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RESOLVING TRANSNATIONAL INSOLVENCIES THROUGH PRIVATE ORDERING

*Robert K. Rasmussen**

There is no international bankruptcy law. No question, there are international insolvencies. Transnational firms, just like domestic ones, often cannot generate sufficient revenue to satisfy their debt obligations. Their financial distress creates a situation where assets and claimants are scattered across more than one country. But there is no international *law* that provides a set of rules for resolving the financial distress of these firms. The absence of any significant free-standing international bankruptcy treaty means that a domestic court confronted with the domestic part of a transnational enterprise has to decide which nation's domestic bankruptcy law will apply to which assets. To the extent that one wants to talk about an "international bankruptcy law," it is nothing more than the question of when, as a matter of domestic law, a court will resolve a dispute according to the law of another country rather than its own nation's bankruptcy law.

International bankruptcy law as it currently exists is thus, in reality, domestic bankruptcy law. The challenge for each nation's domestic law in this area is to mediate the tensions that arise because the firm and its creditors are spread across more than one jurisdiction. This question becomes difficult in large measure because each country's domestic bankruptcy laws diverge. Such divergence is not surprising. Bankruptcy laws address a myriad of discrete questions. At a minimum, the bankruptcy laws of each nation must specify who will decide the future deployment of the insolvent firm's assets, who will own these assets after the proceeding ends, and who will run the firm while all these matters are being sorted out. Scholars exploring the best way to address these questions have provided a number of conceptually coherent theories,[1] yet they have not come to a consensus on the "cor-

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1. For an overview of the current state of bankruptcy theory, see Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573 (1998).

rect" bankruptcy law — and, even if they had, there is little reason to think that the actual political process would embrace this consensus.[2]

Thus, bankruptcy laws differ across nations. We would expect such differences to exist even if all countries agreed that the sole purpose of such laws was to resolve the problems caused by financial distress in the most efficient manner. To be a bit more concrete, perhaps the fundamental question confronting a bankruptcy system concerned with efficiency is how to determine whether a firm in financial distress should be liquidated or reorganized. Some domestic bankruptcy laws guard against inefficient attempts to keep the firm going, while others protect against premature liquidation.[3] These countries agree that the goal is to promote efficiency by liquidating those firms in economic distress but reorganizing those that are suffering from only financial, as opposed to economic distress. The rub is they disagree on how to get there. Indeed, scholars who embrace efficiency as the sole goal of bankruptcy law have yet to reach consensus on the optimal bankruptcy system.[4]

These differences among the world's bankruptcy regimes are exacerbated by the fact that while any insolvency law reflects some concern with efficiency, other interests, such as redistribution to favored groups, shape the final legislative product.[5] These choices reflect different, often conflicting, policy judgments about which group or groups should be favored in the bankruptcy proceeding itself. Some countries provide extra protection to current employees, others to certain other creditors. Some nations treat tort victims on a par with consensual unsecured creditors, and others grant them even lower priority.

The problem that arises when a transnational firm becomes insolvent presents a basic choice-of-law problem: How should law reconcile these differing decisions? Some of these reflect differing judg-

2. For background on the political dynamics that have shaped American bankruptcy law, see Eric A. Posner, *The Political Economy of the Bankruptcy Reform Act of 1978*, 96 MICH. L. REV. 47 (1994); David A. Skeel, Jr., *Bankruptcy Lawyers and the Shape of American Bankruptcy Law*, 67 FORDHAM L. REV. 497 (1998); David A. Skeel, Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1323, 1350-79 (1998).

3. *See* Michelle J. White, *The Costs of Corporate Bankruptcy: A U.S. — European Comparison*, *in* CORPORATE BANKRUPTCY: ECONOMIC AND LEGAL PERSPECTIVES 467 (Jagdeep S. Bhandari & Lawrence A. Weiss eds., 1996).

4. *Compare* Douglas G. Baird, The Hidden Virtues of Chapter 11 (1997) (unpublished manuscript, on file with author), *with* Barry Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311 (1993), Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEXAS L. REV. 51 (1992) [hereinafter Rasmussen, *Debtor's Choice*], *and* Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807 (1998).

5. *See* Elizabeth Warren, *Bankruptcy Policy in an Imperfect World*, 92 MICH. L. REV. 336 (1994); Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 YALE L.J. 437, 467-74 (1992).

ments as to how to implement the same goal, others stem from a disagreement over the goals themselves. Commentators have proposed three general approaches to reconcile these conflicts: universalism, which comes in varying degrees;[6] territorialism;[7] and contractualism.[8]

Universalism posits that a single country's reorganization laws should govern the insolvency of a transnational firm. The system depends on countries agreeing to a set of choice of law rules that identify the "home" country of the transnational firm. The home country administers the insolvency proceeding. Territorialism, in contrast, allows each country to administer the assets that it finds within its borders according to its own domestic bankruptcy law. Finally, contractualism allows each independent corporate entity to specify in its corporate charter the jurisdiction that will handle any bankruptcy proceeding involving that entity.[9] The transnational firm under a bankruptcy selection regime could thus opt for a universalist approach — by having all of its constituent entities select the same jurisdiction to govern bankruptcy proceedings — or for a territorialist approach — by having all of its entities select the jurisdiction in which they are incorporated. It could even adopt a mixed approach under which a subset of the firm's entities would be administered in one jurisdiction while the remainder would be handled where they were incorporated.

The main justification for universalism has been an economic one. Its proponents, the most effective of whom have been Professors Jay Westbrook and Andrew Guzman, suggest that it will lead to more efficient investments and, on average, promise a greater return to the creditors of the insolvent firm.[10] The main proponent of territorialism, Professor Lynn LoPucki, suggests that the economic justification offered for universalism falls suspect, particularly because it is impossi-

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6. A good description of these variations can be found in Lynn M. LoPucki, *Cooperation in International Bankruptcy: A Post-Universalist Approach*, 84 CORNELL L. REV. 696, 704-06, 725-28, 732-33 (1999) [hereinafter LoPucki, *Cooperation*].

7. *See id.* at 742-50.

8. *See* Robert K. Rasmussen, *A New Approach to Transnational Insolvencies*, 19 MICH. J. INT'L L. 1, 32-35 (1997) [hereinafter Rasmussen, *A New Approach*].

9. Professor Westbrook asserts that the approach I have advocated for domestic bankruptcy law — allowing firms to select reorganization regimes — devolves into nothing more than a security interest. *See* Jay Lawrence Westbrook, *The Global Solution to Multinational Default*, 98 MICH. L. REV. 2276, 2303-05 (2000) [hereinafter Westbrook, *The Global Solution*]. My approach, however, allows debtors to select from competing bankruptcy systems, such as Chapter 11, an auction system, or state default law. Indeed, the menu I propose would include all those systems that could plausibly best steer a firm through financial distress. Certainly Professor Westbrook does not think that Chapter 11 is similar to a security interest. Thus, I fail to understand why a firm selecting a bankruptcy is a security interest; it certainly is not a security interest when it is imposed on firms by the state.

10. *See* Lucian Arye Bebchuk & Andrew T. Guzman, *An Economic Analysis of Transnational Bankruptcies*, 42 J.L. & ECON. 775 (1999); Jay Lawrence Westbrook, *Theory and Pragmatism in Global Insolvencies: Choice of Law & Choice of Forums*, 65 AM. BANKR. L.J. 457, 464-71 (1991) [hereinafter Westbrook, *Theory and Pragmatism*].

ble to design a system that can implement universalism in a coherent manner.[11] Professor LoPucki now endorses the holy grail of the universalists — a single law administered by a single court — but insists that territorialism should reign in the interregnum.[12]

One could also mount a noneconomic argument against universalism; namely, that it fails to respect the bankruptcy policies of the different countries involved. This argument relies on a principle of national self-determination and posits that each country ought to be free to pursue its own policies through its bankruptcy law. Any credible theory of how to handle transnational insolvencies must wrestle with the problem of comity between sovereign nations.

Allowing firms to specify the relevant bankruptcy forum through a provision in their corporate charter is, like universalism, premised on efficiency grounds.[13] The justification for the contractual approach begins with the assumption that some firms are better off with a territorial system, others with a universalist model, still others with a mixture of the two. Faced with this heterogeneity of types of firms, the main argument for the contractual approach is that firms ex ante, rather than courts ex post or legislatures ex ante, can best decide which regime is better for them. The one constraint on firm choice is that the ability to change a choice already made has to be constrained so as to guard against opportunistic change.[14] Like universalism, however, contractualism can be subject to the twin attacks that it cannot be implemented in a satisfactory manner[15] and that it fails to take account of comity concerns.

This essay addresses the points of contention among these theories, and endeavors to further the debate by explaining that bankruptcy selection clauses can perform better from an economic perspective than can either of its rivals, and by considering the noneconomic issues that some may offer as a reason to adhere to territorialism. The essay first examines the question, raised by Professor LoPucki, regarding which of the three systems promises the greatest efficiency. It then responds to Professor LoPucki's concern that enforcement of bankruptcy selection clauses would create "debtor havens" that design their laws so as to transfer wealth from small creditors to the debtor and large creditors. Finally, the essay closes by responding to the ar-

11. *See* LoPucki, *Cooperation, supra* note 6, at 709-36.

12. *See* Lynn M. LoPucki, *The Case for Cooperative Territoriality in International Bankruptcy*, 98 MICH. L. REV. 2216, 2222 (2000) [hereinafter LoPucki, *Cooperative Territoriality*].

13. *See* Rasmussen, *A New Approach, supra* note 8, at 4.

14. *See infra* text accompanying notes 39-40.

15. *See* LoPucki, *Cooperation, supra* note 6, at 738-42.

gument that both universalism and the bankruptcy selection clause system frustrate the fulfillment of national policy.[16]

I. EFFICIENCY AND TRANSNATIONAL INSOLVENCIES

All the participants in the debate over transnational insolvencies claim that their approach is the most (economically) efficient. Indeed, to date, this is the primary claim of both the universalist and bankruptcy selection clause approaches, both of which have yet to even assert that they respect the noneconomic decisions reflected in domestic bankruptcy law.[17] The exploration of the force of these efficiency claims, as well as of the argument that neither system can be implemented in a way that would generate its purported benefits, requires the delineation of the theoretical arguments in favor of the universalist and bankruptcy selection clause approaches. Because territorialism has been the de facto approach to transnational insolvencies for years, each system starts with that baseline and attempts to demonstrate that a shift away from territorialism holds the promise of gains.

It is easiest to start with universalism, which has long been the system of choice among academics. The advocates of universalism identify two ways that a universalist system would promote greater efficiency than a territorial system. First, universalism would discourage inefficient investment. As Professors Bebchuk and Guzman have pointed out, territoriality raises the possibility that a debtor will invest in a new country even when such an investment has a negative net present value.[18] This result relies crucially on the premise that the new country will give priority to that country's creditors, who may have extended credit more recently than have creditors in another country. This priority accorded to the new debt effectively places some of the downside risk of the new project on the preexisting creditors in another country. This placement of risk on the old creditors provides an incentive for the debtor to borrow funds from the new lender who, expecting greater bankruptcy returns from a territorialist regime, will offer a lower interest rate for an investment in that country. This incentive can lead a firm to invest in a country with a territorial regime even if an investment in a different country has a greater expected value.

16. Professor LoPucki has made another attack on the universalist model — that no one has specified a workable universalist system. *See id.* at 709-25, 728-32, 734-36. Given that I reject the universalist model on other grounds, I remain agnostic on this issue.

17. *See* Bebchuk & Guzman, *supra* note 10, at *passim* (arguing for universalism on the ground that it would produce efficient investment incentives); Rasmussen, *A New Approach*, *supra* note 8, at 4; Westbrook, *Theory and Pragmatism*, *supra* note 10, at 464-71. Territorialism self-evidently respects the policy choices made by the domestic sovereign, but Professor LoPucki's defense of this system is not premised on these grounds.

18. *See* Bebchuk & Guzman, *supra* note 10, at 787-89.

Universalism combats this incentive by assuring creditors that the new loan will be handled under the priority scheme of the home country.

Second, as articulated most fully by Professor Westbrook, universalism encourages reorganizations that have the potential to increase the returns to creditors.[19] It does so by combating the collective action problem that is the general justification for domestic corporate bankruptcy law in the first instance.[20] Specifically, left to their state law remedies of seizing assets to satisfy their debts, individual creditors will recognize when a debtor cannot pay off all of its debts in full, and each will attempt to be the first to collect on its obligation. This incentive creates a race to the assets and a consequent liquidation of the firm. This forced liquidation may be inefficient both because the assets may already be devoted to their highest valued use and because, even if the firm should be liquidated, an orderly liquidation process conducted by a single forum would bring higher returns than would a piecemeal liquidation conducted by disparate jurisdictions. Bankruptcy law guards against this race by staying all nonbankruptcy collection efforts and forcing all claimants into the single bankruptcy forum where they can, as a group, decide on the optimal deployment of the firm's assets.

Professor Westbrook's justification for universalism parallels this argument. Absent a single proceeding, creditors in each country would have an incentive to grab the assets in that country. A worldwide reorganization of a transnational firm, according to the advocates of universalism, would increase the value of the firm's assets. Universalism, just like domestic bankruptcy law, also promises savings by decreasing the number of forums that would be needed to resolve a firm's financial distress.

The theoretical arguments behind these purported gains are clear; the extent to which any of these gains exist as a practical matter, however, remains unclear. As to investment incentives, Bebchuk and Guzman correctly identify a theoretical problem with the territorial approach, but they fail to offer a convincing explanation as to why the contracting parties cannot eliminate most of the problem through contract.[21] Bankruptcy law, by specifying the distribution of an insolvent firm's assets, affects the selection of a firm's investments.[22] Professors

19. *See* Westbrook, *Theory and Pragmatism*, *supra* note 10, at 465-66.

20. *See* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 7-19 (1986).

21. Also, their argument best justifies treating foreign creditors the same as national creditors (so-called "national treatment"), a practice that almost all countries already follow. *See* Rasmussen, *A New Approach*, *supra* note 8, at 29.

22. *See* Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 473-75 (1992); Barry E. Adler, *A Re-Examination of Near-Bankruptcy Investment Incentives*, 62 U. CHI. L. REV. 575 (1995); Robert K. Rasmussen, *The Ex Ante Effects of Bankruptcy Re-*

Bebchuk and Guzman demonstrate how later lending can reduce the expected return to the earlier creditor. In their model, a country follows territorialism when it grants priority to creditors from that country.[23] This granting of priority has the effect of placing the risk of failure of the new investment on the old creditors. If there are not sufficient assets to pay all claims, domestic creditors get paid first. The earlier creditor, of course, can anticipate this treatment, and price its loan accordingly. The debtor still pays the same overall rate of interest — it is just that the earlier creditors charge a higher rate than they otherwise would, and the later creditors a lower one.

The cost of this adjustment of interest rates induced by territorialism is that it creates an incentive to invest in the country that follows territorialism in order to obtain the lower rate of interest. In other words, firms would not select investments solely based on their expected returns.

Viewed ex ante, debtors bear the cost of not investing in the most promising projects. They thus would have an incentive to commit to not engaging in this behavior. They would want to commit to investing in projects that offer the greatest expected return.

Loan covenants in the original loan agreement could go a long way toward this result. For example, a lending agreement could define, as a default, any attempt to procure credit from abroad on terms that would give the subsequent lender priority. The problem hypothesized by Professors Bebchuk and Guzman is simply a variant of the problem that arises whenever a firm with existing debt issues senior debt. Lenders routinely insist on covenants to guard against this action.[24] Indeed, taking a security interest is one mechanism for preventing the priming of preexisting debt.[25] Another mechanism is the negative pledge clause, which prevents the debtor from incurring senior debt without the permission of the earlier lender.[26]

To be sure, as Professors Bebchuk and Guzman argue,[27] contractual solutions cannot eliminate totally the adverse incentive effects of territorialism. Requiring creditor approval of foreign investments may eliminate the risk of debtor opportunism but create the risk of creditor opportunism. In cases where foreign investment is optimal, old creditors may insist on part of the gains in exchange for their consent.

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form on Investment Incentives, 72 WASH. U. L.Q. 1159 (1994); Alan Schwartz, *The Absolute Priority Rule and the Firm's Investment Policy*, 72 WASH. U. L.Q. 1213 (1994).

23. *See* Bebchuk & Guzman, *supra* note 10, at 788-89.

24. *See* Alan Schwartz, *A Theory of Loan Priorities*, 18 J. LEGAL STUD. 209, 216-18 (1989).

25. *See id.* at 228-34; George G. Triantis, *Secured Debt Under Conditions of Imperfect Information*, 21 J. LEGAL STUD. 225, 236 (1992).

26. *See* Schwartz, *supra* note 24, at 216-18.

27. *See* Bebchuk & Guzman, *supra* note 10, at 800-02.

Creditor opportunism may be constrained by a creditor's desire to foster a reputation for fair dealing with its borrowers and by the debtor's ability to make alternative investments that do not require creditor approval. Indeed, one observes the use of negative-pledge clauses despite the fact that they create the risk of opportunistic behavior by the lender. Thus, contracts can limit the adverse incentive effects generated by territorialism.

Stated differently, for the proponents of universalism to assert that universalism will create better investment incentives, they must show that territorialism generates inefficiencies that cannot be reduced drastically through the adroit use of contract. After all, as Bebchuk and Guzman recognize, creditors can price inefficient lending terms.[28] Since debtors have the incentive to borrow money at the lowest rate possible, they have the incentive to offer contracts that maximize the contracting surplus between the contracting parties.[29]

If universalism cannot be justified entirely by the creation of superior investment incentives, it must find justification on the grounds that it will lead to a greater return to creditors through either global reorganizations or coordinated liquidations. In a transnational corporate structure, one can easily envision firms that could be handled most efficiently on a country-by-country basis.[30] Firms with global operations typically establish legally distinct companies in each country in which they do significant business. This global segmentation provides each country with a discrete firm to focus on. On the one hand, there may be firms that experience financial, but not economic, distress, and whose constituent parts are so well integrated that any successful reorganization will need the active cooperation of all countries in which the firm has an affiliate. On the other hand, some firms may yield a higher return when administered on a territorial basis.

Stated somewhat differently, the universalist concern that the inefficient domestic race to the assets will reoccur at the international level rests on a flawed analogy. Each nation already has in place a domestic bankruptcy system that prevents a destructive race to the assets located in that jurisdiction. For the analogy to carry through, the transnational firm has to generate excess value from the combination of its constituent members. In a world where we routinely see firms changing business strategy and selling off subsidiaries, it is, at the least, not obvious that such a relationship exists for a substantial number of firms.

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28. *See id.* at 803.

29. *See* Frank H. Easterbrook, *Is Corporate Bankruptcy Efficient?*, 27 J. FIN. ECON. 411, 414 (1990); Rasmussen, *Debtor's Choice*, *supra* note 4, at 56-59; Schwartz, *supra* note 4, at 1812-14.

30. *See* Rasmussen, *A New Approach*, *supra* note 8, at 27-32; LoPucki, *Cooperation*, *supra* note 6, at 742-59.

The universalist claim rests on the assumption that for transnational firms, integration of their world-wide operations is more common than having its constituent parts run as individual entities. This claim alone is not necessarily false (although conceivably it could be). But clearly not all firms would benefit from a universalist system. The advantage of the bankruptcy selection clause approach is that it allows firms to sort themselves. Firms that would benefit from a single reorganization proceeding can place a term in the corporate charter of each affiliate specifying which nation will adjudicate any insolvency proceeding involving the firm. Firms with discrete operations can contract for a territorial approach by specifying in each corporate charter that the country of incorporation will handle any bankruptcy situation that may arise. Indeed, some transnational firms may well have some constituent parts that form part of an integrated world-wide operation and some that do not. In such a case, the integrated entities could each select the same jurisdiction to handle an insolvency while having the remaining entities select the nation in which they are incorporated. In other words, the bankruptcy selection clause approach allows firms to tailor the transnational insolvency system to best meet their particular needs. As such, it provides more gains than either universalism or territorialism.

Another cost of universalism that has yet to be recognized in the literature relates to the interaction between bankruptcy law and general corporate law. Often a nation's general corporate law works in tandem with its bankruptcy law. For example, the American corporate governance/bankruptcy system relies on what Professor David Skeel has termed "ex post" correctives of managerial failure, whereas the German and Japanese systems rely on "ex ante" correctives.[31] The details of the argument are not important for present purposes. What is important is the general insight that a nation's corporate law and bankruptcy law work together. Universalism threatens to destroy the symmetry of these systems by superimposing a bankruptcy regime premised on one type of corporate governance system onto a different corporate governance system. By disrupting the harmony that would otherwise exist between bankruptcy and corporate law, universalism threatens the system of laws that nations have developed to police firm performance.

Bankruptcy selection clauses, unlike universalism, respect the integrated nature of corporate law and bankruptcy law. Firms can ensure that the bankruptcy regime they select comports with the governing corporate law. Selecting a bankruptcy law from another country does not necessarily lessen the interactive effect of bankruptcy law and corporate law. Only selecting incompatible bankruptcy laws results in

31. *See* Skeel, *supra* note 2, at 1328.

this harm. To the extent that compatible bankruptcy and corporate laws increase firm value, bankruptcy selection clauses will tend to maintain the balance between the two systems.

Professor LoPucki raises yet another concern, which applies to both the universalist and bankruptcy selection clause approaches. He argues that the informational demands that these systems place on creditors overwhelm any potential gains. Creditors who wish to price all relevant terms of the loan will have to ascertain which law will govern the insolvency of the firm. In the case of universalism, the creditors will have to ascertain the "home" country, and then plumb its bankruptcy law. In a world where courts enforce bankruptcy selection clauses, the creditors will have to look at the corporate charter, figure out which jurisdiction has been selected, and then delve into the intricacies of that nation's insolvency law.[32]

Professor LoPucki raises a valid point; universalism and bankruptcy clause selection would increase the cost of drafting initial lending agreements, especially for those lenders who lend solely to domestic firms. To conclude that these costs justify abandoning either of the proposed alternatives to territorialism, however, requires a finding that these costs exceed the benefits offered by each system. Professors Guzman and Westbrook have responded to Professor LoPucki on behalf of the universalists.[33]

As to the bankruptcy selection clause approach, Professor Westbrook joins Professor LoPucki in asserting that the information demands of the system would rob it of any potential benefit.[34] The question of whether high information costs will swamp any potential benefits boils down to one of intuition. My own sense is that Professors LoPucki and Westbrook drastically overstate the costs of contracting. It will not be difficult to determine, under a bankruptcy selection clause system, what jurisdiction has been selected to administer a firm's bankruptcy. The firm borrowing the money will simply show the lender the relevant provision in its corporate charter.

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32. *See* LoPucki, *Cooperation, supra* note 6, at 738-39.

33. *See* Andrew T. Guzman, *In Defense of Universalism in Cross-Border Insolvencies*, 98 MICH. L. REV. 2177 (2000); Westbrook, *The Global Solution, supra* note 9, at 2307-25.

34. Both Professor LoPucki and Professor Westbrook trot out the claim that the bankruptcy selection clause approach relies on the assumption of perfect markets with zero transaction costs. *See* LoPucki, *Cooperative Territoriality, supra* note 12, at 2242; Westbrook, *The Global Solution, supra* note 9, at 2302-03. As should be clear by now, there is no such reliance. Rather, the claim is that, including transaction costs, efficiency is improved through firm selection rather than government fiat. *See generally* James W. Bowers, *The Fantastic Wisconsylvania Zero-Bureaucratic-Cost School of Bankruptcy Theory: A Comment*, 91 MICH. L. REV. 1773 (1993); Robert K. Rasmussen & David A. Skeel, Jr., *The Economic Analysis of Corporate Bankruptcy Law*, 3 AM. BANKR. INST. L. REV. 85, 110-15 (1995) (considering various impediments to implementing a selection regime); Rasmussen, *A New Approach, supra* note 8, at 20-26 (similar).

The largest potential cost is getting a handle on the law of the country selected. This cost, of course, will only be relevant when firms have selected jurisdictions other than the one in which they are located. Even for these firms, this cost may not loom large. It is, of course, difficult to predict with certainty what selection patterns would emerge in a regime of bankruptcy selection clauses. We currently live in a world of mandated bankruptcy regimes, and thus we have no definitive evidence of how firms would act were they granted the freedom to select the governing bankruptcy law.

Yet it is quite possible that a certain, small number of nations could end up being viewed as having the "best" bankruptcy law. Indeed, such a situation could develop precisely because of the informational concerns expressed by Professor LoPucki. Debtors, to the extent that they are dealing with fully adjusting creditors, will bear the costs that the creditors will incur when they investigate the bankruptcy jurisdiction that the debtor has selected. Debtors thus have an incentive to keep these costs to a minimum. Once lenders become familiar with the workings of a few countries' bankruptcy laws, debtors will have an incentive to select either the law of their home jurisdiction or one of these well-known laws so as to hold down their cost of credit.[35]

Indeed, similar potential information problems exist today in related legal areas, and firms have been able to cope with these problems in a satisfactory manner. For example, although American corporations can incorporate in any one of fifty states, the system has not been bogged down in an informational quagmire. First, most corporations incorporate either in their home state or in Delaware.[36] Thus, lenders that lend only to local businesses need only be familiar with their own state's corporate code and that of Delaware. Large creditors, in contrast, will lend to a number of firms that are governed by a number of different corporation codes. Despite these myriad sources of law and the potential informational problems that in theory could arise, things work pretty well. Indeed, a recent study has confirmed that Delaware corporations, on average, have a higher value than do corporations from other states.[37] In other words, firms have focused on a single jurisdiction, and that jurisdiction appears to be the one that maximizes firm value.

35. For a discussion of the possible network effects that might lead to adoption of a single state's law, see Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995).

36. *See* Robert Daines, How Firms Choose Domicile: Some Evidence on State Competition and the Demand for Corporate Law (2000) (unpublished manuscript on file with author).

37. *See* Robert Daines, Does Delaware Law Improve Firm Value? (2000) (unpublished manuscript on file with author).

A second example that suggests that informational problems may not be debilitating is the general enforceability of forum-selection clauses and choice-of-law clauses. In the international context, these provisions are routinely enforced. This enforcement raises the exact same theoretical problems that Professors LoPucki and Westbrook raise in regard to bankruptcy selection clauses. Despite these theoretical problems, choice of law scholars generally endorse the prevailing practice.[38] Thus, while there exists no guarantee that the gains of a bankruptcy selection regime would not be overwhelmed by information costs, private selection has increased efficiency in situations that appear roughly similar.

Professor LoPucki also argues that information costs regarding changes in a firm's selection will be large. Extant practices in corporate law generally belie this assertion as well. Not surprisingly, firms change both the jurisdiction in which they are incorporated and the provisions of their charter with some frequency. These changes have not frustrated the operations of the securities markets. Thus, one should be suspicious of the assertion that the information costs of changing the bankruptcy selection will be prohibitive. Indeed, a simple solution exists. Creditors in their lending agreements can require that they be informed of changes in the bankruptcy selection.

To be sure, there are transaction costs associated with bankruptcy selection clauses. Yet that is true of all proposals in this area. Professor LoPucki's cooperative territorialism has such costs as well. He envisions extensive negotiations after insolvency among the various jurisdictions that have control over portions of the multinational enterprise. While Professor LoPucki elides over the point, these negotiations would be expensive. Moreover, one can imagine that in at least some instances the negotiations could end in an impasse. Constituent parts of a corporate enterprise that should be reorganized as a single entity may be liquidated individually. Conversely, jurisdictions may agree to cooperate where separate administration would promise a larger return to the creditors. Parties beforehand may thus have difficulty predicting the outcome of future negotiations. All this suggests that the costs of cooperative territorialism may well exceed those of a bankruptcy selection clause regime.

Professor Guzman raises a final concern with bankruptcy selection clauses. He notes that domestic bankruptcy law does not allow for firm choice. Thus, creditors anticipate that their claims will be resolved by domestic bankruptcy law. Once the firm becomes multina-

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38. *See* Linda S. Mullenix, *Another Choice of Forum, Another Choice of Law: Consensual Adjudicating Procedure in Federal Court*, 57 FORDHAM L. REV. 291 (1988); Michael E. Solimine, *Forum-Selection Clauses and the Privatization of Procedure*, 25 CORNELL INT'L L.J. 51 (1992).

tional, however, these expectations would be defeated. The ability to defeat these expectations would, in turn, distort investment choices.

The optimal solution, as recognized by Professor Guzman, would be to extend a choice-based regime to domestic law. Failing this, the appropriate response is a system of constraints on how a charter can be changed. Indeed, as I have noted elsewhere,[39] a system that provides for firm choice has to allow for needed change while at the same time restrict opportunistic amendment. Two solutions come readily to mind, and there probably are others as well. First, one can require a lag time between when an amendment is made and when it becomes effective. This simple rule guards against selection changes driven by imminent financial distress. Second, creditors can put a term in their lending agreement declaring changes to be a default. This term would give the lender the opportunity to terminate or renegotiate its relationship with the debtor if it believes that the change adversely affects its loan.[40] These constraints would ensure that changes in the governing bankruptcy selection would enhance efficiency.

In sum, a regime in which bankruptcy selection clauses are routinely enforced should perform better than one based on either universalism or territorialism.

II. THE ILLUSIVE PROBLEM OF DEBTOR HAVENS

Two other objections can be leveled against a regime of bankruptcy selection clauses. The first is that such a regime would create an incentive for some jurisdictions to become "debtor havens." The second is that it will allow firms to undo noneconomic policy choices made by the appropriate domestic government. This section addresses the first of these concerns.

Professor LoPucki has raised the specter that an international legal system that routinely enforces bankruptcy selection clauses will create "debtor havens."[41] The term implies derision, but to assess the merits of this criticism one must articulate exactly what a debtor's haven would be. Such a haven must have the attribute that it transfers value from creditors to debtors. To adumbrate the scope of this concern, it is useful to employ Professor Guzman's distinction among fully adjusting, weakly nonadjusting, and strongly nonadjusting creditors.[42] This classification helps isolate which creditors — if any — can sys-

39. *See* Rasmussen, *Debtor's Choice*, *supra* note 4, at 116-21; Rasmussen & Skeel, *supra* note 34, at 113-15.

40. *See generally* George G. Triantis & Ronald T. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CAL. L. REV. 1073 (1995) (explaining the role of covenants in lending agreements).

41. *See* LoPucki, *Cooperation*, *supra* note 6, at 739.

42. *See* Guzman, *supra* note 33, at 2180-81, 2182.

tematically be disadvantaged in a way that would spur the creation of debtor's havens.

The first category of creditors — fully adjusting creditors — cannot be systematically shortchanged via a bankruptcy selection clause. These creditors price their transactions such that each transaction offers, ex ante, a market rate of return. Any attempt to select a bankruptcy regime that transferred money to the debtor from these creditors after the filing of a bankruptcy petition would result in an offsetting transfer to these creditors from the debtor at the time they agreed to the transaction. To the extent that fully adjusting creditors affect the analysis at all, their existence would lead the debtor to select the efficient bankruptcy regime so that it would reduce its cost of credit.

To the extent that the problem of debtor's havens exists, it must revolve round the ability of debtors (with the aid of a facilitating country)[43] to exploit systematically either weakly nonadjusting creditors or strongly nonadjusting creditors or both. The distinction between these two types of creditors captures the fact that some creditors, while not adjusting the individual rate of interest they charge to debtors, nonetheless can adjust their overall interest rate so as to earn a competitive rate of return; other creditors, in contrast, cannot change their lending pattern to respond to any change in bankruptcy policy.

Professor Guzman quite rightly notes that for weakly nonadjusting creditors there is a subsidization from low-risk debtors to high-risk debtors.[44] The basic insight here is that since all debtors are charged the same interest rate that reflects a blend of the riskiness of the entire borrowing pool, those debtors with a lower risk of default than the blended average pay a higher rate of interest than they would if the interest rate were based on an individualized determination. Conversely, those debtors with a higher risk of default pay a lower rate than they otherwise would. Professor Guzman also demonstrates that weakly nonadjusting creditors cannot be systematically disadvantaged by any given bankruptcy regime. Regardless of the regime, they will be able to price their loans so as to obtain a market rate of return.

43. LoPucki has not articulated the reasons why nations may tailor their law to attract debtors to select them as the situs of a bankruptcy proceeding. In the case of domestic corporations law, theorists have identified ways in which Delaware has committed itself to providing the law that corporations desire. *See* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 37-44 (1993); Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1927, 1939-45 (1998); Jonathan R. Macey & Geoffrey P. Miller, *Toward An Interest-Group Theory of Delaware Corporate Law*, 65 TEXAS L. REV. 469, 490 (1987); *see also* Robert K. Rasmussen & Randal S. Thomas, *Timing Matters: Promoting Forum Shopping by Insolvent Corporations*, 94 NW. U. L. REV. (forthcoming 2000) (explaining how competition among bankruptcy judges for desirable cases may affect their handling of cases). Indeed, if a country benefits by having a firm select it as the site of its bankruptcy, the race would be to the top. As the text explains, firms, on balance, would benefit from selecting the most efficient bankruptcy regime.

44. *See* Guzman, *supra* note 33, at 2187-88.

To say that these creditors are not systematically disadvantaged does not mean that debtors will necessarily select the regime that would most advance social welfare. This divergence between private incentives and the public good may arise due to a collective action problem. Debtors, as a group, would benefit from the selection of a bankruptcy regime that lowered the overall price of credit. Each debtor, however, would have the individual incentive to select a regime that distributed value from weakly nonadjusting creditors to the debtor. This incentive arises because the debtor does not bear the full cost of its actions, a situation that does not present itself when the debtor deals with a fully adjusting creditor. When borrowing funds from a weakly nonadjusting creditor, the debtor that has selected a bankruptcy regime that, ex post, transfers value from the creditor to the debtor gains the entire value that it appropriates from the weakly nonadjusting creditor. At the same time, its own decision does not noticeably affect the rate of interest that the weakly nonadjusting creditor charges. To be sure, in the aggregate, the decisions of all debtors will affect the rate of interest, but no single debtor will view its decision as affecting that rate. Thus, the dominant strategy for all debtors is to select a bankruptcy regime that transfers value to debtors from weakly nonadjusting creditors. The optimal regime for an individual debtor thus does not transfer value from a fully adjusting creditor, but does expropriate value from weakly adjusting creditors.

As with the informational overload problem identified by Professor LoPucki, one must try to gauge the magnitude of this problem. As the adage goes "My theory beats your practice." Thus, to make a valid assessment of the competing proposals, one needs some sense as to how many weakly nonadjusting creditors exist and how easy it is to craft a bankruptcy regime that transfers value from them to the debtor. While it is difficult to ascertain the number of such creditors today, one would expect the category of weakly nonadjusting creditors to shrink dramatically in the future. A rational creditor is weakly nonadjusting when the cost of making individualized credit determinations exceeds the benefits of such a determination, and recent developments in credit markets have made such determinations easier to make. First, transnational firms tend to be large firms, and there is a wealth of data available on such firms at a low cost. For example, creditors can readily obtain information on such firms from services such as Dun & Bradstreet. Other innovations include credit scoring, which allows a lender to process a loan application in a matter of minutes.[45] Indeed, the entire thrust of recent developments in private markets is the steady decrease of the costs of obtaining and processing

45. *See* Ronald J. Mann, *The Role of Secured Credit in Small-Business Lending*, 86 GEO. L.J. 1, 30-34 (1997).

information.[46] As creditors can obtain information at lower costs, they gain the incentive to become fully adjusting.

Competition forces creditors to become fully adjusting when it is cost justified to do so. A competing creditor who can identify low-risk debtors can offer those debtors a lower interest rate than can a weakly adjusting creditor. Creditors make money by extending credit, and thus seek out potential lending opportunities. To be sure, competition may not drive all creditors to become fully adjusting. There may be a residual class of debtors for whom it is not cost justified to offer credit terms on an individualized basis. Nevertheless, as the amount of a debtor's debt held by fully adjusting creditors increases, the debtor's incentive to make the most efficient bankruptcy selection increases as well.

Added to the uncertainty as to the number of weakly nonadjusting creditors in the transnational context is the difficulty involved for a bankruptcy regime to target such creditors for expropriation. Bankruptcy laws tend to distinguish between secured creditors and unsecured creditors, but this distinction does not map onto the distinction between fully adjusting and weakly nonadjusting creditors. Some secured creditors, such as those who take a security interest in the goods that they sell, may be weakly nonadjusting. Some unsecured creditors, such as financial institutions making operating loans, may be fully adjusting. Thus, even if the amount of weakly nonadjusting creditors is large, it is far from certain that bankruptcy laws can be targeted so as to transfer value from weakly adjusting creditors to debtors on the one hand, while at the same time not to transfer such value from fully adjusting creditors on the other. To the extent that a bankruptcy system inefficiently attempts to transfer value away from fully adjusting creditors, the debtor will pay the cost of this inefficiency.

In light of these observations, the concern over debtor havens must be a concern about the exploitation of strongly nonadjusting creditors. These are creditors for whom changes in the applicable legal rules do not alter their pricing behavior. Professor Guzman treats the government as a strongly nonadjusting creditor,[47] but such treatment seems inappropriate. Governments charge an interest rate on their "loan," and they set this rate by statute.[48] To be sure, institutional reasons may exist that explain why the selected rate does not ensure a market rate of return, but it is these institutional reasons, and not the lack of

46. *See* Ronald J. Mann, *Verification Institutions in Financing Transactions*, 87 GEO. L.J. 2225 (1999).

47. *See* Guzman, *supra* note 33, at 2183. Professor Guzman recognizes, however, that his classification of the government as a strongly nonadjusting creditor is debatable. *See id.* at 2183 n.28.

48. *See, e.g.*, 26 U.S.C. §§ 6601(a) (assessing interest on late taxes) & 6621(a) (setting rate at federal short-term rate plus 3%).

an ability to set an appropriate interest rate, that ensures that the government is not fully compensated. In other words, governments clearly have the ability to set a fully compensatory rate of interest, and thus they should not be considered strongly nonadjusting creditors.

The one group of true strongly nonadjusting creditors is tort victims. The concern raised by Professor LoPucki over how this group would fare under a legal system that routinely enforces bankruptcy selection clauses presents the most formidable objection to the implementation of a regime based on private ordering. Professor LoPucki asserts that a system of bankruptcy selection clauses would worsen the plight of tort victims because debtors will systematically select jurisdictions that provide the worse possible treatment of such claims.[49] He identifies six possible ways in which tort creditors may be disadvantaged in a bankruptcy clause selection regime. First, they may receive a lower priority than they would in a territorial system. This would occur where debtors select forums that accord lower priority to tort claims than does the forum that would otherwise administer the bankruptcy proceeding. Second, Professor LoPucki suggests that tort creditors may face a greater inconvenience when seeking recovery on their claims because debtors will select jurisdictions that make it more inconvenient to pursue one's claim. These two arguments relate to the selected jurisdiction's bankruptcy law's treatment of tort creditors. Professor LoPucki's other four reasons for concluding that a bankruptcy clause selection regime would lead to an increase in the amount of torts committed — firms would select nations that give low verdicts, that have substantive tort law that disfavors tort victims, that have procedural impediments to tort claimants, and that do not have a sufficient number of plaintiffs' attorneys — all relate to the contours of the selected country's tort law system.

Professor LoPucki's first assertion, that debtors will use bankruptcy selection clauses to strategically reduce the value of the claims of tort creditors, implicitly relies on the assumption that such manipulation carries with it the possibility of substantial gains to the debtor. This assumption is difficult to justify. To see why, one must begin with the extant treatment of tort creditors. American law both provides for limited liability and accords tort claims priority status equal to that of consensual unsecured debt. Academics agree that such treatment falls short of the ideal.[50] From an efficiency perspective, law and economics scholars agree that, to the extent that firms do not internalize the full

49. *See* Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1896-902 (1994).

50. *See, e.g., id.* at 1898-99; Lucian Ayre Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 882-83 (1996).

cost of potential torts, they have too little incentive to take care.[51] Those who view fairness as the overriding normative goal of bankruptcy similarly conclude that tort victims should receive better treatment than they currently do.[52] The relevant question for the debate over transnational insolvencies is whether a bankruptcy selection clause regime would *exacerbate* the problems inherent in existing law.

As an initial matter, it may be that few transnational firms would focus on potential tort liability at all. Each firm differs in the potential that it has for inflicting uncompensated injury on third parties. In most situations, firms will have insurance sufficient to cover the claims of the few tort victims it may have.[53] When a firm files for bankruptcy, the proceeds of insurance policies go directly to the injured claimants, despite their nominal status as unsecured creditors.[54] Thus, when adequate insurance exists, tort creditors are compensated in full despite the nominal low priority that their claims receive in bankruptcy.

There certainly will be cases where a firm engages in activities that carry the potential to create tort claims that exceed the combination of their equity and their insurance coverage. It is this subset of firms that must form the basis for Professor LoPucki's fear. Yet the room for strategic manipulation of bankruptcy law to inflict loss on this group is quite small. I am unaware of any country that follows the prescription of most scholars and grants tort creditors priority over the consensual creditors of the firm; at best, nations allow tort creditors to share pro rata with unsecured creditors; at worst, they place tort creditors below unsecured creditors. In other words, to say that there is a problem with firms opportunistically selecting bankruptcy jurisdictions based on the differing treatment accorded to tort creditors, one has to identify jurisdictions that accord different treatment to tort creditors. It would make little sense for debtors to flee to a foreign jurisdiction to ensure that tort creditors have a low priority when they are already accorded such treatment at home.[55]

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51. *See, e.g.*, Barry E. Adler, *A World Without Debt*, 72 WASH. U. L.Q. 811, 826 (1994); F.H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393, 1415-19 (1986); David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1643-49 (1991).

52. *See, e.g.*, Donald R. Korobkin, *Contractarianism and the Normative Foundations of Bankruptcy Law*, 71 TEXAS L. REV. 541, 569 (1993); Elizabeth Warren, *Bankruptcy Policy-making in an Imperfect World*, 92 MICH. L. REV. 336, 354 (1993); *see also* Robert K. Rasmussen, *An Essay on Optimal Bankruptcy Rules and Social Justice*, 1994 U. ILL. L. REV. 1, 31-35 (arguing that a Rawlsian legislature would accord better treatment to tort creditors than does current law).

53. *See* James J. White, *Corporate Judgment Proofing: A Response to Lynn LoPucki's* The Death of Liability, 107 YALE L.J. 1363, 1380-88 (1998).

54. *See* ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW 378 (1988).

55. To the extent that a government does decide to accord its tort victims better treatment than currently exists, it can ensure that this priority is respected by granting these victims a property right in the firm's assets. *See infra* Part III.

To be sure, Professor LoPucki has identified jurisdictions that treat tort claimants even worse than does American law.[56] Yet, the effect of the marginal lowering in priority between the United States and these other countries will not likely be great. Professors Bebchuk and Fried, echoing claims made by Professor LoPucki, have argued that a firm's ability to issue secured debt can lead to a lowering of precaution. This decrease in the level of precaution is in addition to the decrease caused by limited liability.[57] The linchpin of the argument is that by ensuring that the secured creditor can take all of the remaining assets of the firm, regardless of whether the firm takes cost-justified precautions, the firm will pay a lower rate of interest. This lower rate of interest results because priority ensures that when a firm becomes insolvent, the remaining assets go to the secured lender and are not shared with the tort claimants. If the secured creditor had to share the assets with tort creditors, it would have to compensate for this loss by charging a higher rate of interest initially.

Translating this argument to the context of transnational insolvencies takes something of an effort. As an initial matter, Professors Bebchuk and Fried were careful not to claim that the distortion they find caused by secured credit in the domestic context is a large one.[58] When one runs through the argument in the context of transnational insolvencies where the shift is between unsecured creditors and tort claimants, any distortion becomes smaller still. The economic argument for territorialism based on preserving tort creditor priority would start with the observation that American law requires tort creditors to share on a pro rata basis with unsecured creditors. Unsecured creditors, be they fully adjusting or weakly nonadjusting, would charge a higher rate of interest than they would if they had priority over the tort claims. This higher rate of interest would reflect the fact that they would have to share the unencumbered assets of the firm with tort claimants. Debtors could reduce this cost by selecting a jurisdiction that placed tort creditors below consensual claimants.

Such reduction, however, is only partial. Initially, it is unclear, on average, the extent to which assets are even available for distribution to any unsecured. Thus, there may be limited room to maneuver in this area. Moreover, the debtor would not achieve the full benefit of any maneuvering in which it engaged. Only fully adjusting unsecured creditors would take account of the debtor's selected bankruptcy jurisdiction when making their lending decisions. Partially adjusting unsecured creditors, by definition, would not react to a debtor's selection

56. *See* LoPucki, *Cooperation*, *supra* note 6, at nn.61-63.

57. *See* Bebchuk & Fried, *supra* note 50, at 898-900.

58. *See* Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy: Further Thoughts and a Reply to Critics*, 82 CORNELL L. REV. 1279, 1320 (1997).

of bankruptcy jurisdiction. Thus, to the extent that a debtor will select a jurisdiction so as to lower the priority of tort claims, it has to be the case that the debtor expects to gain in its dealings with fully adjusting unsecured creditors.

Yet this state of affairs raises a puzzle: If a fully adjusting unsecured creditor is willing to confer an advantage on a debtor in exchange for having priority over tort victims, then why does it not simply become a secured creditor and get that same advantage? In other words, for Professor LoPucki's concern to be valid, it must be the case that the cost of becoming a secured creditor exceeds the cost of learning about a bankruptcy regime selected by the debtor. Given that the cost of becoming a secured creditor is not excessive,[59] it is hard to imagine a debtor selecting a bankruptcy jurisdiction simply to move tort claims further down the priority ladder.

Even if one could identify a benefit that a debtor could obtain through priority dilution that it could not otherwise get, it is still far from certain that debtors would grab this benefit. The priority dilution that Professor LoPucki identifies forms only a small part of the selected country's bankruptcy law. The efficacy of the remaining law will more likely drive the selection choice. The benefits that can be achieved by selecting the most efficient insolvency law will most likely far exceed any benefits that could be garnered by subrogating the claims of tort victims. The savings promised by selecting the most efficient regime obtain in every insolvency case; the gains generated by lowering priority only occur in cases with substantial tort liability, which are infrequent. Thus, one would expect that debtors would be more concerned with selecting an efficacious bankruptcy law than they would be with lowering tort creditor priority.

Despite the unlikely event that a debtor will select a bankruptcy jurisdiction simply in order to lower the priority of tort claims, I still endorse a requirement that any bankruptcy regime selected by a firm accord at least nominal priority to tort victims similar to what they achieve in their home country.[60] This endorsement, while not central to the entire bankruptcy selection scheme, flows from efficiency concerns.[61] As Professor LoPucki notes, in theory this requirement may prevent some firms from selecting a jurisdiction because it places tort creditors in a lower position than they would be under the law of their home country. Yet, once lawyers and judges in a country became aware that their country was not being selected solely because of its

59. *See* Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625, 658-68 (1997).

60. *See* Rasmussen, *A New Approach*, *supra* note 8, at 35.

61. It is also the case that lowering the priority of tort victims would strike many as unfair. To the extent that this a salient concern, my requirement that the country selected not lower the priority of tort creditors would respond to this concern.

shoddy treatment of tort creditors, these actors would have to attempt to have the country change its laws so as to raise the priority of tort claims. Given that all seem to decry placing tort creditors near the bottom of a firm's capital structure, such an incentive should be applauded.

Professor LoPucki also posits, in his second assertion, that firms would select jurisdictions simply to make it difficult for tort victims to pursue their claims. The easy response to this supposition is that this strategy would impose greater costs on the debtor than it would on the putative tort claimants. This response stems from the fact that if the firm files for bankruptcy, it must deal with this jurisdiction. It is hard to see how a jurisdiction could be inconvenient for the tort creditors, but not the firm and its managers as well. Also, the selected jurisdiction would probably be inconvenient for the firm's fully adjusting creditors. The debtor thus would bear the full cost of its own inconvenience, plus, indirectly, the costs that the choice imposed on the fully adjusting creditors. Thus, inconvenience is a two-edged sword. Given that in most bankruptcy cases there are far more attorneys for debtors and consensual creditors than there are for tort victims, it seems fanciful to suggest that firms would put themselves and all others to such inconvenience just to ensure that, should any tort creditors arise, they would find it inconvenient as well.

The remaining four problems identified by Professor LoPucki all involve situations where the jurisdiction in which the firm commits to file its bankruptcy also has a tort system that is less hospitable to tort claimants than is the firm's home jurisdiction. Again, it is far from clear the extent to which this possibility is a substantial obstacle to implementing a bankruptcy clause selection system. Implicit in Professor LoPucki's concern is the assumption that the selected jurisdiction would resolve the tort dispute according to its own substantive law. But commonly accepted choice-of-law principles require the court that has jurisdiction over a case to apply the law that has the "most significant relationship" to the alleged tort.[62] It is thus unlikely that a debtor could use a bankruptcy selection clause so as to change the substantive law by which its conduct would be judged.

To be sure, the "norms" of the selected jurisdiction may be such that, even if the jurisdiction applied the more plaintiff-friendly substantive law of another jurisdiction, the final amount assigned to a tort victim's claim would be lower than if the claim had been litigated in the other jurisdiction.[63] Even allowing for this possibility, however, it

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62. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 145 (1971) (stating that court should apply law of the jurisdiction that has the "most significant relationship" to the alleged tort).

63. For a discussion of the possible divergence between legal rules and the actual prevailing legal culture, see Lynn M. LoPucki, *Legal Culture, Legal Strategy, and the Law in*

is hard to ascertain why this divergence would drive the selection of a bankruptcy jurisdiction over all of the other factors that a firm would rationally consider. First, for it even to matter at the margin, the selected jurisdiction would have to assign a sufficiently different value to the tort claims, such that the debtor would remain solvent where it otherwise would be insolvent; to the shareholders and the managers who represent their interests, being a little insolvent is the same as being a lot insolvent. Second, selecting a foreign regime makes a bankruptcy proceeding more expensive. If those in charge of the firm believed it would produce significant benefits, they would plausibly make such a selection. The off chance that the firm will incur substantial tort liability, and that the selected jurisdiction will systematically undervalue the tort claims, however, simply does not seem to provide a large ex ante benefit.

In sum, while there are easily identifiable efficiency gains in allowing firms to select the jurisdiction that would handle any future insolvency proceeding, the cost of creating debtor havens is much more difficult to locate. Firms are more likely to choose the regime that best handles financial distress than they are to choose the one that best frustrates the claims of nonadjusting creditors.

That firms will tend to select bankruptcy systems which minimize the cost of financial distress suggests that Professor Westbrook's dream of a single law administered by a single legal system may not be the ideal goal in international bankruptcy law. Though I initially endorsed a multinational treaty that would establish bankruptcy procedures from which firms could select, I now favor a system whereby firms select from the bankruptcy laws of the various countries. My change stems from concerns of institutional competence. I question the ability of any single group, no matter how well intentioned, to craft an ideal bankruptcy procedure. Moreover, it is unclear how responsive such an institution would be to changes that were needed as the economy evolves. On balance, it may be that countries would find it in their interest to have their bankruptcy laws adopted by firms. For example, local attorneys would desire the business that a major bankruptcy generates. To the extent that nations competed for bankruptcy business, and debtors selected their bankruptcy jurisdiction based on the jurisdiction's efficiency in handling financial distress, we could expect nations to produce more effective bankruptcy laws. Such laws, of course, may be far from perfect. The claim here is only that they would be better than those produced by any other institution. A regime of bankruptcy selection clauses thus might not only allow firms to select the best of current law, but also would lead to a general increase in the quality of extant law.

Lawyers' Heads, 90 NW. U. L. REV. 1498 (1996). Of course, it may be that the selected jurisdiction has norms that generate a higher amount.

III. FRUSTRATION OF GOVERNMENT POLICY

One problem confronting both the universalist and the bankruptcy selection scholars is that their claims rest on efficiency, and domestic bankruptcy law clearly is not driven solely by a concern with efficiency. To be sure, differences among various countries' domestic bankruptcy laws do not necessarily imply that these countries embrace differing goals. Rather, these differences may be explained as a disagreement over which procedure best promotes efficiency. Indeed, there is a robust debate in the academic literature over which set of rules would best promote efficiency.[64] Given this lack of academic consensus, it is no surprise that countries have not decided which set of bankruptcy rules promises to maximize firm value.

These disagreements over implementing the efficiency norm should not affect the selection of a transnational bankruptcy rule. In a territorial regime, each country supplies its own solution. In a universalist regime, one country's law will govern, but the other countries have no basis for complaining — their law will govern in other situations, and in all cases the law applied will be attempting to achieve the same goal.[65] Indeed, to the extent that the different laws are just different attempts to reach the same goals, countries could learn from the experiences of other nations and update their law accordingly. For example, Canada not too long ago revamped its insolvency law to move it closer to the insolvency law of the United States.[66] Finally, in a bankruptcy selection regime, firms will select the law or laws that they believe are most efficient. Indeed, this regime best comports with the countries' goals of promoting efficiency. Thus, the mere fact that bankruptcy laws differ across nations is not a basis for rejecting the bankruptcy selection or even the universalist solutions to the problem of transnational insolvencies.

But there are some situations where the governing legislature has sacrificed efficiency for another goal, usually that of redistribution. Everyone has their favorite example — workers in Mexico, fishermen in the United States, and so on. Territorialism undoubtedly respects these choices. If the United States government has decided to protect United States fishermen, the territorial regime respects this decision. The same holds true for workers in Mexico.

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64. See sources cited in note 4.

65. *Cf.* Larry Kramer, *Rethinking Choice of Law*, 90 COLUM. L. REV. 277, 339-44 (1990) (explaining how states can improve the advancement of their own policies through reciprocity).

66. For an argument that this revision departed from the goal of efficiency, see F.H. Buckley, *Free Contracting in Bankruptcy*, *in* THE FALL AND RISE OF FREEDOM OF CONTRACT 301, 306-08 (F.H. Buckley ed., 1999).

It may appear that either universalism or bankruptcy selection clauses would frustrate these noneconomic policy choices. On reflection, however, once a government has made a choice to favor a certain claimant, neither universalism nor contractual choice should stand as a barrier to that choice. To see why, it is important to recognize that bankruptcy regimes generally recognize property interests created by nonbankruptcy law. When a creditor gets a valid security interest in land under local law, that interest will be valid regardless of where a bankruptcy proceeding takes place. Thus, if a government believes that a certain creditor should be paid before all others, it can accomplish this goal by granting that creditor a valid security interest in the domestic assets of the firm. Failure to recognize such property rights would be grounds for a domestic court to ignore the edicts of a foreign jurisdiction under either a universalist or bankruptcy selection clause approach.

That this mechanism would be effective is illustrated by its presence in American bankruptcy law. The Bankruptcy Code recognizes and routinely enforces mechanics liens. These liens allow a creditor who enhances the value of a piece of the debtor's property to have a lien on that property. A holder of a mechanics lien can enforce that lien in a bankruptcy proceeding. Thus, by creating such a lien, the government has decided that that creditor should get paid first. Similarly, if a government decides that its workers need special protection, it can create a lien to ensure that workers receive the wages that they are due. Indeed, the United States does precisely this in situations where workers have not been paid the minimum wage. Thus, to the extent that a government wishes to ensure that one class of claimants gets paid ahead of another, it has the means to effect this decision.

CONCLUSION

Transnational insolvencies raise issues of efficient resolution of financial distress and fidelity to policy decisions made by various national legislatures and courts. The challenge for each country's domestic bankruptcy law is to select a choice of law rule that best promotes efficiency and respects national choices. A regime of bankruptcy selection clauses can harness the incentives of firms to maximize their value and, at the same time, can ensure that governmental decisions to protect favored groups are honored. As such, it provides the best means for resolving the insolvency problems raised by the increasingly transnational nature of firms.