Regulation 2015/848 of 20 May, 2015, Insolvency Proceedings, 2015 O.J. (L141) 19, 19-72.

[34] *Id.*

[35] Case C-649/13, *Comité d'entreprise de Nortel Networks SA and Others*, 2015 E.C.R. 1. (addressing the resulting disputes about allocation).

move within the group from entity to entity. The location of intangible assets is difficult to determine. Worse yet, not all of the value of the firm that continues to operate can be tied to particular assets.[36] While the common approach seeks to bring the value of an operating cross border business "down to earth" by attaching it to assets, this is a fiction. The value actually remains "in the air."

ii. Facilitating a Global Cross Border Consensus

Adjacent to the cross-border architecture, many jurisdictions seek to solve the allocation problem with ADR instruments. Mediation and arbitration of a cross border value distribution scheme is advised and sometimes even practically required. In *Nortel*, mediation and arbitration were the first choice after initial negotiations stalled. Without a mechanism for establishing the entitlement baseline, however, they failed.[37]

Under the existing Model Law on Cross Border Insolvency, a plan of reorganization promulgated by the court at the debtor's COMI will be recognized so long as the interests of creditors are "adequately protected."[38] UNCITRAL has recently proposed two new instruments to enhance the recognition regime of the original Model Law. The recently promulgated UNCITRAL Model Laws on the Insolvency of Enterprise Groups aims at supporting the recognition process for plans of reorganization promulgated for the entire group. This new instrument seeks to facilitate the coordinated adoption of a global distribution scheme by using local (territorial) recognition to enforce plans or reorganization.[39] Under this model, parties would attempt to structure a "group solution" formulated in one jurisdiction – a planning proceeding—to be recognized locally in as many other jurisdictions as possible.[40]

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[36] *See* Edward J. Janger, *The Logic and Limits of Liens*, 2 U. OF ILL. L. REV. 589 (2015); *See also*, Melissa B. Jacoby & Edward J. Janger, *Tracing Equity: Realizing and Allocating Value in Chapter 11*, 96 TEX. L. REV. 673 (2018).

[37] Steven Church, *Nortel Mediation Over Splitting $9 Billion Extended by Judge*, BLOOMBERG (Jan. 22, 2013 PM), https://www.bloomberg.com/news/articles/2013-01-22/nortel-mediation-over-splitting-9-billion-extended-by-judge-1-; Donald Swanson, *The Monstrous Costs of Mediation Failures (the Nortel Networks Bankruptcy, Part One)*, AMERICAN BANKRUPTCY INSTITUTE, https://www.abi.org/feed-item/the-monstrous-costs-of-mediation-failures-the-nortel-networks-bankruptcy-part-one.

[38] Model Law on Cross Border Insolvency Article 22.

[39] Int'l Trade Law Comm'n, Rep of Working Group V (Insolvency Law) on the Work of Its Fifty-Fifth Session, U.N. Doc. A/CN.9/972 at 18-20 (2019).

[40] Article 27 of the UNCITRAL Model Law on the Insolvency of Enterprise Groups (available at: https://undocs.org/en/A/CN.9/WG.V/WP.165).

This approach relies on the ability of receiving jurisdictions to develop local procedures to approve and implement the group solution, and to give meaning to the concept of "adequate protection." Some jurisdictions might require a local vote to bind local creditors. Other jurisdictions might be more permissive, choosing to recognize the global solution because local creditors had adequate opportunity to participate, and the solution is in the best interest of the local claimants. Also, a confirmed plan could be recognized across the globe, thus giving its distributional solution the aspired global effect. The court confirming the proposed plan would, however, need to apply the local tests reflecting the distributional standards in its jurisdiction.[41] This approach addresses the problem of recognition without addressing the underlying problem of entitlement. It remains to be seen whether host (receiving) jurisdictions will actually recognize plans based on foreign distributional standards without safeguards for their local entitlement policies.

As such, the UNCITRAL architecture can facilitate the recognition of a global solution and provides a forum for bargaining in the shadow of entitlement, it does not provide a set of entitlements, or a mechanism for resolving disputes when claims of entitlement differ along national lines.

III. ENTITLEMENT AND GOVERNANCE IN GLOBAL BANKRUPTCY CASES

As noted above, the global bankruptcy architecture developed by UNCITRAL does not provide a mechanism for resolving questions of priority. Instead, it takes claims to priority as it finds them. Cases like *Nortel* and *Lehman* demonstrate the costs of such an approach. The problem faced by a judge or mediator in a global rescue case is that there

[41] United Nations Commission on International Trade Law, *UNCITRAL Model Law on Recognition and Enforcement of Insolvency-Related Judgments,* Art. 13 (Vienna: United Nations, 2018), https://www.uncitral.org/pdf/english/texts/insolven/Interim_MLIJ.pdf; United Nations Commission on International Trade Law, *Enterprise Group Insolvency: Draft Model Law,* art. 20 (Vienna: United Nations, 2018), https://uncitral.un.org/sites/uncitral.un.org/files/draft_model_law_on_enterprise_group_insolvency_0.pdf. In the US, the confirmation would need to follow the requirements of 11 U.S.C. § 1129 and include a best interest test as well as the application of the absolute priority rule. In other jurisdictions other tests may be required. In addition, the decision to recognize a foreign plan in a host jurisdiction would commonly include a test of adherence to local distributional standards, either following a specific provision (*see e.g.*, 11 U.S.C. § 1507) or based on a public policy requirement (see e.g. art. 34 EIR). Globally uniform distributional standards are non- existent.

may be multiple bases for claims to priority, and it is difficult to disentangle them.

a. Entitlement: Equality v. Priority

There are essentially two approaches to such distributional questions that could have resolved the allocative uncertainty that bedeviled *Nortel* more simply: a presumption of equality (bottom up); or a clear system of priority (top down). Broadly speaking, bankruptcy favors equality (*pari passu* treatment and *pro rata distribution*).[42] By contrast transactional lawyers, bankers, and most finance and law and econ theorists favor priority and assert the desirability, under non-bankruptcy law, of a "hierarchical" capital structure—a single waterfall, where A is paid in full before B receives anything, and who must be paid in full before C takes anything.[43]

For single solvent companies the difference matters little. Distribution runs from the top, governance from the bottom. The distributional waterfall situates governance control in the hands of the junior-most class (common equity).[44] Hierarchy—the distributional waterfall—serves only to distinguish fixed claimants with priority—who will be paid in full—from the claimant at the bottom, whose claim is variable and therefore faces and benefits from the risks of continued operation.[45] For solvent firms, the levels of hierarchy are irrelevant. Equity is variable; debt (regardless of its priority) is fixed.

b. Priority v. Governance in Insolvency–The Problem of Vetoes

In insolvency and its vicinity, even for a simple firm without subsidiaries or international operations, the implications of the two approaches diverge. Indeed, they invert and go to war. The wedge is uncertainty–specifically uncertainty about valuation in the future. In the

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[42] *Worsley v. DeMattos*, 97 Eng. Rep. 407, 412 (K.B. 1758). *See* Edward J. Janger, *The Creditors' Bargain Reconstituted: Comments on Barry Adler's The Creditors' Bargain Revisited*, 167 U. PA. L. REV. ONLINE (2019). Some recent commentators question the importance of equality of treatment, and the *pari passu* baseline in particular. David A. Skeel, *The Empty Idea of "Equality of Creditors,"* 166 U. PA. L. REV. 699 (2018); Rizwan Jameel Mokal, *Priority as Pathology: The pari passu Myth*, 60 CAMB. L.J. 581 (2001).

[43] Melissa B. Jacoby & Edward J. Janger, *Tracing Equity: Realizing and Allocating Value in Chapter 11*, 96 TEX. L. REV. 673, 677 (2018.)

[44] *Id.* at 689.

[45] Peter Moles & Nicholas Terry, THE HANDBOOK OF INTERNATIONAL FINANCIAL TERMS (Oxford University Press 1995) (shareholders are entitled to the remaining assets once the fixed claims on a business have been met).

vicinity of insolvency, a firm is not certain to be able to pay its fixed claimants in full. It is, therefore, no longer clear who is variable, who is fixed, and who is out of the money. Worse yet, in a hierarchical distributional scheme, where every claim is potentially variable, everybody has a veto over the continued operation of the firm. Instead of governance running from the bottom up, veto power runs from the top down. Priority claimants must be assured that they will be paid in full before governance power moves down to the next rung on the priority ladder. By contrast, in a regime of equality, all claimants share equally in the future of the firm, and decisions about value maximization are unconflicted, but priority is not respected. In a regime that respects priority, conditions of uncertainty mean that veto rights will run from the top down. The choice between equality and priority is, therefore, fraught.

c. *Priority in the Insolvency of Global Groups: A Taxonomy*

To make matters worse, the top down approach to governance assumes a single waterfall. The problem posed by global enterprises like *Nortel* with an integrated business that operates with multiple functional and national subsidiaries is that multiple distributional waterfalls are inevitable. Each subsidiary has its own distributional waterfall. Each country has its own jurisdictional power over local assets and claims. Each asset may be subject to multiple claims of ownership. Untangling these claims to priority is complicated, and inevitable. Before they can be disentangled, it is necessary to identify the various types of priority. Stated briefly they are: (1) asset-based priority (security); (2) structural priority (corporate form); (3) territorial priority (based on jurisdictional control over assets and priority of local claims) and (4) value-based or waterfall priority (priority creditors, general unsecured creditors, and equity). Each of these claims establishes its priority in a different way, and, except for waterfall priority, each relies on non-bankruptcy entitlements that are extrinsic to establish their priority over other claims to the value of the firm.

i. Security

Secured creditors have claims to priority that are based on a claim to "ownership" or a property interest in the debtor's assets.[46] The debtor can bind the secured creditor by redeeming the collateral at its value. This may be considerably less than at par. This is because these claims to priority

[46] U.C.C § 9-109(a) (Am. Law Inst. & Unif. Law Comm'n 1977).

are based on non-bankruptcy property law: the state law of real property mortgages; and the state law of personal property security (Article 9 of the Uniform Commercial Code in the U.S.). Similar rules exist in many jurisdictions including, for instance, Germany.[47] What they offer are not liens on the value of the firm itself, but instead liens on the firm's specific assets.

For this reason, the claim to priority is limited to the value of the investor's collateral—the encumbered assets.[48] Practitioners and law and economics scholars frequently assume that it is possible to encumber the going concern value of a firm and assert that as a normative matter that this is desirable. However, at least in the US, the limits of the property-based approach found in Article 9, and the absence of a statutory "floating charge" that reaches going concern value, together limit the scope of security to "property" owned by the firm.[49] Even the scholars who favor such a lien recognize that it either does not exist under current law, or at least rests on a "shaky foundation."[50]

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[47] In Germany, property law defines such security, *See* §§ §§ 1113-1203 BGB (Civil Code) for mortgages and §§ 1204-1296 BGB for pledges.

[48] 11 U.S.C. § 506, 552, 1129(b)(2)(A) (2010). *See* Melissa B. Jacoby & Edward J. Janger, *Tracing Equity: Realizing and Allocating Value in Chapter 11*, 96 TEX. L. REV. 673 (2018).

[49] Sarah Paterson, *Finding Our Way: Secured Transactions and Corporate Bankruptcy Law and Policy an America and England*, 18 J. OF CORP. L. STUD. 247 (2018).

[50] Christopher W. Frost, *Secured Credit and Effective Entity Priority*, 51 CONN. L. REV. 575, 612 (2019) ("effective entity priority rests on a fragile footing"). While Douglas Baird acknowledges that:

> A secured creditor's right is asset-based. A creditor is truly senior to another creditor in a firm only to the extent that it has perfected a security interest in each and every asset of the firm. Moreover, even if assets are not valued until the plan is confirmed, the secured creditor's priority is limited to assets in which it had a perfected security interest at the time the petition was filed, or assets acquired with the proceeds of that security interest.

Id. at 856. But he also notes that:

> Whether one looks at a secured creditor as holding the discrete parts worth less than the going concern or whether it enjoys a right to the first cashflows of the firm is a debate that will undoubtedly continue. Resolving these competing views is virtually impossible. Both sides cling to their views as if they were articles of religious faith. On the one hand are those who believe that when stock is taken in bankruptcy, no one should be able to enjoy the assets to the absolute exclusion of other stakeholders. On the other hand are those who believe that stakeholders have a place in line, and the bankruptcy reckoning should respect it. The gap between these two views is likely unbridgeable.

Id. at 860.

ii. Territoriality – Jurisdiction over property and priority of local claims

Territorial claims to priority rely partly on the limited jurisdictional scope of the bankruptcy proceeding, and partly on the fact that countries may rank priorities differently.[51] This can reorder the priority of claims in two distinct ways. First, within a firm, the balance of claims and assets can vary from jurisdiction to jurisdiction. In other words, the opening of a local case may distort the "equal" priority of *pari passu* claims across the firm. General creditors in one jurisdiction may receive a larger haircut than claimants from another jurisdiction. Also, preferential or priority creditors in one jurisdiction may have different (or no) priority in another. Employee claims, tax claims, tort claims may all have different priorities in different jurisdictions. This highlights the fact that where territorial claims are involved, the distributional hierarchy must accommodate multiple distributional waterfalls. Even a fully implemented regime of modified universalism must wrestle with this problem unless it is prepared to reject the concept of local priorities entirely.

iii. Groups – Corporate Form and Structural Priority

There is yet a third form of priority—structural priority. Whereas the usual rule for general unsecured creditors of an insolvent entity is that they share *pari passu* (in equal priority) and *pro rata* (according to the proportion of their claim), the corporate form can be used to structure recourse.[52] Formal partitions between assets can be created through the use of the corporate form. Corporate structure can be used to elevate the priority of claimants with recourse to the partitioned assets. However, as *Nortel* and *Lehman* illustrate, in many modern corporate groups, it is often difficult to discern where value is located. Are the receivables of a particular subsidiary always tied directly to that subsidiary? Is the subsidiary itself solvent? These questions become important when a corporate group is recapitalized or sold as a going concern. To what extent can a creditor of a group member show that they would have received a bigger distribution if their recourse was limited to the subsidiary going it alone? Again, like territorial claims to priority or preferred treatment, these claims to priority are not based on the host nation's bankruptcy priority

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[51] Edward J. Janger, *Silos: Establishing the Distributional Baseline in Cross-Border Bankruptcies*, 9 BROOK. J. CORP. FIN. & COM. L. 180 (2014).
[52] Anthony J. Casey, *The New Corporate Web: Tailored Entity Partitions and Creditors' Selective Enforcement* 124 YALE L.J. 2680 (2015).

scheme per se, but instead on the fact that a group member exists as a separate value waterfall entirely.

iv. Unsecured Priority Claims and Equity

All of the types of priority described above operate by deleting assets from the pool available for pro rata distribution. They carve assets out of the estate and dedicate them to satisfying a particular claim. Unsecured creditors have a claim against the leftovers—the residual unencumbered value of the firm. However, even within the class of claims that lack collateral or a dedicated pool of assets, there may be priorities. Administrative claims of the estate take priority over employee claims, take priority over tax claims take priority over ordinary debt claims.[53] And, needless to say, ordinary debt claims take priority over equity interests. While the basic bankruptcy principal of distribution is equality, the amount left over to distribute to those claimants may be quite small or quite large.

d. Vetoes and Realizable Value

The lesson of the preceding section is that the idea of a single priority waterfall is a myth, both as a legal and a practical matter. Instead, the various claims to priority create a series of veto rights, each with the power to block both a value maximizing rescue and a consensual distribution scheme in a sale case.

The myth of waterfall priority has costs. Modern bankruptcy practice has shifted its emphasis from liquidation to rescue in the form of restructuring and going concern sales.[54] This shift causes uncertainty and confusion about claims to priority that arise on a number of axes: (1) there is confusion about the nature of the entitlements that give rise to various types of priority; (2) there is conflation of the nominal and realizable value of those claims to priority. The exorbitant cost of cases like *Nortel,* and also in cases where the business continues, comes from these intertwined uncertainties about valuation and allocation. Where uncertainty is linked to a formal priority, the result is a veto right to any approach that has a consensual solution at its core. Where the veto cannot be satisfied by payment in full, disputes hinder efficient solutions. In cases like *Nortel* the

[53] 11 U.S.C. § 507.

[54] We recognize that *Nortel* was a liquidation and that In *Lehman* the fight was over the location of particular assets. The point in those cases, was that in a modern corporate group, even hard assets may be difficult to locate. In a rescue case, one of those elements of homeless value is the going concern increment.

result is that value is allocated to lawyers. In cases where rescue is in the balance the result may be destruction of value altogether.

e. *Allocation Is Not the Answer*

The EIR takes one approach to this problem. It seeks (1) to solve the territoriality problem by developing globally or regionally accepted allocation rules (e.g. art. 2 (9) EIR) that pin both assets and claims to a specific jurisdiction (including those of group entities); and (2) it applies local rules on entitlement and distribution to solve questions about the scope of security rights or waterfall entitlements. The European approach establishes both allocation rules and seeks to respect local distribution rules.

The limits of this approach become visible, however, when value cannot be traced to specific assets and thus cannot be allocated. Just as a firm is worth more than the value of its assets, a corporate group is worth more than the sum of the value of its subsidiaries. As a result, the existence of a pool of homeless value (In particular reorganization surplus value and group synergy value) is an inevitable consequence of rescue and not covered neatly by an approach that is based on priority. Such an approach must bring value "down to earth" and assign it to a local distributional framework. Such a step is artificial and often arbitrary. A new approach is needed.

IV. A NEW APPROACH TO VALUE TRACING IN CORPORATE GROUP INSOLVENCIES

The great success of modified universalism is that it provides a process to facilitate value maximization by preserving enterprise value either through global recapitalization or coordinated going concern sales. The greatest weakness is its silence on substance. The standard of adequate protection provides no basis for breaking deadlocks when negotiations fail.

We suggest a simple, perhaps naïve, mechanism for balancing claims to priority against the principle of equal distribution: we would grant a claim priority only to the extent that the claimant is able to establish the realizable value of that claim in the absence of the global resolution of the firm's value. To put it concretely:

- Any claim to priority must be traced to realizable assets or to value that can be situated in a distinct jurisdiction or entity and distributed according to the respective local distribution regime. This, of course, might include local avoidance rules.

- Any remaining homeless, or un-situated value would constitute what we call the "rump estate," a residual pool of value, left in the hands of the estate fiduciary. This would not be a result of consolidation. It would simply be an incident of rescue.

- To the extent that local assets, entity assets, or liened assets prove insufficient to satisfy the creditor's claim they would have a deficiency claim against the residuum. This rump estate would then be shared on a pro rata basis amongst all creditors with deficiency claims.

This approach provides both a cap and a floor to the priority claim. Therefore, for governance purposes, the veto power associated with a claim of distributional priority is fixed and limited to this realizable amount.

Crucially, this approach does not require consolidation, disrespect of the corporate form, or of abrogation of property rights. The key move here is not consolidation; it is realization. The sale or recapitalization of the firm creates a pool of realized value. Priority claimants can claim their share, but only if they can prove it is theirs. This approach respects the distributional priority of asset-based claims based on liens, and entity-based priority based on local corporate law, and territorial priority based on jurisdictional authority. When an estate fiduciary realizes on the value of the enterprise, it distributes the pool of value according to those priorities, but only to the extent their realizable value can be established. The residuum, the money left over, must go somewhere. So must the debt. However, these deficiency claims have no particular claim to priority over other unsecured claims, and they are not tied to assets or entities. These deficiency claims share pro rata.

By shifting the burden of establishing priority, Our approach ensures that distribution can run from the top down, while governance will run from the bottom up; by fixing the value of the priority claims they can be cashed out, leaving the residual claimants to maximize the value of the enterprise

as a whole. It is our hope that this approach will minimize the stakes, and hence the costs of allocation fights.

As we have noted, this approach mirrors the distributional approach reached in *Nortel.* But, in our view, "partial substantive consolidation" is a misnomer. It suggests that the court is invoking an extraordinary remedy that disrespects the corporate form. Under our approach, no disrespect is involved. We merely impose a requirement of proof and recognize that some value cannot be situated. In our view, the problem lies not in consolidating the pool of assets across corporate limits, but more generally in fixing the claims to priority based on the realizable value of those asset-based, entity-based, or jurisdiction-claims to priority. Equality of treatment solves the rest.

a. Fixing the Realizable Value of Priority Claims

A corporate group has aspects of separateness, but also operates, at some level as a single entity or firm. Where liabilities and value can be located in particular entities the analysis is straightforward. Those claims may be satisfied out of that entity based on the realizable value of the entity's assets or the realizable stand-alone value of the entity. Any deficiency continues as an orphan claim. Since recourse against the assets or entity have been exhausted, and the "group" is not an entity, there is no recourse against the group *per se*. Similarly, while many assets and much firm value may be situated in single entities, jurisdictions, or may be pledged to particular creditors, some assets may be homeless (like the cash in *Lehman),* and some value may not be tied to assets. This forms what we have referred to as the "rump estate." Most importantly, going concern value and various business synergies inhere in the firm. We are left with orphan claims and homeless value.

For individual firms this analysis is straightforward. Where a group of entities form a consolidated enterprise, however, the analysis is more problematic. The homeless value may inhere in the group, rather than any particular corporate entity. However, corporate law does not provide a place to put this value. For a solvent firm, this value would flow up to the corporate parent as equity. If the entities themselves are insolvent, the stock is worthless. This will be true, even when the consolidated enterprise has value over and above the value of the group members. The question becomes how to administer the homeless value and orphan claims that inhere in a rescue case.

In a rescue case for a corporate group, the orphan claims should be assertible against the rump estate. Each claim to priority against a group member or assets of a group member is limited to the realizable value of that priority claim, based either on the value of their encumbered asset, or the realizable value of their claim against a particular entity. To the extent that funds remain, all deficiency claims against the various estates would be assertible against the rump estate.

b. The "Rump Estate"

The key point is that any creditor claiming a preference over pro rata distribution should have to prove the realizable value of their priority claim. Secured creditors' priority would be allowed based on the realizable value of their collateral according to the non-bankruptcy rules applicable to such a realization. Creditors claiming a preference under a specific territorial priority rule would need to demonstrate the realizable value of this priority relying on assets covered by the respective jurisdiction. Creditors claiming priority based on assets partitioned in a particular entity would also need to demonstrate the realizable value of their claim.

It is possible that some group members may be solvent. If there happens to be surplus value attached to assets in a subsidiary, equity would be entitled to claim it. In practice, this would usually mean that creditors with share pledges would come forward. Otherwise, the administrator of the group entity holding the share could claim preference to such value.

Once all value that can be located in a jurisdiction, entity or asset has been situated, that value can be applied to claims with the related "priority." However, inevitably there will be value that cannot be assigned. It might be a little. It might be a lot. That will depend on the nature of the firm. Whatever is left, however, for whatever reason, be it going concern surplus, option value, homeless assets, or value that inheres in the group itself, constitutes the rump estate. That residual value is available for pro rata distribution across the firm on a global and firmwide basis.

Again, when this approach is applied to cases like *Nortel* or *Lehman,* the answer is the same, but the result is reached as a simple accounting matter, not through exercise of an extraordinary remedy.

V. CONCLUSION

In sum, we do not propose any change to the rules of substantive consolidation. Quite the opposite. Instead, we argue that the limits of the corporate form be respected for distributional purposes. Neither do we propose or intend any disrespect to principles of priority. Instead, we seek to free both principles from the single waterfall liquidation paradigm and adapt them to a global regime with multiple asset and value waterfalls. The major conceptual innovation lies in allocating the burden of proof for priority. Where the value of a corporate group is realized on a consolidated basis, claims to special priority must be proven by the claimant, and the priority entitlement is limited to the amount that could have been realized by the creditor claiming against the asset or entity alone.

We do not propose anything that should not already be true under current law. We simply consider more carefully how to implement these principles. On a practical level, however, the implications of our approach may be far reaching. For most modern integrated corporate groups, much of the value will either be part of the integrated group or will be part of the going concern surplus. As a result, a significant share of the value should be available for pro rata distribution.