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# BEYOND CARVE-OUTS AND TOWARD RELIANCE: A NORMATIVE FRAMEWORK FOR CROSS-BORDER INSOLVENCY CHOICE OF LAW

John A. E. Pottow \*

The title of this Article purports to develop a normative framework for cross-border insolvency choice of law. That can be a task of varying scope, so at the outset any pretense of ambition for a wholly new choice of law model should be dispelled. Indeed, at the most generalized level, bankruptcy choice of law theory has already been fully ventilated in the well-rehearsed universalism versus territorialism debates.<sup>1</sup> And it has been settled. The universalists, at least as a normative matter, appear to have won: choice of law, as it is increasingly accepted, should be determined by the debtor's center of main interests (COMI).<sup>2</sup> But no sooner did the universalists claim theoretical superiority than did they bow to concessions animated by such pragmatic concerns as reality, begetting the now-dominant paradigm of modified universalism.<sup>3</sup> One could argue this raises a nomenclature question: is “modified universalism” an independent normative theory for choice of insolvency law in cross-border proceedings or is it merely a pragmatic gloss put on the universalist theory, which retains the normative theoretical core?<sup>4</sup> For purposes of this Article, I prefer to cast modified universalism as its own normative theory. Modified

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\* © John A. E. Pottow, John Philip Dawson Collegiate Professor of Law, University of Michigan Law School, 2014. Thanks to all participants at the symposium for comments and especially Pete Osornio (Michigan J.D. Class of 2014) for research help. Ted Janger, the Center for the Study of Business Law and Regulation at Brooklyn Law School, and the International Insolvency Institute all get credit for the wisdom of the need for this symposium.

1. E.g., Lynn M. LoPucki, *The Case for Cooperative Territoriality in International Bankruptcy*, 98 MICH. L. REV. 2216 (2000); 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*].

2. See U.N. COMM. ON INT'L TRADE LAW, MODEL LAW ON CROSS-BORDER INSOLVENCY WITH GUIDE TO ENACTMENT AND INTERPRETATION, U.N. Sales No. E.99.V.3 (1997) [hereinafter UNCITRAL MODEL LAW]; Council Regulation 1346/2000, On Insolvency Proceedings, art. 12, 2000 O.J. (L 160) 1 (EC) [hereinafter EU Insolvency Regulation].

3. See John A. E. Pottow, *Procedural Incrementalism: A Model for International Bankruptcy*, 45 VA. J. INT'L L. 935, 952 (2005) [hereinafter Pottow, *Procedural Incrementalism*]. Although as others well note, universalism, “modified” enough, can dissolve into territorialism. Charles W. Mooney, Jr., *Harmonizing Choice-of-Law Rules for International Insolvency Cases: Virtual Territoriality, Virtual Universalism, and the Problem of Local Interests*, 9 BROOK. J. CORP. FIN. & COM. L. 120, 132–35 (2014); see also Edward J. Janger, *Silos: Establishing the Distributional Baseline in Cross-Border Bankruptcies*, 9 BROOK. J. CORP. FIN. & COM. L. 180, 189 (2014) (noting that the EU proposals turn “modified universalism on its head by validating a virtual territorial approach to distribution”) [hereinafter Janger, *Silos*]; Edward J. Janger, *Virtual Territoriality*, 48 COLUM. J. TRANSNAT'L L. 401, 418 (2010) [hereinafter Janger, *Virtual Territoriality*].

4. See generally Pottow, *Procedural Incrementalism*, supra note 3, at 952–53 (discussing modified universalism's outgrowth from universalism).

universalism is more specifically a *second-order* choice of law theory. It argues that the theoretical purity of universalism is desirable as a first-order matter, but because that purity is not yet attainable and because incremental advancement toward universalism is preferable to failed swings for the fences,<sup>5</sup> a second-order approach is warranted. This second-order theory is mindful of pragmatic constraints and counsels that it is normatively desirable to “modify” universalism with some territorialist concessions.<sup>6</sup> Thus, non-trivial accommodation of local law not only can but also should be tolerated in cross-border insolvency proceedings.<sup>7</sup>

Viewed in this manner, modified universalism is a form of incrementalism, a thus-far successful approach to cross-border insolvency reform. As deployed in the UNCITRAL Model Law,<sup>8</sup> chapter 15 of the U.S. Bankruptcy Code,<sup>9</sup> and to a large degree the EU Insolvency Regulation,<sup>10</sup> modified universalism is more specifically an instance of *procedural incrementalism*, a form of incrementalism that moves for gradually increasing subjugation of sovereignty on seemingly less threatening, procedural matters as a form of acclimation to the imposition of foreign law upon (or at least foreign court control over) domestic insolvency proceedings.<sup>11</sup> As operationalized, the modified universalism of these current regimes finds doctrinal outlet in a presumptive universalist choice of law rule—COMI *lex fori concursus*—but which backtracks with a series of carve-outs under which local insolvency law can apply in non-COMI states.<sup>12</sup> We can thus fairly characterize the present state of affairs even more specifically as a *carve-out-based regime* of modified universalism.

If this assessment is correct, that modified universalism—the stipulated normatively superior (at present) framework for cross-border insolvency—pursues an incremental trajectory, then the question naturally arises: what is the next stage along this uncharted but dimly perceptible path toward fuller and complete universalism? Specifically, which carve-outs are ready for retirement to yield to COMI-state law? The question is not merely one of academic interest. UNCITRAL’s Working Group V has put the issue squarely in the crosshairs by seeking input for reforms from scholars and practitioners alike<sup>13</sup> with particular focus on choice of law issues

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5. *See id.*

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

7. *See, e.g.*, UNCITRAL MODEL LAW, *supra* note 2, art. 28.

8. UNCITRAL MODEL LAW, *supra* note 2.

9. 11 U.S.C. §§ 1501 et seq (2012).

10. EU Insolvency Regulation, *supra* note 2.

11. *See* Pottow, *Procedural Incrementalism*, *supra* note 3, at 952.

12. *See* EU Insolvency Regulation, *supra* note 2; 11 U.S.C. § 1501; UNCITRAL MODEL LAW, *supra* note 2.

13. U.N. Comm. on Int’l Trade Law, Working Group V (Insolvency Law), Rep. on its 45th Sess., Apr. 21–25, 2014, U.N. Doc. A/CN.9/803 (May 6, 2014).

(recognizing that as just mentioned, at a grander level the universalism-territorialism debate is already one about choice of law).<sup>14</sup>

The purpose of this Article is two-fold. First, this Article seeks to address the *third-order* choice of law considerations under present debate in answering the question of what's next. That is, accepting universalism as a first-order normative theory, and then accepting modified universalism as a second-order normative theory, how might we theoretically anchor—as a matter of normative analysis—the best way to take the next step in reforming a carve-out-based choice of law regime? Rather than rely upon serendipitous fits and starts, which seem to drive the field to a certain extent in directing the vector of carve-out reform, this Article proposes a framework based on *actual, defensive litigant reliance* as the third-order theoretical principle to guide the doctrinal development within modified universalism. Second, this Article tries to flesh out some choice of law rules that might flow from, or at the very least be consistent with, such a reliance-based normative framework. Because the prescriptive/evaluative aspect of this Article builds upon current efforts, however, it is first necessary to review the bidding of where cross-border insolvency reform has moved on choice of law. This Article thus divides into these three parts—reviewing the bidding, explaining the suggested framework, and assessing the current proposals—and unfolds accordingly (with one interlude). The reader should be forewarned before proceeding: we are deeply inside baseball here. This is a technical paper for experts; it assumes substantial familiarity with the subject matter of cross-border insolvency. You have been warned.

## I. REVIEWING THE BIDDING: CURRENT CROSS-BORDER INSOLVENCY CHOICE OF LAW DEVELOPMENTS

Modified universalism makes “give-backs” to territorialists in order to garner broader acceptance of projects like the EU Insolvency Regulation and UNCITRAL Model Law. There are two broad mechanisms through which these territorialist give-backs manifest themselves: choice of law carve-outs and secondary proceedings. (Technically, as the unassailable Ian Fletcher points out,<sup>15</sup> the former mechanism—choice of law carve-outs—can actually divide into two analytically distinct subsets: restriction on the scope of *lex fori concursus*,<sup>16</sup> and explicit selection of non-*lex fori*

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14. Pottow, *Procedural Incrementalism*, *supra* note 3, at 944 (“In a critical respect, the ‘problem’ of transnational insolvencies, at least at one level, might be nothing more than an admittedly challenging choice of law issue: whose (policy-rich) laws of distribution, priority, and avoidance should govern the insolvency of the multi-jurisdiction debtor?”).

15. BOB WESSELS & IAN F. FLETCHER, AM. LAW INST., *Global Rules on Conflict-of-Laws Matters in Insolvency Cases*, in TRANSNATIONAL INSOLVENCY: GLOBAL PRINCIPLES FOR COOPERATION IN INTERNATIONAL INSOLVENCY CASES ann. at 200, 252–53 (2012), available at <http://www.iiiglobal.org/component/jdownloads/finish/557/5932.htm> [hereinafter *GP Annex*].

16. *E.g.*, EU Insolvency Regulation, *supra* note 2, art. 6.

concurus for specific litigation matters, such as *lex laboris*.<sup>17</sup> While conceptually discrete, however, these are both carve-outs from the presumptive choice of law rule of *lex fori concursus*.) Let us first turn to the latter territorialist mechanism of *lex fori concursus* disapplication—secondary proceedings—in reviewing the current proposals to reform the EU Insolvency Regulation (and cognate innovations) from a modified universalist’s perspective.

### A. SECONDARY PROCEEDINGS: A NECESSARY EVIL

Secondary proceedings, by contrast to the subject-specific choice of law exclusion of a carve-out, are wholesale vetoes of the COMI *lex fori concursus*, deploying what perhaps should be considered *lex secundus*. More precisely, secondary proceedings allow application of a different forum’s *lex fori concursus* upon the opening of the secondary proceeding in the new forum. While commentators, and not without reason, have characterized these secondary proceedings as enabling a local creditor veto over COMI law, blackmail, etc.,<sup>18</sup> secondary proceedings can also be properly conceived, and perhaps even better conceived, as choice of law carve-outs writ large (albeit contingent). That is, when (but only when) the contingency arises that a local creditor possessing claims under local law chooses to open a secondary proceeding, then (but only then) the COMI state insolvency law will be presumptively displaced in favor of the local state’s insolvency law: *lex secundus*.<sup>19</sup> (Chapter 15 allows parallel proceedings under sections 1528–29, which are a looser form of secondary proceedings but have the same flavor of allowing for the primacy of local law, albeit in a territorially limited matter.)<sup>20</sup>

From a normative perspective, secondary proceedings present something of an embarrassment to universalists. As I have argued elsewhere, however, secondaries are a necessary evil: a pit stop on the road

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17. *Id.* art. 10.

18. Janger, *Silos*, *supra* note 3, at 182 (describing secondary proceedings as the “functional territorial [equivalent of] blackmail”).

19. Yes, I know, I am conflating choice of forum with choice of law. Jay Westbrook has already admonished us to keep the two distinct, *see* Westbrook, *Theory and Pragmatism*, *supra* note 1, at 461 (“[T]here is a difference between choice of forum, the explicit focus of the universalist rule, and choice of law, a result of universalism often implicitly assumed.”), and he is right, but as I have also already admonished, choice of forum can have, at times, important and even dispositive effects on choice of law. *See* John A. E. Pottow, *The Maxwell Case*, in *BANKRUPTCY LAW STORIES* 222, 229 (Robert K. Rasmussen ed., 2007). Furthermore, local insolvency law can choose foreign law (including COMI law) on a transaction-by-transaction basis, as was indeed the implication of *Maxwell*. *In re Maxwell Commc’n Corp. plc* by Homan, 93 F.3d 1036 (2d Cir. 1996).

20. 11 U.S.C. § 1528 (2012) (“The effects of such case shall be restricted to the assets of the debtor that are within the territorial jurisdiction of the United States . . . .”); 11 U.S.C. § 1529(2)(B) (“[I]f such foreign proceeding is a foreign main proceeding, the stay and suspension referred to in section 1520(a) shall be modified or terminated if inconsistent with the relief granted in the United States.”).

toward universalism that was required to secure the buy-in of skeptical states.<sup>21</sup> For the modified universalist, secondary proceedings should be tolerated, but they should be slowly, in successive waves of reform, restricted in scope.<sup>22</sup>

As a self-described universalist, I may have surprised some in seeming not just to apologize for but to applaud secondary proceedings. Specifically, I have endorsed the use of so-called “synthetic secondary proceedings” to treat foreign creditor priority claims in the COMI forum “as if” (to use Bob Wessel’s terminology)<sup>23</sup> secondary proceedings have been opened.<sup>24</sup> There are reasons for this seeming capitulation. Synthetic secondaries are welcome in my view because they both reduce the value-gobbling transaction costs of local proceedings *and* cabin the scope and incidence (by pre-emption) of true secondary proceedings. With increasing disuse of true secondaries will likely come increasing acceptance of COMI-state law more generally, and so synthetic secondaries are a territorialist step backward for a universalist leap forward.<sup>25</sup> Ted Janger calls these proceedings an application of “virtual territoriality”<sup>26</sup> and others have offered the even more evocative label of “virtual contractual secondary proceedings.”<sup>27</sup> Although we vary in our enthusiasm, we all arrive at the same place: all agree that synthetic secondaries are better than full secondaries (three cheers for the *Collins & Aikman* case, and more for *Nortel*),<sup>28</sup> but even better would be no secondaries at all.

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21. John A. E. Pottow, *A New Role for Secondary Proceedings in International Bankruptcies*, 46 TEX. INT’L L.J. 579, 584 (2011) [hereinafter Pottow, *Secondary Proceedings*] (“In sum, the most accurate understanding (from the normative perspective of a universalist) of secondary proceedings is that they are a necessary evil. They are required to dampen territorialist and competitive impulses.”).

22. *Id.* at 589 (declaring that future reform efforts should limit the scope of secondary proceedings to real property disputes, disputes where local judicial authority is needed to exercise equitable or other non-monetary bankruptcy-related relief, and other extraordinary circumstances pursuant to some safety valve escape clause).

23. Bob Wessels, *Contracting Out of Secondary Insolvency Proceedings: The Main Liquidator’s Undertaking in the Meaning of Article 18 in the Proposal to Amend the EU Insolvency Regulation*, 9 BROOK. J. CORP. FIN. & COM. L. 63, 76 (2014).

24. Pottow, *Secondary Proceedings*, *supra* note 21, at 584 (“In other words, all that is advocated is a centripetal push of the activity of putative secondary proceedings to resolution in the COMI, without necessary change in actual outcome.”).

25. Aggressive universalist that I am, even I allow for secondary proceedings for certain matters such as *in rem* real property disputes, equitable proceedings under local law, etc. *Id.*

26. Janger, *Virtual Territoriality*, *supra* note 3.

27. Michael Menjucq & Reinhard Dammann, *Regulation No. 1346/2000 on Insolvency Proceedings: Facing the Companies Group Phenomenon*, 9 BUS. L. INT’L. 145, 154 (2008) (using the phrase “virtual contractual secondary proceedings” to describe the practice of providing creditors the same treatment as if secondary proceedings had been opened).

28. *Re Collins & Aikman Europe SA*, [2006] EWHC (Ch) 1343; *Re Nortel Networks SA & ORS*, [2009] EWHC (Ch) 206.

## B. SECONDARY PROCEEDINGS: DOUBLING DOWN ON EVIL?

Taking secondary proceedings as here for now, the current wave of EU reform—the proposals to amend the Regulation (ping-ponging back and forth between the EU Commission, Council, and Parliament)<sup>29</sup>—builds upon the assumption these proceedings will remain part of the procedural landscape for some time. The amendments, however, seek to “drastically” change the way secondary proceedings are to be used,<sup>30</sup> but in a way that might give a universalist heartburn, namely, by *expanding* their incidence. Initially, this sounds like bad news for the modified universalist, but upon reflection the expansion as proposed should be encouraged. First, expanding the use of secondaries to non-liquidation purposes means that if the (normatively regrettable) local law veto is exercised, it at least need not lead to the winding up of the multinational subsidiary.<sup>31</sup> Second, and more importantly, the expansion of the powers of the primary liquidator (insolvency representative) strengthens the notion of what I have called “jurisdictional hierarchy,” by expressly increasing the domains in which the COMI officer has dominance over the secondary proceeding officers, especially in corporate group proceedings.<sup>32</sup> For example, the first right to propose a group-wide plan of reorganization vested in the COMI officer mirrors the U.S. chapter 11 concept of exclusivity that is specifically designed to empower debtors-in-possession in the domestic reorganization context.<sup>33</sup> Third, and perhaps most exciting from a theoretical perspective, the recitals from the EU amendments contain all sorts of language (albeit in the maddening, compromise-laden generalities that constitute legal Euro-speak) that recognize the ugly side of secondary proceedings. Thus, while there is still some encomium about the grand importance of protecting local creditors, there is also candid assessment that secondary proceedings can “hamper” reorganizations.<sup>34</sup>

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29. See *Proposal for a Regulation of the European Parliament and of the Council Amending Council Regulation (EC) No 1346/2000 on Insolvency Proceedings*, COM (2012) 744 final (Dec. 12, 2012) [hereinafter *Proposal*]; *Draft Report on the Proposal for a Regulation of the European Parliament and of the Council Amending Council Regulation (EC) No 1346/2000 on Insolvency Proceedings*, COM (2012) 0744 (Dec. 20, 2012) (*Parliament Draft Report*).

30. Wessels, *supra* note 23, at 87.

31. *Proposal*, *supra* note 29, para. 5 (“[T]he requirement that secondary proceedings must be winding-up proceedings should be abolished.”).

32. Pottow, *Secondary Proceedings*, *supra* note 21, at 583.

33. *Proposal*, *supra* note 29, para. 45, art. 42(d)(1)(c) (empowering the liquidator with the right “to propose a rescue plan . . . for all or some members of the group for which insolvency proceedings have been opened and to introduce it into any of the proceedings opened with respect to another member of the same group”); 11 U.S.C. § 1121(b) (2012) (“Except as otherwise provided in this section, only the debtor may file a plan until after 120 days after the date of the order for relief under this chapter.”).

34. *Proposal*, *supra* note 29, para. 12, recital 19(a) (noting that the opening of secondary proceedings can “hamper the efficient administration of the estate”).

### C. SUMMARY: DUBIOUS REFORM IN SEARCH OF A NORMATIVE ANCHOR

Assessing the direction of the circulating EU amendments from a modified universalist perspective leads to a middling but passing grade regarding the change in the role of secondary proceedings. True, the recitals starting to call out the potential evils of secondaries are a step in the right direction, but some disappointments remain. At the most basic level, secondaries persist as an instantiation of choice of law veto. Additionally, and perhaps more importantly, there does not seem to be serious movement in the choice of law provisions; none of the amendments confronts the issue of the carve-outs from *lex fori concursus*. And most troublingly from the vantage of this Article's ambitions, there is no apparent normative compass guiding these reforms. That is, for synthetic secondaries, the report simply recognizes generalized feedback from respondents to questionnaires expressing "dissatisfaction" with secondary proceedings;<sup>35</sup> it cites the success of *Collins & Aikman* as a workaround,<sup>36</sup> but then shies away from striking a new path guided by a strong normative vision. Rather, the amendments seem to have restricted their changes to secondary proceedings (and other choice of law provisions) to the level of housekeeping: necessary and deft cleanups, to be sure, but nothing moving the ball forward in any significantly normative way.<sup>37</sup> This restricted scope is perhaps not surprising given the touchiness with which choice of law gets treated in insolvency. Consider the voluminous Legislative Guide (LG) propounded by UNCITRAL.<sup>38</sup> While generally not bashful about offering prescriptive recommendations for domestic insolvency laws for countries seeking to update their regimes (including such micromanagement as spelling out super-majoritarian voting rules in reorganization proceedings),<sup>39</sup> the LG does not touch choice of law with a ten-foot pole, other than meekly suggesting that if countries want to persist in having priority payment provisions for preferred creditors in local law, they should minimize those unwelcome attributes of a bankruptcy law regime.<sup>40</sup>

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35. *Id.* at 4 (noting that "half of the respondents were dissatisfied with the coordination between main and secondary proceedings.").

36. *Id.* at 7.

37. I know, housekeeping was essentially the scope of its mandate, *id.* at 3 (noting that, after consultation with stakeholders and receipt of results of studies, improving efficiency was the primary objective of the revision of the Insolvency Regulation), so I'm not blaming the technocrats here—in fact, I think they did a great technocratic job. Ten points for Ravenclaw.

38. U.N. COMM'N ON INT'L TRADE LAW, UNCITRAL LEGISLATIVE GUIDE ON INSOLVENCY LAW, U.N. Sales No. E.05.V.10 (2005) [hereinafter UNCITRAL LEGISLATIVE GUIDE].

39. *Id.* recs. 145–151.

40. *Id.* rec. 187 ("The insolvency law should minimize the priorities accorded to unsecured claims."). I would translate this into more direct speech thus: "We all know they're just gravy trains for favored local lobbies, so if you have no shame and include them in your bankruptcy laws, at least be discreet about it and don't do it too much."



#### D. FUMBLING TOWARD NORMATIVITY: THE GLOBAL PRINCIPLES ANNEX

All of this discussion should lead the knowledgeable reader to want to explore the Global Principles Annex (GP Annex), with its comparatively ambitious agenda for a choice of law regime to supplement the EU Insolvency Regulation.<sup>41</sup> There, carve-outs abound as the modified universalist approach to choice of law.<sup>42</sup> The GP Annex is certainly a bold innovation, but at the same time it too is unnecessarily timid in its embrace of modified universalism. That is, by its own terms, it worries that perhaps the provisions of EU Insolvency Regulation, and certainly the choice of law suggestions in the LG, are too universalist for international rollout, having too few carve-outs from COMI insolvency law for the Reporters' comfort.<sup>43</sup> In that sense, the GP Annex is a theoretical step backward.<sup>44</sup> Indeed, this reveals the greatest risk with an incrementalist reform system (procedural or otherwise). The glass half full narrative is that modest reforms will tear down sovereign mistrust and participant-actors' skepticism of the evils of applying foreign insolvency law. The half empty narrative, however, is that these modest reforms will get readily enacted with self-congratulatory back-slapping but then stall without further progress when the truly difficult sovereignty concessions have to be made (e.g., selection of priority and distribution rules).<sup>45</sup> Worse, "critical carve-out mass" might be reached that encourages protectionist-minded lobbyists to seek to add their own carve-outs into the mix, resulting in rent-seeking chaos and the loss of any universalist core.<sup>46</sup>

Viewed from the half empty perspective, it is easy to dismiss the GP Annex as "just a bunch of carve-outs" and bemoan its increased carve-out usage when compared with other instruments. But that would be a mistake. Carefully analyzed, the carve-outs have a common normative thread. Indeed, the painstakingly crafted Comments and Reporters' Notes to each

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41. *GP Annex*, *supra* note 15, Statement of the Reporters.

42. *E.g.*, *id.* r. 19–21 cmt. ("Based on perceived impressions of the importance of certain social policies and on several high-profile court cases, the Reporters believe that a [carve-out] rule of global application should be proposed with regard to current contracts of employment in case of the insolvency of the employer.")

43. *Id.* Statement of the Reporters ("With respect, the Reporters consider that so limited a range of exceptions to the dominant role of the *lex concursus* is unlikely to prove commercially convenient or acceptable to the majority of parties engaged in international trade and business, given the present stage of uneven development of national laws governing such sensitive matters as security interests, set-off, and transaction avoidance.")

44. Of course, the Reporters will fairly retort that they score a huge victory in scope—the intended reach of the GP Annex is to be universal, not just European—and so it can be argued that with wider scope and exposure to more diverse legal systems comes a necessary reduction in ambition regarding acceptance of universalist choice of law principles.

45. See Pottow, *Procedural Incrementalism*, *supra* note 3, at 1012 ("[I]t might well be that as the cession of sovereignty gets increasingly painful, states will reach a balking point.")

46. As an example, see The Innovation Act, H.R. 3309, 113th Cong. § 6(d) (2013), enacted as 11 U.S.C. § 365(n).

Rule in the GP Annex demonstrate that the drafters were trying to anchor each carve-out in a justified principle of insolvency or commercial law policy.<sup>47</sup> The proposal of this Article is to draw that common normative thread out into the open and propose a unifying theme. Thus, this Article contends that the better approach is to use this normative vision to guide from the top-down an analysis of which, if any, carve-outs should exist from a strong *lex fori concursus* rule in a modified universalist regime, rather than justify which, if any, current carve-outs are theoretically defensible from a bottoms-up, issue-by-issue approach.<sup>48</sup>

## II. PROPOSED NORMATIVE FOCUS: PROTECTING DEFENSIVE RELIANCE INTERESTS.

As a clarifying reminder, the normative focus proposed in this next section presupposes a modified universalist insolvency regime. That is, the most top-level normative framework is stipulated to be universalism; the transactional gains and operational simplicity are taken as givens in need of no further theoretical defense.<sup>49</sup> But the modified universalist system allows clawback from this ideal, and as currently operationalized, that clawback is by way of carve-outs. Thus, the “lower-level” focus of this normative discussion is how best to design and identify the appropriate carve-outs.

### A. FIRST PRINCIPLES: PARTY RELIANCE

As a starting point, then, we might blend the normative into the descriptive and examine the current carve-outs of the status quo (at least the status quo of current reform proposals). Looking at Rules 15 through 23 of the GP Annex that permit carve-outs to the *lex fori concursus*, such as “in rem” (security);<sup>50</sup> labor contracts;<sup>51</sup> set-off defenses;<sup>52</sup> and voidable transactions,<sup>53</sup> it is submitted that a common theme of reliance can be divined. For example, the avoidance carve-outs protect the party accused of a voidable transaction’s defense to avoidance available under local law.<sup>54</sup> The presumed reliance of a local worker to the protections accorded under domestic insolvency law is similarly vindicated.<sup>55</sup> Broadening the focus of reliance to *ex ante* business expectations, it can also be argued (at least plausibly) that secured lenders equally rely upon the insolvency protections

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47. *GP Annex*, *supra* note 15, cmts. *passim*.

48. The GP Annex takes a bottoms-up approach under this taxonomy.

49. *See, e.g.*, Westbrook, *Theory and Pragmatism*, *supra* note 1, at 466; Lucian Arye Bebchuk & Andrew T. Guzman, *An Economic Analysis of Transnational Bankruptcies*, 42 *J.L. & ECON.* 775 (1999).

50. *GP Annex*, *supra* note 15, r. 15.

51. *Id.* r. 20.

52. *Id.* r. 17.

53. *Id.* r. 22.

54. *Id.*

55. *Id.* r. 20.

of transaction-state law regarding rights upon default.<sup>56</sup> Thus, the carve-outs from strict application of *lex fori concursus* can each, to a greater or lesser extent, be justified as protecting this “local law reliance interest.” This should not be a provocative position; the Reporters themselves frequently cite reliance interests in their commentary.<sup>57</sup>

Accordingly, I propose that rather than have a reliance tail wagging the choice of law carve-out dog, we should promote reliance to the status of dog proper: reliance should become the necessary and (nearly) exclusive justification for a choice of law carve-out. That is, a more theoretically pure approach to insolvency choice of law would be to have a global rule that whenever a party to a transaction actually and reasonably relies upon the provisions of domestic insolvency law, that substantive law should govern resolution of an insolvency-related dispute. That pure a rule, however, is unlikely to come about. Even setting aside administrability concerns for present discussion, such a party-focused rule would be a radical departure from the interest-focused analysis of modern choice of law rules in many legal systems.<sup>58</sup> Indeed, it even seems like a reversion to the vested rights approach of a bygone era,<sup>59</sup> perhaps prompting concern by private international law scholars that this would be the worst of all possible worlds.<sup>60</sup>

Let me nevertheless defend this seemingly provocative normative stance from such global attack. First, “contacts”—really, state-based reliance interests—are not the proper reliance interests that should be protected in insolvency choice of law rules. (In earlier work, I have argued for a general carve-out in favor of local state insolvency law as a bone to throw to territorialists in the truest pragmatic spirit of modified

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56. *Id.* r. 15–16 cmt. (“The extent to which the rights of a secured creditor are capable of being affected by the debtor’s insolvency is an essential aspect of the creditor’s assessment of the net risk to which he is exposed, and can have a significant bearing upon the decision whether to extend credit, and if so, on what terms.”).

57. *Id.* Statement of the Reporters (describing the “enhanced certainty and predictability of . . . outcomes” as “a worthwhile goal”).

58. See, e.g., RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 6 (1971) (articulating a “most significant contacts” test); see also *id.* cmt. c (articulating the principle that the law of the jurisdiction with the “most significant relationship” to a dispute should govern).

59. See RESTATEMENT (FIRST) OF CONFLICT OF LAWS § 1 (1934).

60. See, e.g., J.H.C. Morris, *Law and Reason Triumphant, or How Not to Review a Restatement*, 21 AM. J. COMP. L. 322, 330 (1973) (calling the Restatement (Second) of Conflicts “the most impressive, comprehensive and valuable work on the conflict of laws that has ever been produced in any country, in any language, at any time.”). However, the Restatement (Second) has, much as its predecessor, faced considerable criticism. See, e.g., Douglas Laycock, *Equal Citizens of Equal and Territorial States: The Constitutional Foundations of Choice of Law*, 92 COLUM. L. REV. 249, 253 (1992) (“Trying to be all things to all people, [the Restatement (Second) of Conflicts] produced mush.”); Symeon C. Symeonides, *The Need for A Third Conflicts Restatement (and A Proposal for Tort Conflicts)*, 75 IND. L.J. 437, 448 (2000) (“Courts need and are entitled to more guidance than either the Second Restatement or the iconoclastic literature of the last two decades have provided.”).

universalism,<sup>61</sup> but here I am engaging in a more theoretically pure analysis.) Indeed, state interests are already well protected in the standard escape clause public policy exceptions within the universalist choice of law regimes,<sup>62</sup> so it is hardly fair to suggest that party-focused reliance leaves state public policies out in the cold. Second, as will be revealed below, I am not necessarily against “presumed” party reliance as a back-door protection of state interests in certain policy-sensitive areas, such as labor rights, that have traditionally bedeviled multinational insolvency proposals.<sup>63</sup> (Some might label this a fudge, and there may be some force to that criticism, but I will counter their purity with pragmatism.) Accordingly, I am trying to capture the fairness-oriented concerns undergirding some, if not all, of the GP Annex exceptions in suggesting that party reliance—and not state reliance—should be elevated to become the proper focus of attention in crafting choice of insolvency law carve-out rules within a modified universalist system.

## B. SECOND PRINCIPLES: DEFENSIVE RELIANCE

Even if the theoretical purity of an exclusively reliance-based choice of law regime could overcome pragmatism objections, it would still encounter challenges based on the multi-party nature of bankruptcy law. Consider, for example, avoidance law. Creditor A, recipient of a voidable preference under COMI-state law, pleads that under the private international law rules of her state the obligation would be covered by home-state law, and under home-state law she has an absolute defense to avoidance. The GP Annex accommodates this “defendant reliance” by exempting the application of COMI state avoidance law to “save” the defendant from liability and thereby protect A’s legitimate legal expectations.<sup>64</sup> An intrinsic fallacy with this approach, however, is a vividness focus on A’s interest to the extent of

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61. John A. E. Pottow, *Greed and Pride in International Bankruptcy: The Problems of and Proposed Solutions to “Local Interests”*, 104 MICH. L. REV. 1899, 1939 (2006) [hereinafter Pottow, *Greed and Pride*].

62. *E.g.*, 11 U.S.C. § 1506 (2012) (“Nothing in this chapter prevents the court from refusing to take an action governed by this chapter if the action would be manifestly contrary to the public policy of the United States.”).

63. *See* EU Insolvency Regulation, *supra* note 2, rec. 11 (noting that the varying views on rights *in rem* and contracts of employment make it impractical to introduce insolvency proceedings that are universal in scope).

64. The GP Annex contains three examples demonstrating the application of Global Rules 22 and 23. Two of those examples illustrate how the GP Annex “saves” creditors who rely on a certain state’s law from the application of COMI law. *GP Annex, supra* note 15, r. 22–23 cmt., Reporters’ Notes. Example (a) is the quintessential example of a creditor who relies on local law being saved from the application of COMI law by the GP Annex. Example (c) provides an example of how the GP Annex saves a creditor who structures a transaction relying on usage of trade, rather than local law. By contrast, example (b) illustrates how the GP Annex does not “save” creditors who do not rely on either local law or usage of trade. Instead, the GP Annex dictates that COMI law should apply if the only motive for structuring a transaction is to avoid the application of avoidance law.

diffuse-parties B through Z's interests, represented by a bankruptcy trustee, liquidator, etc. Creditors B through Z surely have a fair retort that under COMI law they legitimately expect a bankruptcy estate will not be unfairly depleted by transactions of the sort that A just protected. Yet the GP Annex, following all major reforms to date, protects A at the expense of B through Z in the name of reliance.

The vividness (or perhaps salience) bias of concentrated losses versus diffuse gains is not hard to understand in the realm of voidable transactions: the creditor who writes the cheque back to the bankruptcy estate smarts; the other creditors, whose unsecured dividend increases marginally as a result, may barely notice. To be sure, some gains are too diffuse to count: when a criminal defendant's rights are violated securing a wrongful conviction, we generally do not talk about the diffuse gain received by having someone dangerous off the street. The real question, then, for bankruptcy, is not just what a given party relies upon in arranging its legal affairs, but whether that expectation is concentrated enough that it warrants special protection in the face of countervailing antithetical expectations of myriad other parties that will necessarily be compromised. Thus, mere incantations of "reliance," on their own, cannot suffice to justify automatic legal protection; more searching scrutiny is required.

To help sort the types of reliance and find those sufficiently special to warrant choice of law protection in bankruptcy, a subsidiary consideration might be deployed: whether the expectation should be considered "affirmative" or "defensive." Let us revisit the sympathy one might have toward the voidable preference defendant.<sup>65</sup> It is not just the concentration of loss upon the party that inclines us to offer protection but also the fact that it is a *loss* and not a gain. To be sure, technically this is swapping one cognitive bias (vividness) for another (endowment). But the law, perhaps to the lament of economists, privileges loss aversion in all sorts of ways that differ from gain protection.<sup>66</sup> I build happily upon that scaffolding in submitting that the sympathy accorded a voidable transaction recipient might markedly exceed that accorded, say, a secured transaction lender who was "legitimately expecting" State A's law to allow it to have unqualified priority in insolvency and who would be disappointed to find that an insolvency proceeding under (COMI) State B's law might surcharge that priority. The loss of a potential priority seems a different order of expectation to protect than being tagged with civil liability to disgorge a

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65. Preference recipients are especially sympathetic under U.S. law because of their lack of culpability. See 11 U.S.C. § 547 (voiding preference transfers under a strict liability regime).

66. See, e.g., Eyal Zamir, *Loss Aversion and the Law*, 65 VAND. L. REV. 829 (2012) (noting, for example, how the loss-focused law of tort gives rise to greater remedies than the law of unjust enrichment and how the Constitution's Takings Clause limits the government's power to take property without just compensation while no provision limits the government's power to confer benefits).

“wrongful” transaction. We can thus conceive the use of reliance expectations in choice of law as a sword as being categorically different from their use as a shield, perhaps inclining us to protect the latter more than the former.<sup>67</sup>

Accordingly, a focus on “defensive” reliance can help solve an especially prevalent reliance question in the bankruptcy context: *whose* reliance? But that theoretical starting point is still not enough; the idea also needs to be implemented. That implementation can take several forms. At the cleanest level, if one wants to operationalize a defensive reliance-based normative framework for choice of law in the most theoretically pure manner, one could simply abolish all the carve-outs from COMI law that seem to grasp around reliance justifications and replace them with an omnibus reliance exception. To wit, global application of COMI law could be tempered by a freestanding exception as follows: “Any party who has actually and reasonably relied upon local insolvency law in conducting its affairs with the debtor shall not be subjected to the application of the COMI-state’s insolvency law.” This straightforward rule would not only adhere more directly to the normative principles I contend (rightly) undergird the present carve-outs but also have the additional attraction of drafting simplicity. Relaxing the need for theoretical purity, however, I might reject such a blanket rule and instead use the principle of defensive litigant reliance as a “framework” to guide further movement along the paths already blazed by current international insolvency instruments, such as the EU amendments or GP Annex. Path dependency has its virtues, and modified universalism, by definition, recognizes the desirability of pragmatics over purity.

In Part IV, *infra*, I will suggest where such a framework leads, but first we must detour briefly to a reconsideration of the merits of so-called “bankruptcy contractualism.” This is not an indulgence. It is a discussion that is necessitated by the Article’s proposed normative refocus of cross-border insolvency law onto reliance.

### III. INTERLUDE: CONTRACTUALISM RECONSIDERED

If a normatively desirable approach to choice of insolvency law rules involves protecting legitimate party expectation, we run squarely into the world of contractualism, which espouses allowing parties freedom to

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67. This example is not perfect. From the perspective of the disappointed secured creditor, there has been a “loss” of expected entitlement, but that loss still does not rise to the level of the disgorged preference recipient. Perhaps a better analogy might be that of the disappointed unsecured creditor who cajoled a trustee into pursuing a preference action that is subsequently abandoned. That “loss” clearly does not engage the same endowment concerns of the preference recipient’s disgorgement.

choose their own bankruptcy law regime.<sup>68</sup> Assuming that such party choice is permissible (i.e., the contra-indicating policy concerns are put to rest),<sup>69</sup> then we have given away the choice of law farm. That is, if parties to a transaction have agreed contractually that the law, including the insolvency law, of State C will apply to any dispute arising out of a loan, then the COMI state's law in insolvency proceedings is rendered irrelevant. This is not a problem if what we truly care about under our normative framework is protecting these parties' legitimate expectations. In other words, it is difficult to adopt a normative approach to insolvency choice of law that centers on reliance without taking a stand (and presumably a strongly supportive one) on the merits of contractualism.

Increasingly unfettered party autonomy in choice of law contracts is clearly gaining ascendancy.<sup>70</sup> Furthermore, in the international commercial context, courts have been especially permissive to forum selection clauses.<sup>71</sup> Accordingly, it seems the anti-contractualist has an uphill battle in cabining the scope of free party choice between sophisticated legal actors of governing legal law. On the other hand, and for similar reasons to those discussed in the preceding section, the unique multi-party context of insolvency draws into sharp relief the very problem with extending the presumptively free governing force of party-selected choice of law clauses: insolvency is not just a proceeding between the parties to a contract. Bankruptcy involves many other parties not at the contracting table. Consider the example of a bank and debtor who agree to structure their loan subject to a choice of law rule that the insolvency law of State X, which subordinates tort claims, will apply. Both debtor and bank will happily lower the cost of credit at the expense of the non-present (and perhaps not-yet-existent) tort victims.<sup>72</sup>

American insolvency law guards against this concern of two parties' control over the fate of the many, for example, by invalidating certain *ex ante* agreements to waive the automatic stay upon filing bankruptcy.<sup>73</sup> Such

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68. See, e.g., Robert K. Rasmussen, *Resolving Transnational Insolvencies Through Private Ordering*, 98 MICH. L. REV. 2252 (2000).

69. For a discussion of countervailing concerns, see John A. E. Pottow, *The Myth (and Realities) of Forum Shopping in Transnational Insolvency*, 32 BROOK. J. INT'L L. 785, 816 (2007) (pointing out that contractualism is systematically biased in favor of those creditors "likely to have, process, and credit-adjust to [] notice and [against] those likely to not").

70. Regulation 593/2008, of the European Parliament and of the Council of 17 June 2008 on the Law Applicable to Contractual Obligations, 2008 O.J. (L 177) 6 (EC); Regulation 864/2007, of the European Parliament and of the Council of 11 July 2007 on the Law Applicable to Non-Contractual Obligations, 2007 O.J. (L 199) 40 (EC).

71. *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1 (1972); *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585 (1991).

72. See Barry E. Adler, *Bankruptcy Primitives*, 12 AM. BANKR. INST. L. REV. 219, 243 (2004) (noting that shareholders and lenders can externalize risk on nonconsensual creditors and arguing that such creditors be given priority above even secured creditors).

73. E.g., *Farm Credit of Cent. Florida, ACA v. Polk*, 160 B.R. 870, 873 (M.D. Fla. 1993); *In re Sky Grp. Int'l, Inc.*, 108 B.R. 86, 89 (Bankr. W.D. Pa. 1989) ("To grant a creditor relief from

agreements between the debtor and a lender, courts reason, cannot bind the bankruptcy trustee, because the trustee enjoys the protection of the stay for the protection of all creditors.

The GP Annex takes some good first steps to curb this potential for mischief by requiring some “connection” between State X and the parties to the loan.<sup>74</sup> As a practical matter, however, such connection is easy to concoct in a modern age.<sup>75</sup> Thus, unless a truly restrictive test for “connections” is set up—which is possible doctrinally, although not yet proposed—then the (utilitarian) policymaker has to confront the difficult task of weighing the benefits of vindication of party choice against the costs of third-party exclusion.<sup>76</sup>

Three observations flow from and should guide resolution of this tension. First, if categorical exclusions can correctly anticipate *ex ante* all potentials for third-party abuse, then a free contractual choice regime can be defended. For example, Barry Adler has endorsed a system of bankruptcy contractualism with the precondition that all tort creditors have automatic priority for preferred distribution.<sup>77</sup> Second, vindicating party choice of forum and/or governing law need not be an all-or-nothing proposition.

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stay simply because the *debtor* elected to waive the protection afforded the debtor by the automatic stay ignores the fact that it also is designed to protect *all creditors* and to treat them *equally*. The orderly liquidation procedure contemplated by the Code would be placed in jeopardy, especially where (as here) none of the creditors who brought the involuntary petition was a party to the Agreement in which debtor allegedly waived its right to the automatic stay.”).

74. *E.g.*, GP Annex, *supra* note 15, r. 16.1 (making Rule 15 on Secured Creditors inapplicable if the state where the assets are situated has no substantial relationship to the parties or the transaction); r. 18 (making Rule 17 on Set-off inapplicable if the law of the state chosen by the parties has no substantial relationship to the parties or the transaction); r. 23 (making Rule 22 on Defenses to Avoidance of Detrimental Acts inapplicable if proof is provided that the state whose law that applies has no “substantial relationship to the parties or the transaction”).

75. The European Parliament attempted to address this concern in insolvency cases involving groups by proposing a presumption that allows the application of a certain state’s law when a group member or members existing in that state contribute at least ten percent to the consolidated balance-sheet total and consolidated turnover. European Parliament, Comm. on Legal Affairs, *Report on the Proposal for a Regulation of the European Parliament and of the Council Amending Council Regulation (EC) No 1346/2000 on Insolvency Proceedings*, amend. 26(ja)(ii), (COM(2012)0744 – C7-0413/2012 – 2012/0360(COD)) (Nov. 9, 2013) [hereinafter Parliament Report].

76. Even this analysis sidesteps the administrability concerns of multi-creditor negotiations. For a sobering analysis, see Elizabeth Warren & Jay Lawrence Westbrook, *Contracting Out of Bankruptcy: An Empirical Intervention*, 118 HARV. L. REV. 1197 (2005).

77. Adler, *supra* note 72, at 243; *see also* Robert K. Rasmussen, *Debtor’s Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 67 (1992) (“The question of the appropriate treatment of nonconsensual claimants when a firm is insolvent is the subject of a rich literature. This Article does not, and need not, enter this debate. Rather, once policymakers decide the optimal treatment of nonconsensual creditors, this treatment should be unalterable by any debt contract. In other words, the priority status of tort claimants should not depend on which bankruptcy option a firm selects. Thus, a bankruptcy regime consisting primarily of default rules can readily accommodate the existence of nonconsensual claimants.”); *cf.* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991) (arguing against even shareholder limited liability where plaintiff is tort victim).



Consider, for example, family law contracts (antenuptial, postnuptial, etc.). For some of the same reasons as insolvency law (implication of the rights of non-contracting third parties, i.e., children),<sup>78</sup> many domestic systems will give only presumptive—not dispositive—weight to the parties’ contractually expressed preferences for legal distributions.<sup>79</sup> A similar presumption-based approach to contractualism could be deployed in multi-national insolvency to see if the hypothetically exploited tort victim actually arises in any given case. Third, harkening back to the distinction earlier about parties’ expectations serving as either a sword or a shield, choice of law rules could be otherwise less solicitous to party choice involving preferred distribution (swords) to ones involving defensive protections from liability (shields).<sup>80</sup> This third point blends with the second point to underscore that a “looser” approach to vindicating party expectation as expressed through contracted choice of law clauses can indeed be justified—even in a context of extra-party concerns.

#### IV. DEPLOYING A RELIANCE-BASED CHOICE OF LAW FRAMEWORK.

Earlier I proposed how a theoretically pure reliance-based choice of law principle might be implemented as a categorical rule. Now it is time, as modified universalism commands, to relax the commitment to theoretical purity and build upon the incrementalist path already laid out by prior

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78. Allison A. Marston, *Planning for Love: The Politics of Prenuptial Agreements*, 49 STAN. L. REV. 887, 898 (1997) (“The most common types of provisions that courts have held invalid contravening public policy concern children, including waiver of child support, custody, or visitation rights.”); see, e.g., N.J. STAT. ANN. § 37:2-35 (West, Westlaw through 2014 Sess.) (“A premarital or pre-civil union agreement shall not adversely affect the right of a child to support.”); CONN. GEN. STAT. ANN. § 46b-36d (West, Westlaw through 2014 Sess.) (“The right of a child to support may not be adversely affected by a premarital agreement. Any provision relating to the care, custody and visitation or other provisions affecting a child shall be subject to judicial review and modification.”).

79. For example, in the United Kingdom, prenuptial agreements are not legally binding. Courts retain broad discretion to distribute family assets as they see fit, so as to bring about fairness between the couple. Matrimonial Causes Act, 1973, c. 18, §§ 23–24 (U.K.). A prenup is merely one of the factors the court will take into account when distributing assets. *Id.* § 7. Similar issues arise regarding forum selection clauses. See *Stewart Org., Inc. v. Ricoh Corp.*, 487 U.S. 22 (1988) (viewing enforcement not as a question of contract formation, but instead as a question of whether the action should be transferred from a noncontractual forum to the contractual forum depending upon the factors outlined in the transfer of venue statute, 28 U.S.C. § 1404(a) (2012), namely, convenience of parties and witnesses and “the interest of justice”).

80. This final point may need some unpacking. A contract necessarily involves at least two actors, and so one party’s shield may be another’s sword. My thinking here is that parties might structure a transaction to provide protection from avoidance under (appropriate) local law. Accordingly, a logical extension of the argument advanced in this Article regarding the role reliance should play in choice of cross-border insolvency law is that a general theory of bankruptcy contractualism should be embraced. So long as “embraced” allows cautious application of the principles derived from the theory and not a full-throated commitment to “the contract trumps all,” then this Article’s author approves and endorses the logical extension of this Article’s arguments!

efforts in the field. We can go through some of the current carve-outs, such as those relating to set-offs and labor laws, both to see how they fare under our reliance-focused framework and to make appropriate remedial recommendations as needed.

### A. SET-OFF

To start, let us consider the case of set-off. After a comprehensive discussion, the Reporters of the GP Annex adopted the exception from *lex fori concursus* for a local state set-off law in circumstances when set-off is allowed by the passive claim's law.<sup>81</sup> This is basically a defendant-protective position based on reliance. Note that other approaches could have been proposed that would vindicate different policies. For example, one could have proposed allowing a set-off only if *both* COMI law *and* local law allow for set-off. This would be considered a "debtor-protective" stance (or, equally, an "anti-set-off" stance); both of those positions can be justified normatively as a matter of policy, but not on the reliance grounds advanced here. Similarly, one could have suggested allowing a set-off if *either* COMI *or* local law allows. While promoting a plausible normative policy (maximal creditor self-help in bankruptcy), this approach similarly cannot be said to follow reliance vindication.

Against this backdrop, it might be assumed that the GP Annex set-off exception scores well on this Article's proposed framework. It does, but it also does not. First, the positive: by focusing on the defendant's local law,<sup>82</sup> the exception properly restricts itself to the domain of "protective" expectations, which vindicates defensive reliance. The reason for withholding full marks, however, is that the carve-out assumes that the creditor has, in fact, relied on that local law (or, even more precisely, assumes that the creditor relied upon the non-application of COMI law in lending to the debtor). While of course administrability concerns might justify an approach of such presumed reliance, a modified universalist should want to minimize carve-outs as much as possible to maximize the reach of COMI-law rule.<sup>83</sup> Accordingly, a better approach would be one that allows defenses to COMI law not when they are presumed, but only when they are actually needed. This might be considered "calling the reliance bluff" of the putative setter-off. Indeed, this consideration is already cogently mentioned in the Reporters' notes, where they ask whether set-off should be allowed upon its entitlement under passive claim law or

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81. GP Annex, *supra* note 15, r. 17.

82. I realize this discussion frames set-off as an attack on a defendant. Of course, it could also be characterized as a privilege accorded the setter-off. I think it is nevertheless fair to think of an offsetting creditor as resisting payment of its claim to the estate and hence as a putative defendant. (If not, the analysis of this discussion can be carried over to preference recipients.)

83. Pottow, *Secondary Proceedings*, *supra* note 21, at 588–89.

whether there should be a further requirement that the party invoking set-off must show that such a right has formed part of its legitimate expectations arising in the context of the lending relationship between the creditor and the insolvent debtor, so as to have been part of the calculation of risk during the process of becoming a creditor on the terms agreed.<sup>84</sup>

Yes, of course it should. The setter-off is the one who wants the Get-Out-of-COMI-Free Card; let the burden lie accordingly.<sup>85</sup>

Thus, a better rule under the suggested normative framework of this Article would be to amend Rule 17 of the GP Annex to read something like this for the conditions of allowing set-off: “If set-off is permitted by the law applicable to the insolvent debtor’s claim *and* the party with the right to set-off demonstrates it relied upon the application of that law to the exclusion of the law of the state of the main insolvency proceeding in lending to the debtor.” For those tut-tutting on administrability grounds that such an approach necessarily draws a fact-intensive debate into each set-off claim, I threaten them with offering an alternative reformulation that is less likely to ground viable litigation: “and the offsetting party demonstrates it was unaware of the debtor’s COMI.” That way, the truly “local” creditors who are purportedly unsophisticated in dealing with multinational conglomerates would get a pass, but the rest would be bound by the *Gebhard* maxim of when you do business with a foreign company, you know you’re getting yourself into foreign law.<sup>86</sup> In the spirit of incrementalism, if the alternative proposal is deemed too aggressive for the present state of affairs, consider it a negotiating anchor to make the primary proposal seem more reasonable! More seriously, if we want to circumscribe normatively well grounded rules doctrinally by functional considerations—an eminently sensible impulse—then such “cut-offs” should not just be expeditious (e.g., no carve-out for

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84. GP Annex, *supra* note 15, r. 17–18 cmt.

85. I am unapologetic that this apparently reverses the British Parliament’s statutory semi-outruling of *Forster v. Wilson*, (1843) 152 Eng. Rep. 1165. In *Forster*, one Wilson was in debt to a bank that had gone bankrupt. He acquired several classes of £5 notes payable from the bank to the bearer. Some of the notes were from customers on account of antecedent debt and other notes provided that “the defendants were to pay so much only as they should receive from the assignees . . . .” Wilson argued that he had a right to set-off for all classes of notes. The Court held that Wilson and his co-defendants possessed the latter class of notes solely as trustees for third parties. In essence, they themselves had not relied on the notes. The purpose of the right of set-off, the court said, is to do “substantial justice” between the parties, “where a debt is really due from the bankrupt to the debtor to his estate.” In this case, the court found the latter classes of notes were not debts that were due since the defendants were to pay only as much as they received. Since there was no reliance, the defendants did not have a right of set-off as to those notes. When it enacted a set-off statute, Insolvency Act, 1986, c. 45, § 323 (Eng.), the British Parliament allowed for the assignment of claims while eschewing the analysis of the court in *Forster*. Cf. *Stein v. Blake*, [1996] A.C. 243 (declaring that the right of set-off is automatic and self-executing).

86. *Canada S. Ry. Co. v. Gebhard*, 109 U.S. 527, 537 (1883) (“[E]very 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.”).

creditors whose names begin with “P”), but should be guided by principles themselves furthering the higher-level ideal (here, universalism). In this specific instance, therefore, one could respond to concerns of excessive litigation with an evidentiary presumption. Given the universalist reluctance toward carve-outs, in this case that presumption could be that the defendant did *not* rely on local law. (If that rule were thought to be too broad, further tweaks could be added: e.g., a presumption of no local law reliance for a creditor whose COMI is outside the local jurisdiction, a counter-presumption of local law reliance for a creditor who conducts business solely within the local jurisdiction, etc.).

In sum, the GP Annex carve-out for set-off is consistent with this Article’s framework; to be fully consonant, however, it should include an actual reliance test.

## B. LABOR LAW

Labor law presents a different challenge, because here it is harder to justify a *lex fori concursus* carve-out from an expectations-based normative lens. In fact, it stretches the fiction of legal knowledge to its breaking point. (As an informal self-survey, I can attest I was unaware of any insolvency labor entitlements until I became employed as a bankruptcy professor.)<sup>87</sup> Rather, the labor law carve-out is for “certain social policies,” as the GP Annex Reporters candidly admit.<sup>88</sup> In fact, the EU Insolvency Regulation reveals the inappositeness of expectations to its rule by saying point-blank that the justification of the labor law carve-out is “in order to protect employees and jobs.”<sup>89</sup> To be clear, pro-labor is a perfectly defensible insolvency law policy—indeed, I have argued elsewhere for the permissibility of such a policy-based carve-out from *lex fori concursus*<sup>90</sup>—but a *lex laboris* carve-out cannot honestly be justified on the grounds of protecting expectations.<sup>91</sup> Consider: if the purpose of the carve-out is, as the

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87. By contrast, I suspect most directors and officers are acutely aware of their responsibilities—and defenses—under local law. For this reason, and for the desire to favor “defensive” carve-outs from *lex fori concursus*, a reliance-based choice of law regime would protect local officers from liability if entitled to immunity under local law regardless of COMI law. Indeed, “presumed reliance” might even be an appropriate evidentiary standard.

88. GP Annex, *supra* note 15, r. 19–21 cmt. (“Based on perceived impressions of the importance of certain social policies and on several high-profile court cases, the Reporters believe that a rule of global application should be proposed with regard to current contracts of employment in case of the insolvency of the employer.”).

89. EU Insolvency Regulation, *supra* note 2, rec. 28 (“In order to protect employees and jobs, the effects of insolvency proceedings on the continuation or termination of employment and on the rights and obligations of all parties to such employment must be determined by the law applicable to the agreement in accordance with the general rules on conflict law.”).

90. Pottow, *Secondary Proceedings*, *supra* note 21, at 589.

91. The Legislative Guide gamely tries. The rationale for the *lex laboris* carve-out, according to the Guide, is “protecting the *reasonable expectations of employees* with respect to their contract of employment, recognizing that workers may have a relatively weaker bargaining position than their employer, and ensuring non-discrimination amongst workers working in the same state,

EU Insolvency Regulation intones, to protect jobs, then a COMI rule that was *more* protective of employees than local insolvency law should be enthusiastically embraced rather than subordinated by carve-out. Yet to be theoretically consistent, one interested in protecting expectations alone would try to “save” the local workers in such a situation by restricting them to the more limited benefits of local law—all to vindicate their purported expectations. I doubt many laborers would begrudge being treated “discriminatorily” from other domestic workers by the application of more favorable COMI law in these circumstances.<sup>92</sup>

The *lex laboris* rule is even more confusing when it is coupled with the ambition of the GP Annex that priority payout *not* be carved out from the application of *lex fori concursus*.<sup>93</sup> This means the “insolvency effects” carve-out from COMI law is limited to presumably such matters as *ipso facto* termination of labor agreements but not—which one might predict many employees owed back wages care about—priority distribution.<sup>94</sup> While I applaud this carve-out-within-a-carve-out approach (indeed, it comports with an approach I have commended earlier),<sup>95</sup> it once again seems intellectually difficult to square with a reliance-based normative mission. Either the workers legitimately expect the application of local law—with the full panoply of its insolvency goodies—or they do not. This hybrid approach surely cannot be founded on a fine empirical line between just what they do expect and what they don’t. Rather, it is a policy balance: this is what they can rely on, but no more. Again, to belabor the point, I do not object to this line-drawing-cum-sausage-making; my intention simply is to underscore the tension between policy-driven compromises, such as the current *lex laboris concursus*, and more normatively driven approaches, be they animated by substantive policies (e.g., protecting employees) or more “meta” legal principles (e.g., protecting reliance).

Employment contracts are the most politically sensitive area of insolvency choice of law discussion, perhaps next to secured credit.<sup>96</sup> Accordingly, my modified universalist inclination is to defer subjugation to

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whether they are employed by a local or by a foreign employer.” UNCITRAL LEGISLATIVE GUIDE, *supra* note 38, at 70 (emphasis added).

92. Pottow, *Greed and Pride*, *supra* note 61, at 1914 (“[W]e cannot say with certainty whether the content of local law on its own inclines legally privileged creditors toward universalism or territorialism; we can only say with certainty that it inclines them toward the application of the most favorable law.”).

93. GP Annex, *supra* note 15, r. 20.

94. *Cf. Re Collins & Aikman Europe SA*, [2006] EWHC (Ch) 1343 (suggesting such priority distributions motivate restructuring plan design).

95. Pottow, *Secondary Proceedings*, *supra* note 21, at 589.

96. See UNCITRAL LEGISLATIVE GUIDE, *supra* note 38, at 131 (“[T]he relationship between employee and employer raises some of the most difficult questions in insolvency law . . . . The difficult question is generally the extent to which [non-insolvency statutory] provisions will have an impact on the insolvency, raising issues that are much broader than termination of the contract and priority of monetary claims . . . .”).

COMI state law for as long as possible along the incrementalist path; I would let states apply local state law to local workers as and not push the envelope. The problem is fitting that within my normative framework. I have two choices on how to do so (absent hypocrisy): first, I can repair to categorical treatment and simply say that for policy reasons, labor law is “off the table” for universalist choice of law subject to reliance-based carve-outs. Second, I can try to shoehorn the *lex laboris* rules suggested thus far into a reliance, or at least “deemed” reliance, analysis. My critique above portends an uphill battle.<sup>97</sup> Worse, deemed reliance drags me into the very quagmire I criticize the British Parliament for regarding set-off expectations. In part for that reason, I would recommend treating employment contracts as a straight-out categorical exception—yes, a carve-out (a meta-carve-out?)—from the approach espoused in this Article. Especially if the carve-out does not encompass priority distribution along the lines of the GP Annex approach, it seems justifiable on an “extraordinary state interests” ground (i.e., control of the labor markets, minimizing pitchfork-based uprisings, etc.).<sup>98</sup> Nothing precludes such a “policy overlay” upon an otherwise reliance-based regime, especially in a world of modified universalism.

One point of reflection in closing on this possible cop-out: a decade or two ago, were I writing this same assessment, I would have assumed that tax priorities fell into the same sensitive policy domain and would have to be carved out from the *lex fori concursus* for political necessity.<sup>99</sup> Now, tax priorities are being abolished left and right; they do not even make the list of carve-outs under many of the proposals to date.<sup>100</sup> So some qualification might be in order regarding my pessimism for the universalization of employee rights. They too may change with time. But for now, discretion is the better part of valor.

### C. SECURITY INTERESTS

Rights in rem are mostly subject to a registration system, and so the contractualist analysis above governs whether to require actual reliance on non-COMI law in light of this registration. While of course a modified

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97. See *supra* discussion accompanying notes 91–92.

98. *Id.*

99. See Barbara K. Morgan, *Should the Sovereign Be Paid First? A Comparative International Analysis of the Priority for Tax Claims in Bankruptcy*, 74 AM. BANKR. L.J. 461, 461–62 (2000) (asserting that a fundamental question that a country attempting to develop a bankruptcy system must face is whether tax claims should be subject to insolvency laws and, if so, to what extent tax claims should be afforded priority treatment); see also INT’L INSOLVENCY INST., REPORT ON TAX CLAIMS (2005) (surveying differing national treatments of tax claims in insolvency proceedings); cf. AM. L. INST., PRINCIPLES OF COOPERATION AMONG THE NAFTA COUNTRIES 13 (2003) (recommending that rather than adopt parallel legislation regarding treatment of tax claims, such claims should be the subject of an international agreement).

100. See, e.g., The Enterprise Act, 2002, § 251 (U.K.) (abolishing the priority of the Crown).

universalist would like to subject these claims to COMI law as well (absent actual reliance) and eliminate the carve-out—bristling at the characterization of what is essentially a bankruptcy distribution priority as an inviolable property right—I am less insistent, given the careful distinctions already addressed by the Reporters and others between what might and what might not rise to the level of truly violating “rights in rem.” Thus, for example, a limited moratorium on the realization of the security interest that holds the secured creditor at bay for a bit may not even be a “violation” of rights in rem so long as the underlying lien remains preserved.<sup>101</sup> If so, then the value-destructive risk of leaving secured creditors with unfettered rights to pull the plug on a reorganization proceeding afoot under a debtor-protective COMI law becomes less worrisome, because the (protective) stay would escape carve-out treatment. For non-registered charges, however, I would revert to the requirement of demonstrating actual reliance and/or lack of knowledge of the foreign COMI of the debtor. (Real property, for path-dependent jurisprudential reasons, can stick with a strict *lex situs* rule.)<sup>102</sup>

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In sum, the modified universalist following a normative framework of reliance-based exceptions to *lex fori concursus* would counsel restricting the carve-outs to demonstrated instances of actual, defensive reliance. Such a framework could additionally accommodate, or at least not be intellectually embarrassed by, residual carve-outs for certain extraordinary policy categories (such as labor rights) or historically rooted categories (such as the *situs* rule for real property). Finally, a reliance-based regime could also tolerate a role for contractual choice of law selection, which may in reality functionally eclipse any secured credit rules, if the contracts were held in check and given presumptive, but not dispositive force, with careful scrutiny of adverse third-party effects. Two closing comments on administration and forum shopping seem in order. On administration: some instances of “deemed reliance” would not be antithetical to this Article’s normative enterprise. Perhaps creditors of a certain size or whose operations do not transcend national borders could be deemed to have relied on local law *per se*.<sup>103</sup> American bankruptcy law has all sorts of “small potatoes” exceptions and flatters itself still to be intellectually coherent.<sup>104</sup> Similarly,

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101. GP Annex, *supra* note 15, at 39 (asserting that a temporary moratorium does not interfere with the right in rem itself but merely affects the exercising of the right).

102. Pottow, *Secondary Proceedings*, *supra* note 21, at 588–89 n.63.

103. See 11 U.S.C. § 101(51D) (2012) (defining “small business debtor”); see also Wessels, *supra* note 23, at 98–99 (discussing the need for a definition of localization in Article 2(g) of the EU Insolvency Regulation and proposing some possibilities).

104. 11 U.S.C. § 547(c)(8)–(9) (excepting from preference attack transactions below a certain dollar amount).

for policy reasons we might, or might not, want to deem individual directors to have relied upon the defenses of local corporate law. The key point is to countenance some sliding by through a flexible conception of reliance for smaller fish but call the reliance bluff for other, larger, more sophisticated creditors, who often don't in reality truly rely on the provisions of local law at all when dealing with an international debtor, but rather use a choice of law arbitrage potential to gain strategic advantage.

Secondly, on forum shopping: much debate between universalism and territorialism has centered on the ability to police or facilitate forum shopping.<sup>105</sup> One of the vectors of complaint has been the difficulty in situating assets (under territorialism) and determining a debtor's COMI (under universalism).<sup>106</sup> The approach of this Article—by allowing in some instances the persistence of carve-outs—at one level is the worst of all worlds because it requires both the situation of assets *and* the location of COMI. That is, however, a necessary outcome of the pragmatics of modified universalism.

## CONCLUSION.

Choice of law in multinational bankruptcy proceedings stands at an important crossroads. While universalism has gained an intellectual foothold, the realities of the modern political landscape require its deployment at present only in modified form. But the degree of how much to “modify” universalism back into territorialism is now under discussion. The scope and extent of COMI law carve-outs are being examined by international institutions, such as UNCITRAL, that stand ready to advance further reform.<sup>107</sup> Within these confines, this Article has proposed a normative approach centered on reliance: rather than vague exhortations to the importance of protecting “local creditors,” explicit requirement should be made for actual, defensive reliance on the application of local law to the exclusion of COMI law before a litigant may evade the *lexi fori concursus*.

Yet rather than be fully committed to the normative implications of this argument—having a general rule of actual reliance cutting across all choice of law circumstances—this Article further aligns itself with the modified universalist project of incremental reform and prefers to build upon extant regimes; wheel re-inventing is neither welcome nor required. As such, this Article proposes to apply the reliance-based rule only in the subset of instances already identified as appropriate areas for carve-out. In a similar vein, this framework will bow to the political necessities of modified universalism and tolerate limited policy-based categorical carve-outs to

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105. Jay Lawrence Westbrook, *Multinational Financial Distress: The Last Hurrah of Territorialism*, 41 TEX. INT'L L.J. 321 (2006); Lynn M. LoPucki, *Global and Out of Control?*, 79 AM. BANKR. L.J. 79 (2005).

106. Pottow, *supra* note 69.

107. Working Group V (Insolvency Law), *supra* note 13.



persist, such as *lex laboris*. It is submitted that this new framework, with its focus on reliance and actual legitimate expectations, in addition to enjoying intellectual consistency, will ultimately serve a cabining effect on putative carve-outs by reserving the application of non-COMI law only when truly “required.” More importantly, the axis of cabining is one of principle, and so those left behind will be hard-placed to criticize the advance (i.e., when someone does not, in fact, rely on local law, it is hard to demand from a moral high ground that he should nevertheless enjoy the windfall of local law on bankruptcy distribution in a multi-jurisdictional proceeding). This new approach to choice of insolvency law can thus further the ultimate top-level normative goal: a truly universalist cross-border insolvency system.