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Three Principles of Transnational Corporate Bankruptcy Law: A Review

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Abstract: *After having discussed the weaknesses of the universalist and territorialist approaches to transnational corporate bankruptcy law, this paper argues that a free-choice regime could combine the advantage of ex post value maximisation of the firm's assets with a comparatively higher degree of ex ante predictability to investors. In addition, it could lead to a better alignment between corporate ownership structures and corporate bankruptcy regimes. Moreover, a free-choice regime could potentially open the door for regulatory competition in corporate bankruptcy law. However, the EC Regulation 1346/00 on insolvency proceedings implements a system of modified universalism, which allows for strategic ex post forum shopping by debtors while keeping the national legislatures' monopoly in the field of corporate bankruptcy in place. It is suggested that even though it cannot be predicted that a free-choice regime will pressure state lawmakers to improve their corporate bankruptcy laws, a system of free choice could redirect the lawmaking agenda in the EU by focusing the coordination efforts of lawmakers on those issues - such as security interests in property and statutory priority rights - that could negatively affect the proper functioning of the internal market, while enabling Members States to customise corporate bankruptcy laws to local preferences and needs.*

I Introduction

The principles of universalism and territorialism play a starring role in the legal debate on transnational business failure. Universalism claims its superiority over territorialism in that it would offer investors an enhanced *ex ante* predictability of the outcomes of their debtors' bankruptcies as well as foster *ex post* value maximisation of transnational businesses. Yet, despite the claimed advantages of universalism, territorialism still is the dominant approach to cross-border insolvency, not in the least because states resist universalist regimes by pointing to the differences in local redistributive policies. Consequently, efforts aiming at the adoption of universalist regimes have largely failed.

Because of the little success of many international initiatives so far, the adoption of the Council Regulation 2000/1346/EC on insolvency proceedings (EC Regulation or Regulation) by fourteen EU Member States is generally perceived as a landmark in the

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world of cross-border business failure.[1] The EC Regulation provides a set of uniform conflict of laws rules that are binding and directly applicable in the Member States, thereby overriding the fourteen Member States' national conflict of laws rules.[2] It forwards a universalist approach by vesting the jurisdiction to open universal main proceedings with the courts of the Member State where the debtor has its 'centre of main interests.' Moreover, it offers a uniform framework for the immediate recognition of judgments that are delivered directly on the basis of insolvency proceedings or are closely connected with such proceedings.[3] However, also the EC Regulation is prone to the divergence of the Member States' laws on such substantive issues as security interests in property, statutory priority rights of creditors, the treatment of employment contracts in bankruptcy, and the difference in actions to avoid fraudulent or preferential transfers of assets. This has led to the inclusion of important territorial carve-outs as well as the possibility to open secondary territorial proceedings.

Due to its use of an imprecise home-country standard, the question arises whether the EC Regulation enhances the predictability of outcomes to investors. Furthermore, the fact that the EC Regulation fails to address the more difficult issue of the divergence of the Member States' laws in such areas as security interests in property and statutory priority rights raises the issue of whether the choice of law approach forwarded by the EC Regulation facilitates the development toward more efficient bankruptcy regimes within the European Union. This paper assesses these issues by first recounting, in Part II, the main arguments exchanged in the debate on universalism and territorialism as the two main competing principles of transnational bankruptcy law. This debate demonstrates that, although universalism may have advantages with respect to the *ex post* value maximisation of cross-border businesses, proponents of universalism have not been able to argue convincingly that universalism would offer a higher degree of *ex ante* predictability to investors. Proponents of territorialism, on the other hand, have not been able to demonstrate that local creditors and local policies would be systematically harmed if a universalist approach were adopted. Part III then turns to the discussion of a more novel approach to transnational business failure, which advances the principle of freedom of choice in corporate bankruptcy as a rival principle of transnational corporate bankruptcy law. Free choice in bankruptcy combines the advantages of universalism with respect to *ex post* value maximisation with a comparatively higher degree of *ex ante* predictability thereby potentially decreasing the costs of capital for firms. In addition, by offering firms the possibility to choose *ex ante* a bankruptcy regime that fits their governance needs and preferences, free choice addresses an issue that neither universalism nor territorialism take into account, namely that of the complementarities between corporate ownership

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[1] Council Regulation 2000/1346/EC of 29 May 2000 on insolvency proceedings, OJ L 160, 30 June 2000, p. 1 (Reg 1346/00). The EC Regulation entered into force on May 31, 2002. All Member States except for Denmark adopted the EC Regulation. It applies to the collective insolvency proceedings of the Member States as indicated in annex A to the EC Regulation.

[2] The scope of the EC Regulation is confined to proceedings where the debtor's centre of main interests is located in the Community. The direct applicability of the EC Regulation means that no implementing national legislation is required in order for it to have legal effect in the Member States involved.

[3] See Art 16, 17 and Recitals (6), (22), Reg 1346/00.

structure and bankruptcy regimes. Subsequently, Part IV briefly touches upon two main barriers to the implementation of both universalism and free choice. First, states will resist universalist regimes if influential local interest groups expect to be jeopardised by such regimes. Second, the failure to address the problem of the divergence of substantial laws outside of bankruptcy – importantly the validity and recognition of security interests – potentially stifles any attempt to reach a universalist or free-choice regime in international bankruptcy. Next, Part V demonstrates how the weakened form of universalism embraced by the EC Regulation neither solves the problem of *ex ante* predictability due to the use of an indeterminate home-country standard nor paves the way for the development of efficient bankruptcy regimes within the EU. In contrast, introducing free choice might pressure state lawmakers to improve their own corporate bankruptcy regimes. Finally, the paper concludes that if the European Union is to consider the potential advantages of regulatory competition for the development of more efficient corporate bankruptcy laws, it needs to focus in the first place on the convergence of substantial laws outside of bankruptcy such as the development of a uniform system for the recognition of security interests and priority rights of creditors, and the finding of solutions to cross-border tax issues.

II Universalism versus Territorialism

Universalism has received much acclaim among bankruptcy scholars.[4] According to the principle of universalism, one single forum controls the administration and distribution of a transnational company's assets, wherever located. All the debtor's creditors have the right to file claims with and share in distributions from the bankruptcy estate. The appropriate forum for starting a universal proceeding is often specified as the court of the company's home country. In general, the home-country standard refers to the company's principal place of business as the connecting factor for the vesting of jurisdiction. Where the principal place of business is located may be determined by the company's country of incorporation, the location of its corporate headquarters, the location of its principal assets, or its principal business activities. Because universalism would not make much sense without a choice of law, the theory of universalism implicitly assumes that the choice of forum also includes the choice of the home country's laws as the rules governing the debtor's bankruptcy.[5] For

[4] See, eg, André J. Berends, 'The UNCITRAL Model Law on Cross-Border Insolvency: A Comprehensive Overview', (1998) 6 *Tulane Journal of International & Comparative Law* 309; U. Drobnig, 'Secured Credit in International Insolvency Proceedings', (1998) 33 *Texas International Law Journal* 53, 66; Jay Lawrence Westbrook, 'Theory and Pragmatism in Global Insolvencies: Choice of Law and Choice of Forum', (1991) 65 *American Bankruptcy Law Journal* 457, 461; Jay Lawrence Westbrook, 'Choice of Avoidance Law in Global Insolvencies', (1991) 17 *Brooklyn Journal of International Law* 499, 516; Jay Lawrence Westbrook, 'Universal Priorities', (1998) 33 *Texas International Law Journal* 27, at 39 and 91; Lucian Arye Bebchuk and Andrew Guzman, 'An Economic Analysis of Transnational Bankruptcies', (1999) 42 *Journal of Law & Economics* 775; Andrew T. Guzman, 'International Bankruptcy: In Defense of Universalism', (2000) 98 *Michigan Law Review* 2177.

[5] See Westbrook, 'Theory and Pragmatism', n 4 above at 462-464; Guzman, 'International Bankruptcy', n 4 above at 2179; Hannah L. Buxbaum, 'Rethinking International Insolvency: The Neglected Role of Choice-of-Law Rules and Theory', (2000) 36 *Stanford Journal of International Law*, 23, 30-31.

universalism to work states should agree on the mutual recognition and enforcement of the home country's insolvency proceedings.[6]

Although universalists do not concur on the exact scope of the home-country law, they generally agree that the home country's bankruptcy laws apply to such issues as the conduct of the administration over the assets, the priority ranking among creditors, the stay of creditors' enforcement rights, the question whether and on what terms the firm should be liquidated or reorganised, and the avoidance of pre-bankruptcy preferential or fraudulent transfers of assets.[7] However, they disagree as to whether the home-country law should govern every aspect of the debtor's affairs including issues that are essentially regulated outside of bankruptcy law.[8] It is, however, important to bear in mind that most universalists do not defend a system in which one single law decides on all substantive law issues related to a firm's failure.[9]

Notwithstanding the widespread academic support for universalism, territorialism still persists as the dominant approach to transnational corporate bankruptcy. Although until now few academics have defended territorialism, it has recently gained more academic support, not in the least because the divergence of substantial laws among countries impedes the establishment of a true universalist system.[10] In a territorial system, the power of bankruptcy courts to administer the assets of the bankrupt company is restricted to the assets located within the territories of their jurisdictions. However, the persistence of territorialism in the real world does not follow from the approach chosen by most national bankruptcy laws. In general, national bankruptcy regimes adhere to the principle that the bankrupt estate should encompass all the debtor's assets wherever located. Unilateral universalism thus is the main standard. However, because countries generally do not recognise the universal reach of foreign bankruptcy proceedings, territorialism is the dominant approach to transnational corporate bankruptcy as each country's universalist ambitions are halted at its own borders.

The protection of local creditors and local policies is the most common justification for denying the effects of foreign bankruptcy proceedings. Such 'public policy' arguments are not only used by jurisdictions that essentially deny any effect of foreign insolvency proceedings, but, also, for instance by the modified universalist regime of Section 304 of the US Bankruptcy Code,[11] which allows a qualified representative of a foreign bankruptcy estate to seek assistance by filing an ancillary proceeding in the United States.[12] Pursuant to Section 304, the US bankruptcy court can enjoin the commencement or continuation of any action against the debtor's property, order the turnover of property or the proceeds thereof to the foreign representative, or order

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[6] See, eg, Westbrook, 'Theory and Pragmatism', n 4 above at 467-468.
[7] See Lynn M. LoPucki, 'Cooperation in International Bankruptcy: A Post-Universalist Approach', (1999) 84 *Cornell Law Review* 696, 705-706; Westbrook, 'Theory and Pragmatism', n 4 above at 470.
[8] cf Westbrook, 'Choice of Avoidance Law', n 4 above at 515.
[9] See, eg, Berends, n 4 above at 315-317.
[10] See LoPucki, 'Cooperation', n 7 above; see also Frederick Tung, 'Is International Bankruptcy Possible?', (2001) 23 *Michigan Journal of International Law* 31 (arguing that international bankruptcy should focus on territorially-based cooperation).
[11] See Westbrook, 'Choice of Avoidance Law', n 4 above at 517 (denoting 11 U.S.C. § 304 as 'modified universalism').
[12] See 11 U.S.C. § 304(1).

other appropriate relief.[13] However, in order to benefit from this promise of universalism, the laws of the foreign forum have to stand a substantive test by the US bankruptcy court.[14] What this boils down to is that the US bankruptcy court can deny relief to a foreign representative if it finds that US claimholders are not adequately protected under the foreign proceeding or the priority of distribution deviates from the priority under the US Bankruptcy Code.[15]

In general, three main issues figure in the debate on universalism and territorialism. First, the issue of *ex ante* predictability to creditors of the bankruptcy laws applicable to their debtor's failure. Second, the issue of protection of local creditors and policies. Third, the issue of value maximisation of insolvent transnational companies. In the following three sections, each of these issues will be reviewed.

A Ex Ante Predictability

Advocates of universalism argue that its most important *ex ante* advantage would be the higher *ex ante* predictability to creditors, leading to a reduction in informational costs and a more accurate pricing of credit.[16] Territorialism would adversely affect *ex ante* predictability by not guaranteeing foreign lenders exactly the same legal position as they have under their home-country laws. In order for lenders to price the risk associated with such legal uncertainty, they need to inform themselves *ex ante* on the bankruptcy laws of each country in which the debtor has assets. Informational, contracting, and enforcement costs will thus be high and passed on to the debtors in the form of increased costs of borrowing.[17]

Yet, the fact that territorialism negatively affects *ex ante* predictability does not automatically lead to the conclusion that universalism would increase predictability. In order for universalism to do so, it needs to provide lenders *ex ante* with an unequivocal answer to the question what bankruptcy proceedings and laws will govern their debtors' insolvencies. However, by simultaneously using different connecting factors the home-country standard is likely to refer to more than one jurisdiction in which a universal proceeding can be initiated. In addition, the ample discretion for judicial interpretation adds to the vagueness of the home-country standard. Hence, the

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[13] See 11 U.S.C. § 304(2).
[14] See 11 U.S.C. § 304(3).
[15] See Mary Elaine Knecht, 'Comment, The "Drapery of Illusion" of Section 304 – What Lurks Beneath: Territoriality in the Judicial Application of Section 304 of the Bankruptcy Code', (1992) 13 *University of Pennsylvania Journal of International Business Law* 287; see differently Buxbaum, 'Rethinking', n 5 above at 304.
[16] See, eg, Westbrook, 'Theory and Pragmatism', n 4 above at 460. Bebchuk and Guzman point to another *ex ante* efficiency of universalism. Multilateral universalism would foster more efficient *ex ante* allocations of capital across countries, thereby facilitating efficient investment decisions by firms. However, their argument is based on the assumptions that in a territorialist regime local creditors are paid before foreign creditors, whereas in a universalist regime local and foreign creditors are paid on a pro rata basis. Because these assumptions do not correspond to the way in which bankruptcy regimes deal with foreign creditors, the predictive power of their model is arguable. See Bebchuk and Guzman, 'An Economic Analysis', note 4 above.
[17] See, eg, Westbrook, 'Theory and Pragmatism', n 4 above at 460-461; Guzman, 'International Bankruptcy', n 4 above at 2199-2201.

imprecision of the home-country standard considerably lowers *ex ante* predictability increasing informational costs, drafting costs, and enforcement costs. The argument that a universalist system would be more predictable *ex ante* to lenders than a territorialist system therefore seems to fail. The extent to which either one of the systems would be more *ex ante* predictable to creditors depends to a large extent on the facts of each case. For instance, if a debtor only has assets in two states whereas the home-country standard refers to four states, territorialism is more predictable and vice versa.

Another factor that affects *ex ante* predictability is the possibility universalism and territorialism offer a debtor to forum shop. Because bankruptcy is a typical endgame the chance that a debtor will strategically use the opportunities to forum shop to the detriment of his creditors or other third parties is higher in bankruptcy than outside of bankruptcy.[18] Universalists contend that basing jurisdiction on the mere existence of assets would increase the possibilities for forum shopping because debtors can strategically shift assets from one jurisdiction to another on the eve of bankruptcy.[19] Universalism, on the other hand, would prevent such manipulative behaviour, as it would be very difficult for companies to change their principal place of business in the period preceding bankruptcy. Universalists are therefore opposed to a rule that unequivocally vests jurisdiction with the courts of the country in which the debtor is incorporated as such a bright-line rule would facilitate eve-of-bankruptcy re-incorporations. However, this argument denies the fact that the vagueness of the home-country standard opens a wide array of forum-shopping possibilities as well, not in the least because the further specification of the concept is left to the courts. For instance, the broadly formulated venue rule of the US Bankruptcy Code, which vests jurisdiction with US bankruptcy courts if the debtor has assets or a place of business in the US, has given rise to eve-of-bankruptcy manipulation by corporate debtors by divesting assets or moving headquarters.[20] Even if the home-country standard limits jurisdiction to principal place of business, there is enough room for creative interpretation and concomitant eve-of-bankruptcy actions by debtors. For instance, if courts consider the place of headquarters an important connecting factor, debtors could move their headquarters prior to bankruptcy. In sum, it is by no means evident that universalism would do a better job than territorialism in preventing eve-of-bankruptcy manipulation by debtors. To the contrary, the home-country standard may turn out to be such a flexible concept that eve-of-bankruptcy actions may not even be necessary as the mere judicial interpretation of the home-country standard enables a transnational firm to pick from a menu of possible bankruptcy forums the one of its liking.[21]

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[18] In an endgame, the debtor knows that he will not have future relationships with his creditors or other third parties. As a result, his incentive to shift wealth from other parties to himself is at its maximum.

[19] See, eg, Guzman, 'International Bankruptcy', n 4 above at 2212.

[20] See 11 U.S.C. § 109(a) ('[…] only a person that resides or has a domicile, a place of business, or property in the United States, or a municipality, may be a debtor under this title').

[21] cf Paul Stephan, 'The Futility of Unification and Harmonization in International Commercial Law', (1999) 39 *Virginia Journal of International Law* 743, 785 (noting with respect to the UNCITRAL Model Law on Cross-Border Insolvency that it expands the range of action of bankruptcy courts without imposing substantial obligations that those bodies must honour, which is likely to result in a regime that would decrease the predictability of outcomes in international bankruptcies without achieving any clear improvements in the legal rules).

B Protection of Local Creditors and Local Policies

A typical territorialist objection against universalism is that it sets aside local policies on such issues as creditors' priorities, security rights, statutory priority rights, and tort law.[22] The costs of disregarding such local policies would disproportionately fall on local non-adjusting creditors,[23] whereas large international lenders who are able to adjust their contractual terms on a debtor-by-debtor basis would benefit from the system.[24] As opposed to universalism, by applying the priority law of each jurisdiction on the assets located in its territory territorialism would give effect to the existing expectations of local non-adjusting creditors, while not affecting internationally oriented creditors as these are typically fully adjusting.[25]

However, the impact of universalism on local creditors and tort victims may be less dramatic than anticipated by the opponents of universalism. To start, most local lenders are likely to be weakly non-adjusting. This means that, even though they may not adjust their contracts on a debtor-by-debtor basis,[26] they may still adjust by charging competitive rates of return on their entire portfolio of loans. Consequently, they do not bear the costs of *ex ante* legal uncertainty. Thus, in a universalist regime there would be no need to protect local creditors to the extent that they are either fully adjusting or weakly non-adjusting.

Nevertheless, by causing a part of the lenders to charge competitive interest rates universalism leads to *ex ante* inefficiencies in a way that territorialism does not.[27] Charging both high-risk and low-risk borrowers the same interest rate is suboptimal to the extent that it makes high-risk debtors borrow more and overinvest in their activities and low-risk debtors borrow less and underinvest in their activities. Universalism may thus lead to inefficient investments by firms. In contrast, under a territorial system local lenders would only have to take into account the effects of the local laws and practices so that theoretically they could ask risk-adjusted rates of return. However, it is unrealistic to assume that local creditors would suddenly become fully adjusting creditors under a territorial system. Local lenders take into account many factors when setting their rates of return, and the applicability of a foreign bankruptcy regime is only one of them. Many other factors unrelated to the system of international bankruptcy law may have a more direct effect on the level of adjustment by local

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[22] cf Westbrook, 'Theory and Pragmatism', n 4 above at 466.

[23] The terms 'adjusting,' 'non-adjusting,' 'weakly non-adjusting,' and 'strongly non-adjusting' used in this text were introduced by Lucian A. Bebchuk and Jesse M. Fried, 'The Uneasy Case for the Priority of Secured Claims in Bankruptcy', (1996) 105 *Yale Law Journal* 857. Fully-adjusting creditors can charge their debtors a risk-adjusted market rate of return. Other adjustments they can make include altering the maturity of loans, altering monitoring provisions, or requiring security interests in the debtor's property. As opposed to fully-adjusting creditors, non-adjusting creditors cannot adjust their positions *ex ante* to the risks associated with their debtor's insolvency.

[24] See LoPucki, 'Cooperation', n 7 above at 709; cf Guzman, 'International Bankruptcy', n 4 above at 2186.

[25] See LoPucki, id at 748.

[26] The choice not to adjust on a debtor-by-debtor basis may be a rational one if the costs of the adjustments are higher than the benefits.

[27] See Guzman, 'International Bankruptcy', n 4 above at 2184, 2187-2191.

creditors.[28] If these other factors are the primary determinants of the variance in returns to local creditors, the impact on their contractual terms of a choice-of-law rule referring to a foreign bankruptcy regime may be insignificant. Put differently, the extent to which lenders are able to ask risk-adjusted rates of return depends in the first place on the characteristics of their businesses and the market in which they are active, and not on the question whether they are internationally oriented or local creditors.

A second group of weakly non-adjusting creditors are trade creditors. To the extent that they are unsecured, the choice-of-law regime may have limited effect on their recovery in bankruptcy as unsecured creditors generally do not recover anything or very little on their claims.[29] More importantly, however, is the effect of foreign bankruptcy laws on the position of trade creditors that have security interests in the debtor's property such as retention-of-title clauses or mechanic's liens. Current practice is that bankruptcy courts generally recognise the validity of foreign security interests, provided that they are validly created under foreign law. Once recognised, bankruptcy courts assimilate the foreign security interest to the forum's priority and property regime by assigning it the status of a right most similar to it. However, as a result of such assimilation the creditor's priority ranking vis-à-vis other creditors, as well as the scope of his right vis-à-vis the debtor's property may change. Still, despite the fact that foreign trade creditors thus run the risk that their interests do not have the same effect under the home country's laws as they would have under the foreign laws concerned, they are not necessarily relegated to the position of unsecured creditors. Equating foreign security interests to similar, albeit somewhat different, security rights of the home country therefore attenuates to some extent the costs imposed on trade creditors by a foreign bankruptcy regime. Yet, the uncertainty related to the scope of recognition of foreign security interests undoubtedly imposes costs on trade creditors. Similarly, lenders incur costs if their security interests are not fully recognised under the rules of a foreign bankruptcy proceeding. These costs, however, are incurred under both a universalist and a territorial system so long as security-interest regimes considerably differ and no uniform system of recognition and ranking of these interests exists. Moreover, to the extent that lenders and trade creditors adjust their prices to such uncertainty these costs are borne by firms in the form of increased costs of capital.

With respect to foreign statutory priority rights the situation is somewhat different. Because in a universalist system the home country's forum applies its own priority scheme, it disregards foreign priority rights thereby relegating creditors with such rights to the status of generally unsecured creditors. In this way, universalism interferes with local distributive policies, which are typically translated into statutory priority rights. However, under the real-world forms of territorialism or modified universalism bankruptcy courts generally do not recognise foreign statutory priority rights either. On the one hand, in a territorial system local bankruptcy courts only

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[28] See Guzman, id at 2193-2194 (mentioning such factors as the pool of debtors, alternative uses for the funds, the out-of-court bankruptcy collection system available to the creditor, the likelihood of bankruptcy, the number and priority of other creditors, the total amount of outstanding debt, the likelihood that debtors will acquire future debt, the likelihood that legal claims are pending or will arise in the future, and the ability to enforce judgments against a foreign debtor).

[29] See also Guzman, id at 2196.

recognise local statutory priority rights. The extent to which local creditors could benefit from their statutory priority rights then depends on the amount of assets available in the local estate. On the other hand, a universalist system replaces all local statutory priority rights by those of the home country. Foreign local rights are then negated insofar as the home country's laws do not grant the same statutory priority status to the creditors involved.

The issue of statutory priority rights is perceived as highly sensitive, as it affects differing national policies and political beliefs on desired forms of redistribution. Nevertheless, the question arises of whether such national policies – apart from certain exotic statutory priority rights that can be found here and there – do indeed differ in any fundamental way. Notably, most bankruptcy regimes afford employee wage claims priority over unsecured creditors, albeit the scope of the priority right and the exact priority ranking may differ from jurisdiction to jurisdiction. However, such differences may not constitute serious problems if one considers that at the moment of filing for bankruptcy wage liabilities are generally low, since most corporate debtors will have an interest in paying their employees as long as possible if they want to continue their operations. Consequently, corporate debtors' incentives to forum shop *ex post* may not be strong as the *de facto* treatment of wage claims may not differ that much among jurisdictions.

Even if the impact of universalism on local priorities may be less far-reaching than initially expected, territorialists could still point to the way in which universalism protects tort victims as a source of its relative *ex ante* and *ex post* inefficiency. However, the choice of bankruptcy regime has no *ex ante* impact on tort creditors, as they typically cannot adjust to the likelihood of recovery in bankruptcy.[30] In addition, because in a universalist system the applicable bankruptcy regime is determined *ex post* on the basis of the home-country standard, debtors cannot *ex ante* opt for a regime that offers a low priority status to tort claimants. Thus, viewed from an *ex ante* perspective, universalism appears not to affect the position of tort creditors.

From an *ex post* perspective, however, the fear for forum shopping may be attenuated if one considers that most bankruptcy laws afford tort claimants the status of generally unsecured creditors, and that arguably only a small minority of bankruptcy laws afford a higher or lower priority to tort claimants. Yet, opponents of universalism also point to the substantial differences in treatment of tort claimants among countries, such as differences in the amount of damages granted. Forum shopping would then be attractive if the debtor could choose to file for bankruptcy in a country that grants lower damage amounts to tort claimants. This, however, assumes that the home country's substantive laws and practices extend to the adjudication of tort claims, a point of view that is generally not defended by universalists. Nevertheless, a reason for strategic bankruptcy filings may be that some bankruptcy regimes offer possibilities to settle both existing and future tort claims against the debtor. Thus, it could be attractive for a debtor facing high tort liabilities, its shareholders as well as its major commercial creditors to file for bankruptcy in a jurisdiction that allows for such settlements in bankruptcy.[31]

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[30] See Guzman, id at 2191-2192.

[31] Notably, under Chapter 11 of the US Bankruptcy Code a settlement of future tort claims is possible.

C Insolvency of the Transnational Firm and Value Maximisation

Universalism claims that it provides a better solution to the insolvency problems faced by transnational firms than territorialism by reducing both the direct and the indirect costs of bankruptcy. First, the direct costs associated with corporate bankruptcy are likely to be lower as only one court deals with the administration of the bankruptcy case and creditors need to file their claims only once. In addition, the judgments and orders issued by the home country court are automatically recognised by the other jurisdictions participating in the universalist system. In contrast, under a territorial system cross-border restructuring efforts require ad hoc cooperation among bankruptcy courts and professionals on a case-by-case basis. Moreover, up to now only the transnational insolvency cases of large firms have enjoyed the benefits of ad hoc negotiated solutions, whereas smaller firms that face cross-border insolvency problems may not be able to rely on such ad hoc negotiated solutions due to the smaller financial stakes and lower professional prestige involved.[32]

Second, by providing a centralized procedure that administers all the assets of the separate legal entities universalism would facilitate reorganisation or going-concern asset sales of transnational firms. Universalism would thus address the collective action problem more effectively and better align with corporate bankruptcy law's goal of value maximisation.[33] Arguably, territorialism impedes the efficient bankruptcy administration of companies by confining bankruptcy procedures to national borders. To the extent that legal entities only have assets within the territory of their jurisdiction of incorporation, such limitation would not be a problem.[34] However, legal entities tend to have assets abroad as well so that the failure to include all assets of a legal entity within the bankrupt estate clearly is a disadvantage of territorialism. With respect to separate legal entities, the application of the home country's bankruptcy law's to assets located outside the territory of the home-country jurisdiction thus has advantages from a value-maximising perspective.

However, when applied to the insolvency problems of a group of companies universalism raises problems of its own. That centralized proceedings with respect to companies belonging to the same corporate group are not necessarily value maximising is an issue largely not addressed by proponents of universalism.[35] The reason for this is that the theory of universalism does not properly distinguish the insolvency of a single legal entity from the insolvency problems faced by a transnational corporate group by not specifying whether the home-country standard is determined for each member of the group separately, for the entire corporate group as a whole or, for the financially distressed entities of the group.[36] Yet, it often emphasises the need of reorganisation of corporate groups as a whole. In so doing, the theory of universalism implicitly assumes that if large parts of a corporate group are confronted with insolvency problems, the application of a single set of insolvency laws

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[32] See also Bebchuk and Guzman, 'An Economic Analysis', n 4 above at 776.

[33] See, eg, Westbrook, 'Theory and Pragmatism', n 4 above at 466; Guzman, 'International Bankruptcy', n 4 above at 2012.

[34] cf LoPucki, 'Cooperation', n 7 above at 750; Buxbaum, 'Rethinking', n 5 above at 70.

[35] See Westbrook, 'Theory and Pragmatism', n 4 above at 465-466; Guzman, n 4 above at 2203.

[36] See LoPucki, 'Cooperation', n 7 above at 717.

to the legal entities involved would lead to more efficient outcomes than leaving the administration of the legal entities' assets to local courts, regardless of the question whether the creditors of each legal entity would benefit equally from the approach chosen by the home-country forum.

Undoubtedly, there are circumstances under which the application of a single set of insolvency laws to the separate legal entities belonging to a group is the value-maximising approach. The issue, thus, is not that a universalist proceeding would never be beneficial for corporate groups, but that universalism implicitly assumes that it would always be the better option. In so doing, it denies the variety of ways in which assets and activities are organized within corporate groups. In some corporate groups, the centre of gravity lies with the parent company while the activities of its subsidiaries are fully integrated with those of the parent company. In these circumstances, the application of a single set of insolvency laws may be value maximising as solving these problems may require a unified approach. Other corporate groups, however, may be organized in such a way that the separate legal entities represent independent businesses or groups of assets that might as well be reorganised or liquidated on a stand-alone basis so that a unified approach to the separate legal entities' insolvency problems may not be warranted. The desirability of a rule that cedes bankruptcy jurisdiction over subsidiaries to the home country of the parent corporation is therefore by no means evident. Admittedly, such a rule could be qualified by providing that a certain level of integration among the group companies is required, so that legal entities that have independent businesses are not forced to participate in the bankruptcy proceedings of the parent company. Yet, as a definition of the required level of integration is likely to be vague and prone to creative interpretations, it may reach too far and subject subsidiaries to an insolvency proceeding that does not guarantee the most efficient deployment of their assets.

III Freedom of Choice and Regulatory Competition

Reviewing the debate on universalism and territorialism, the case made against universalism by pointing to the redistributive effects caused by its interference with local policies can hardly be called convincing. Not only may priority rankings of national bankruptcy laws show more similarities than differences, but also the current application of territorialism may in practice not lead to a better protection of local or non-adjusting creditors. Yet, two pressing problems remain unresolved under both universalism and territorialism. First, the problem of legal uncertainty as to the law that applies to a transnational firm's bankruptcy. Second, and related to the first problem, is the failure of both universalism and territorialism to consider the relationship between corporate bankruptcy law and corporate governance by disregarding the *ex ante* governance needs and preferences of firms. Put differently, not only the fact that legal uncertainty exists as to the applicable bankruptcy laws increases the costs of capital for firms but also the fact that firms cannot align their bankruptcy regimes to their ownership structures by making an *ex ante* bankruptcy choice.

Because an unequivocal *ex ante* choice for bankruptcy law might decrease the costs of capital, some scholars have advanced freedom of choice as a rival principle of international corporate bankruptcy law. Advancing freedom of choice as a conflict of laws rule is closely related to a normative approach that advances contractualism in corporate bankruptcy law. Advocates of the contract approach to corporate bankruptcy emphasise the costs associated with mandatory one-size-fits-all bankruptcy regimes that typically only correspond to the governance preferences and needs of only a subset of firms. In contrast, a default system of bankruptcy rules could lead to more efficient bankruptcy arrangements by allowing a corporate debtor and his creditors to deviate *ex ante* from one or more bankruptcy rules if such a deviation would better fit the debtor's governance needs.[37] Similarly, proponents of freedom of choice in transnational corporate bankruptcy point to the costs that universalism imposes on firms as a result of its neglect of the interaction between corporate bankruptcy law and ownership structures.[38] A freedom-of-choice regime could provide an opportunity for corporate entities to opt out of their national systems by choosing a jurisdiction providing bankruptcy laws that better correspond to their specific governance needs. Moreover, such an *ex ante* choice increases predictability for creditors by giving them unequivocal information on the applicable bankruptcy law in the case of their debtor's bankruptcy as well as by blocking the possibility for debtors to counteract their creditors' expectations by *ex post* forum shopping or other strategic eve-of-bankruptcy actions. Free choice in bankruptcy could thus potentially lower the costs of capital for firms.

Under a free-choice regime independent corporate entities specify in their corporate charters the bankruptcy laws that apply in case of their insolvencies.[39] Corporations are allowed to select in their corporate charters bankruptcy laws of a different state than their state of incorporation. Nonetheless, if a corporation were to fail to make a choice in its corporate charter, the default rule could be that the bankruptcy laws of the state of incorporation apply. In the case of a corporate group the *ex ante* choice is made on an entity-by-entity basis. The chosen bankruptcy laws govern the firm's bankruptcy regardless of the main location of the debtor's assets or its principal place of business. Because bankruptcy courts are best equipped to apply the bankruptcy laws of their own jurisdictions, the choice of law should include the choice of forum as well. Like under a universalist regime the administration of the bankruptcy forum extends to all the assets of the legal entity wherever located. Needless to say, for a freedom-of-choice regime to work, states have to recognise and enforce bankruptcy selection clauses. Free choice thus requires a rather revolutionary move from state-

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[37] See Robert K. Rasmussen, 'Debtor's Choice: A Menu Approach to Corporate Bankruptcy', (1992) 71 *Texas Law Review* 51; Alan Schwartz, 'A Contract Theory Approach to Business Bankruptcy', (1998) 107 *Yale Law Journal* 1807.

[38] See Robert K. Rasmussen, 'A New Approach to Transnational Insolvencies', (1997) 19 *Michigan Journal of International Law* 1; Robert K. Rasmussen, 'Resolving Transnational Insolvencies Through Private Ordering', (2000) 98 *Michigan Law Review* 2252, 2260-2261; David A. Skeel Jr., 'Rethinking the Line Between Corporate Law and Corporate Bankruptcy', (1994) 72 *Texas Law Review* 471, 523; cf Frederick Tung, 'Passports, Private Choice, and Private Interests: Regulatory Competition and Cooperation in Corporate, Securities, and Bankruptcy Law', (2002) 3 *Chicago Journal of International Law* 369.

[39] See Rasmussen, 'A New Approach', n 38 above at 32-34.

mandated bankruptcy laws to a choice-of-law system that embraces freedom of contract in corporate bankruptcy as its main principle.

Contrary to universalism, the freedom-of-choice approach suggests that firms are better decision makers *ex ante* than firms and courts *ex post*.[40] Because firms have to make their choice of law at incorporation, they cannot strategically choose bankruptcy laws in order to realise wealth shifts from creditors to debtors. Because firms need to attract funding from lenders in order to make value-enhancing investments, they have an interest in opting for bankruptcy regimes that offer high levels of creditor protection. Conversely, if debtors choose bankruptcy regimes that offer low levels of creditor protection, creditors will penalise these debtors by raising the price of credit. Arguably, in this way corporate bankruptcy law could indirectly influence the choice of incorporation by affecting the price of credit.[41] Moreover, because firms are bound to their *ex ante* choice, *ex post* forum shopping no longer is a possibility. A system of freedom of choice thus fosters *ex ante* as well as *ex post* value-maximising investment behaviour by forcing firms to choose bankruptcy laws that lower the costs of capital.

Clearly, defending freedom of choice in corporate bankruptcy law equals favouring a system of regulatory competition. The theory of regulatory competition asserts that market forces impel state lawmakers to enact laws that benefit the consumers of the 'law as a product'. First, lower-level governments would adapt their regulations better to the preferences of local citizens. Second, decentralized lawmaking would increase the probability that jurisdictions offer a wider range of regulatory products in order to meet a diverse range of preferences. Put differently, the process of regulatory arbitrage – that is the choice of citizens for the laws that best suit their preferences – potentially forces state lawmakers to satisfy the preferences articulated by the customers of their products. Regulatory arbitrage causes regulatory competition among state lawmakers if states adapt their legal regimes in order to attract, or not to lose, their constituencies. Ideally, regulatory competition would lead to an optimal equilibrium of regulatory outcomes and citizen preferences.[42] A freedom-of-choice regime could thus pressure state lawmakers to shape their bankruptcy laws in accordance with the governance needs of firms that they would like to attract or the firms that are already incorporated in their jurisdictions. Moreover, it could arguably entice lawmakers to include more than one bankruptcy option in their laws in order to meet the bankruptcy preferences of a variety of legal business forms. Firms could then make a choice from a menu of options. In this way, a freedom-of-choice regime could pressure state lawmakers to better align their bankruptcy policies to their policies on legal business forms.

In general, advocates of regulatory competition predict that it ensues a 'race to the top', while opponents contend that it results in a 'race to the bottom'. On the one hand, the race-to-the-top view purports that competitive diversity counteracts the influence of dominant interest groups on the lawmaking process by tailoring regulation to local preferences. Moreover, it would lead to more efficient regulatory outcomes because

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[40] See id at 4.

[41] See Skeel, 'Rethinking the Line', n 38 above at 523.

[42] For a critical appraisal of the theoretical underpinnings of regulatory competition and its reception by law-and-economics see William W. Bratton and Joseph A. McCahery, 'The New Economics of Jurisdictional Competition: Devolutionary Federalism in a Second-Best World', (1997) 86 *Georgetown Law Journal* 201.

the decentralized nature of the lawmaking process would decrease information asymmetries between lawmakers and their constituencies and would foster innovation by lawmakers by enticing them to amend their laws to changing preferences. On the other hand, the race-to-the-bottom view perceives regulatory competition as leading to undesirable legal outcomes as states forsake public welfare by focusing on the preferences of small groups in their constituencies. Moreover, regulatory competition would lead state lawmakers to ignore the impact of the laws outside their own jurisdictions.

With respect to corporate law, the race-to-the-top view purports that charter competition in the United States has led to state corporate laws that increase shareholder wealth by benefiting both managers and shareholders.[43] This is countered by a race-to-the-bottom argument holding that, because managers ordinarily choose a firm's state of incorporation, charter competition leads states to enact increasingly management-friendly laws at the expense of shareholders.[44] The race-to-the-top view rebuts this by pointing out that shareholders will penalise such incorporation choices by discounting the share price. Also, under performing firms are targets for out-of-state corporate raiders. Thus, market forces would automatically halt the race-to-the-bottom, as managers will increasingly choose jurisdictions with high standards of shareholder protection thereby forcing states to adopt corporate laws that maximise shareholder wealth.

Considering corporate bankruptcy law, the endgame dynamic of corporate failure could support a race-to-the-bottom view when state lawmakers would enact manager-friendly and shareholder-friendly corporate bankruptcy laws. Because managers fear the loss of their jobs, shareholders the loss of their investments, and state lawmakers the loss of corporations or income for their local bar and court system, their interests may align in favouring manager-friendly and shareholder-friendly bankruptcy laws to the detriment of creditors' interests.[45] In addition, because states want to attract investments, countries could be enticed to favour bankruptcy laws that attract debtors and large lenders to the detriment of weakly and strongly non-adjusting creditors. Yet, the risk of the enactment of overly debtor-protective bankruptcy laws may be overstated to the extent that both adjusting and weakly non-adjusting creditors could *ex ante* price the chance of wealth shifts from creditors to shareholders.[46] Significantly, debtors will *ex ante* choose the bankruptcy regime that lowers their cost of capital so that they are not likely to favour bankruptcy regimes that systematically shift wealth from creditors to debtors.

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[43] For the race-to-the-top argument see, eg, Ralph K. Winter, 'State Law, Shareholder Protection, and the Theory of the Corporation', (1977) 6 *Journal of Legal Studies* 251; Roberta Romano, 'Law as a Product: Some Pieces of the Incorporation Puzzle', (1985) 1 *Journal of Law, Economics & Organization* 225.

[44] For the race-to-the-bottom view see, eg, William L. Cary, 'Federalism and Corporate Law: Reflections upon Delaware', (1974) 83 *Yale Law Journal* 663; Jeffrey N. Gordon, 'The Mandatory Structure of Corporate Law', (1989) 89 *Columbia Law Review* 1549; Lucian A. Bebchuk and Allen Ferrell, 'Federalism and Corporate Law: The Race to Protect Managers from Takeovers', (1999) 99 *Columbia Law Review* 1168.

[45] See also Guzman, 'International Bankruptcy', n 4 above at 2210.

[46] See Skeel, 'Rethinking the Line', n 38 above at 535; Rasmussen, 'Resolving', n 38 above at 2264-2267.

Fundamentally, bankruptcy selection clauses could enhance *ex ante* predictability, as creditors would only have to investigate the effects of the bankruptcy laws selected in the corporate charter. Easy access to the bankruptcy selection clauses could, for instance, be facilitated by registering the contents thereof with the trade register, requiring companies to include their selection on their letter paper or in the general conditions they use and requiring them to make such a selection public on their web sites. Still, knowing which bankruptcy laws a firm has chosen is one thing, knowing the effects of such laws on creditors' rights is another. The latter requires an investigation into both the law in the books and the law in action, which may only be cost effective for creditors who assess their risks on a debtor-by-debtor basis.

In order for free choice to put pressure on state lawmakers to innovate their bankruptcy laws in accordance with the preferences of firms and creditors, the choice of bankruptcy regime should, however, not be tied to the choice of the state of incorporation. If the choice of bankruptcy regime were to be tied to the state of incorporation, the pressure on lawmakers to align corporate bankruptcy laws and general corporate laws might be too weak. Because the bankruptcy regime will only be one of the factors firms consider when choosing their state of incorporation, they may trade off the inefficiencies in a bankruptcy regime against efficiencies in the corporate law regime or other related areas such as corporate taxation. In addition, if bankruptcy choice were to be tied to the state of incorporation, firms could strategically re-incorporate in another state on the eve of bankruptcy in order to take advantage of debtor-protective bankruptcy laws. Consequently, the efficiency gains of an *ex ante* choice would be forgone.

More generally, re-incorporation should not lead to an immediate change of corporate bankruptcy regime. This brings us to one of the most important weaknesses of a bankruptcy selection regime, namely the possibility of strategic eve-of-bankruptcy amendments of bankruptcy selection clauses. Future revisions of bankruptcy selection clauses in a way reintroduce the same uncertainty as the home-country standard under a universalist regime. The chance that such revisions occur affect *ex ante* predictability of the applicable bankruptcy regime to existing creditors, thereby potentially increasing the costs of capital. Ideally, revisions of bankruptcy selection clauses should only take place if such changes reflect fundamental changes in the governance structures of firms or in the bankruptcy regime initially chosen. To the extent that revisions of bankruptcy selection clauses could be limited to these instances, the costs thereof for pre-existing creditors might arguably be limited. In addition, lenders might deter debtors from choosing less efficient bankruptcy regimes by including penalties in the contracts such as an increase in the price of their credit or the termination of their credit extensions. Thus, prevention of abuse of revision of bankruptcy selection clauses might require some form of mandatory regulation.

Another problem related with bankruptcy selection clauses is that they do not necessarily guarantee that firms choose the more efficient bankruptcy regime. Informational costs at the time of incorporation may inhibit firms from choosing the bankruptcy regime that best fits their preferences. Consequently, especially smaller, and possibly locally oriented, firms might end up choosing the bankruptcy regime of their country of incorporation regardless of whether such a regime would be the more

efficient regime for these firms. Also, subsidiaries may choose a certain bankruptcy regime only because their parent company pressures them to make such a choice.

IV Some Barriers to Implementing a Universalist or Free-Choice Regime

Even though from the point of view of *ex post* value maximisation both universalism and freedom of choice may be more desirable regimes than territorialism, there are important barriers to the implementation by states of either of these regimes. Assuming that state lawmakers have a tendency to focus on the interests of their own constituencies,[47] a part of the states in the world will resist the implementation of universalist or free-choice regimes. Whether or not states will want to take part in these regimes thus depends largely on the alignment between state lawmakers and interest groups.

An important interest group that has influenced the development of the bankruptcy laws of various countries is that of bankruptcy professionals.[48] If state lawmakers are aligned with the interests of local professionals, their willingness to accept a universalist or free-choice regime in bankruptcy depends on whether the professionals involved expect to be able to export their bankruptcy expertise and practices more often than having to import foreign expertise.[49] Specifically, professionals that work in jurisdictions housing important financial centres as well as large transnational firms may favour a universalist approach to cross-border corporate bankruptcy. Consequently, the states that house these professionals have an interest in favouring universalism as this will increase their professionals' incomes and prestige. In contrast, states where professionals fear that universalism is likely to result in a loss of business to professionals in other states may resist a universalist system as such a system is likely to lead to the dominance of foreign bankruptcy regimes over the local regimes. If professionals who expect to benefit from a universalist or free-choice regime are mainly present in only a few states, the chance that a workable universalist regime arises is, however, small.

Furthermore, universalism or freedom of choice could interfere with local redistributive policies that typically are translated into statutory priority rights that benefit local creditors. States' defence of their own priority-ranking schemes often results from the preferences of domestic interest groups for the distributive choices made by the local laws. Because the effects of a choice for a foreign bankruptcy regime may be more visible to these local interest groups than the possible *ex ante* or *ex post* efficiencies of a universalist or free-choice regime, governments are inclined to prefer their own regimes in order to receive national support for their policies.[50]

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[47] See, eg, Berends, 'The UNCITRAL Model Law', n 4 above at 314.

[48] The influence of Wall Street investment bankers and law firms on the development of the US federal reorganisation schemes is well known. See on this David A. Skeel Jr., 'Bankruptcy Lawyers and the Shape of American Bankruptcy Law', (1998) 67 *Fordham Law Review* 497; see also Bruce G. Carruthers and Terrence C. Halliday, 'Professionals in Systemic Reform of Bankruptcy Law: The 1978 Bankruptcy Code and the English Insolvency Act of 1986', (2000) 74 *American Bankruptcy Law Journal* 35.

[49] cf Stephan, 'The Futility of Unification', n 21 above at 787 (pointing to the involvement of bankruptcy practitioners in developing the UNCITRAL Model Law).

[50] See Tung, 'Is International Bankruptcy Possible?', n 10 above at 45-47.

Viewed from the perspective of creditors who have a preference for their local insolvency laws, a free-choice regime could result in a race to the bottom. By counteracting redistributive policies at the local level, it would arguably lead to a lower level of government-mandated wealth redistribution than the citizens of the states affected might prefer. As a consequence, states may prefer weakened forms of universalism that provide territorial carve-outs to the benefit of local interests.

More generally, the claim may hold that the more similar the outcome of bankruptcy laws on such issues as security interests, priority rights, or labour contracts, the smaller the immediate cost of universalism or free choice at the local level. Universalism and free choice would thus require states to agree on a uniform system of security interests, priority rights, and the treatment of labour contracts in bankruptcy. In essence, this means that state laws should considerably converge on matters that are typically regulated outside of bankruptcy law.[51] A preliminary requirement for a universalist or freedom of choice regime would thus be that states agree on the demarcation of issues that are true bankruptcy matters and issues that should ideally fall outside the scope of bankruptcy regulation. In the main, issues that are typically regulated outside of bankruptcy concern such matters as the validity and recognition of security interests, statutory priority rights, the ranking of creditors' rights, and labour law issues. Bankruptcy law, on the other hand, should primarily deal with the collective action problem that is reflected in rules on the scope and effect of stay provisions and rules on avoiding powers, as well as with the question who controls the bankruptcy estate and the question whether deviation in bankruptcy from the priority-ranking outside of bankruptcy should be allowed. However, the demarcation of bankruptcy issues already poses considerable problems at the level of national bankruptcy laws. Undoubtedly, in many insolvency regimes there are instances where bankruptcy law overrides issues that are in principle regulated outside of bankruptcy, thereby denying entitlements or obligations that exist outside of bankruptcy law and vice versa. Moreover, universalism blurs the proper identification of issues that fall outside the scope of bankruptcy law even more, by not clearly identifying the matters that are governed by home-country bankruptcy law and those that are governed by the laws of other countries.

V The EC Regulation and Corporate Bankruptcy

The EC Regulation on insolvency proceedings offers a salient example of a weakened form of universalism that provides territorial carve-outs to the benefit of local interests and policies. The EC Regulation has a hybrid character, consisting of both universalist and territorialist elements. Its main universalist characteristic is the application of a broad home-country standard, which provides that universal main proceedings can be opened in the Member State where the debtor has its 'centre of main interests.'[52] The main proceedings are governed by the home-country law[53] and encompass all the

[51] See, eg, Westbrook, 'Theory and Pragmatism', n 4 above at 468-469.
[52] See Art 3(1), Reg 1346/00.
[53] See Recital (12) and Art 4(1), (2), Reg 1346/00. The *lex concursus* determines, among others, the conditions for the opening of the proceedings, the assets which form part of the estate, the powers of the debtor and the liquidator, the effects of the insolvency proceedings on proceedings brought by

debtor's assets, also those located in other Member States. If two or more Member States claim competence to open main insolvency proceedings, Member States have to recognise the decision of the court that first opened the main proceedings without having the power to scrutinise such a decision.[54]

Yet, the EC Regulation makes several important exceptions to the universal scope of the main proceedings with a view to the widely differing substantive laws on such issues as security interests and priority rights in the Member States and with a view to the protection of legitimate expectations and the certainty of transactions in Member States other than of the main proceedings.[55] The Member States' preferences for their own territorial bankruptcy regimes and policies have thus considerably restricted the scope of the home country's jurisdiction.

A The Regulation's Home-Country Standard: 'Centre of Main Interests'

Under the EC Regulation, jurisdiction needs to be determined with respect to each legal entity separately, including legal entities that are part of a group of companies.[56] With respect to companies or legal persons, the EC Regulation provides that the place of the registered office shall be presumed to be the centre of main interests. On the basis of this presumption jurisdiction is thus basically assigned to the Member State in which the company is incorporated. Nevertheless, jurisdiction can also be vested with the court of another Member State provided that it is established that the company has its main centre of interests in that other State.[57]

Despite the fact that the concept of 'centre of main interests' is thus an important connecting factor, no article in the EC Regulation defines such a concept. Only Recital (13) states that the centre of main interests should 'correspond to the place where the debtor conducts the administration of its interests on a regular basis and is therefore ascertainable by third parties'. The Virgós-Schmit Report remarks that the registered office normally corresponds to the debtor's head office.[58] This might imply that in order to prove that the company is located in another state than the state of its registered office, one would need to show that the head-office functions are carried out in another state. This has important implications for subsidiaries. If, for instance, the head-office functions of a subsidiary are carried out at the group headquarters, the

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individual creditors, the ranking of claims, and the rules relating to the voidness, voidability, or unenforceability of legal acts detrimental to all the creditors.

[54] See Recital (22) and Art 17(1), Reg 1346/00.

[55] See Recitals (11) and (24), Reg 1346/00; Miguel Virgós and Etienne Schmit, 'Report on the Convention on Insolvency Proceedings', Brussels, 8 July 1996, nos. 12, 13, 21-23 (Virgós-Schmit). The Virgós-Schmit Report was drafted during the negotiations for a Council Convention on Insolvency Proceedings. Due to the abortion of the Council Convention the Virgós-Schmit Report never became official. However, because of the similarity of substance between the Convention and the EC Regulation, the Virgós-Schmit Report is considered an important source for the interpretation of the EC Regulation.

[56] See Virgós-Schmit, id no. 76.

[57] See Art 3(1), Reg 1346/00; Virgós-Schmit, 'Report', n 55 above no. 75.

[58] See Virgós-Schmit, id.

court of the Member State where the group headquarters are located could open the main insolvency proceedings with respect to the subsidiary.[59]

There is, however, no reason to assume that the further specification of the concept of centre of main interests would be restricted to the location of the head office functions. Because the Regulation provides little to no help in delineating the home country standard, there is ample discretion for creative judicial interpretation. Moreover, courts could 'administratively consolidate' the bankruptcy of group companies if there are facts that support the view that group companies in different countries all have the same centre of main interests. Hence, the vagueness of the concept could enable corporate groups to file bankruptcy of both parent company and subsidiaries with the same bankruptcy court. Moreover, corporations not incorporated or registered in one of the Member States could still fall within the scope of the Regulation provided that they have their centre of main interests in the Community. This would allow foreign corporations to file for bankruptcy in one of the Members States. Similarly, the use of such a fact driven standard increases the scope of jurisdiction of many national bankruptcy courts of which the national laws until now provided that they could only assert jurisdiction if the debtor was incorporated or registered in accordance with the law of their jurisdictions. These courts now can expand their jurisdiction to corporations that have their centre of main interests within their jurisdictions albeit not being incorporated or registered there.[60]

Recent case law, notably of English courts, already demonstrates that the concept of 'centre of main interests' can be used in the aforementioned way. With respect to the Delaware-based corporation *BRAC Rent-A-Car International Inc.*, the English High Court held that it had jurisdiction to grant an administration order because the corporation had its centre of main interests in England.[61] Because BRAC Rent-A-Car was a non-EC corporation, the judge not only had to establish whether the corporation had its centre of main interests in England but also if the EC Regulation allows a court

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[59] See Gabriel Moss QC and Tom Smith, 'Commentary on Council Regulation 1346/2000 on Insolvency Proceedings', in Gabriel Moss QC, Ian F. Fletcher LLD and Stuart Isaacs QC (eds), *The EC Regulation on Insolvency Proceedings: A Commentary and Annotated Guide* (Oxford University Press, 2002) p 169 comment 8.39.

[60] In England this led to amendments to the Insolvency Act 1986 that broadened the scope of administration orders and company voluntary arrangements in general. Section 8(1) of the Insolvency Act 1986 – which provision empowered the court to make an administration order in relation to a 'company' – was amended by providing that reference to a company in this section includes reference to a company in relation to which an administration order may be made by virtue of Article 3 of the EC Regulation. Before this amendment it was uncertain whether administration orders could be made in relation to companies not registered under the Companies Act 1985. However, because Article 3(1) of the EC Regulation refers to 'company or legal person', administration orders can now also be made in relation to English companies that have legal personality but are not registered under the Companies Act. Likewise, the class of entities that can enter company voluntary arrangements has been broadened to unregistered companies as well; see Section 1(4) of the Insolvency Act 1986. For an application of the broadened domestic scope of administration orders and company voluntary arrangements in relation to an association of members established by Royal Charter see, *Re Salvage Association*, [2003] EWHC 1028 (Ch), [2003] 2 BCLC 333.

[61] *Re BRAC Rent-A-Car International Inc.* [2003] EWHC (Ch) 128, [2003] 1 WLR 1421. At the time of its request, BRAC Rent-A-Car already was in Chapter 11 administration. Because the automatic stay of Chapter 11 has no direct effect in England, an administration order was requested in England, see *Re BRAC* at 6.

to assert jurisdiction with respect to companies incorporated outside the Community. As to the latter issue, the High Court held that the EC Regulation only defines the scope of its application in terms of the location of the centre of main interests without limiting jurisdiction to debtors incorporated in the Community.[62] In addition, the Court referred to one of the purposes of the Regulation, namely that of avoiding incentives for the parties to transfer assets or judicial proceedings from one Member State to another in order to obtain a more favourable legal position. This purpose would be counteracted if companies having their principal place of business within the Community were able to incorporate outside the EC.[63] On the basis of these arguments, the Court held that it was in a position to assume jurisdiction with respect to the Delaware-based corporation.[64]

As to the question whether the corporation had its centre of main interests in England, the Court established that a literal reading of the EC Regulation leads to the conclusion that the debtor's centre of main interests is the only relevant test to be applied.[65] The corporation's centre of main interests was considered to be in England, because it had never traded in the US, its operations were conducted almost entirely in the UK, it had subsidiaries in many Western European countries, its trading activities were carried out by means of contracts with its subsidiaries and franchisees that were all governed by English law, it had for a long time been registered under the Companies Act as an overseas company, all its employees worked in England, and their employment contracts were governed by English law.[66] In sum, the interpretation of the concept 'centre of main interests' allows English courts to extend administration orders to companies that are incorporated outside England, notably those incorporated in the United States and other European countries.[67] Similarly, other jurisdictions that until now could only order bankruptcy proceedings with respect to companies incorporated or registered within their jurisdictions can do the same.

The *Daisytek-Isa Limited* case provides another example of the extension of administration orders to non-UK companies. In this case, administration orders were granted against the English parent company Daisytek-Isa Limited, ten of its English subsidiaries, three German subsidiaries and one French subsidiary based on the ground that these subsidiaries had their centres of main interests with the Bradford head office of ISA International Plc, a direct subsidiary of the parent company performing the function of head office for the group.[68] ISA International negotiated supply contracts

[62] See id at 24-25.

[63] See id at 27; Recitals (3) and (4), Reg 1346/00.

[64] It should be borne in mind, though, that the application of the EC Regulation to a company incorporated under the laws of a jurisdiction that is not subject to the EC Regulation raises conflict of laws issues in that the insolvency proceedings as well as the orders and judgments rendered by the court involved may not be recognised and enforceable outside the territories covered by the EC Regulation.

[65] See *Re Brac-Rent-A-Car*, n 61 above at 29-31.

[66] See id at 4-5.

[67] Prior to the EC Regulation, administration orders could only be extended to UK incorporated companies and to companies incorporated in several designated countries, which essentially were Commonwealth countries. See § 426 Insolvency Act 1986.

[68] See *Re Daisytek-ISA Limited*, [2003] WL 21353254 (Ch) [claim nos. 861-876] (available through Westlaw). After the French subsidiary ISA Daisytek SAS had already been put in administration, the Pointoise Commercial Court ordered second main proceedings in France with respect to the same

with and gave guarantees to major suppliers, including guarantees for the amounts due to creditors by ISA Daisytek SAS, the French subsidiary, and PAR Beteiligungs GmbH, the German parent company of two German subsidiaries. The supply contracts negotiated by ISA International provided for goods to be sold directly to the trading subsidiaries including the German and French ones. The High Court considered that the German group companies had their centres of main interests with the Bradford head office, even though their registered offices were in Germany and their businesses were conducted from premises in German cities.[69] The Court considered that the majority of the administration of the German companies was conducted from the Bradford office of ISA International because the finance function was operated from Bradford; the German companies required the approval of ISA International to buy anything in excess of 5000 Euros; all senior employees of the German companies were recruited in consultation with ISA International; all information technology and support was run from Bradford; all contracts with pan-European customers were negotiated and entered into by ISA International, which contracts amounted to 15% of the sales of the German companies; 70 percent of the purchases were negotiated and dealt with from Bradford; all corporate identity and branding was run from Bradford; and the German companies were required to carry out their business in accordance with a management strategy plan drawn up by the CEO of Daisytek-ISA Limited.[70] Furthermore, the High Court held that the 'identification of the debtor's main interests required the court to consider both the scale of the interests administered at a particular place and their importance and then consider the scale and importance of its interests administered at any other place which may be regarded as its centre of main interests.'[71] In addition, it held that the debtor's centre of main interests must be ascertainable by third parties as indicated by Recital (13) of the EC Regulation.[72] In the view of the High Court, the most important third parties were the creditors, who in the case of a trading company are likely to be its financers and suppliers. The Court added that it appeared that a large majority of potential creditors by value knew that Bradford is where many important functions of the German companies are carried out.[73] The French subsidiary related to the English Bradford offices in the same way as the German subsidiaries did save that the French subsidiary relied on financial support from ISA International and the CEO spent 40% of its time on the management of the French subsidiary.[74]

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company. The English administrators lodged an appeal with the Court of Appeal of Versailles, which court set aside the French bankruptcy order as issuing second main proceedings is clearly in violation of the EC Regulation. See *Klempka v. ISA Daisytek SAS*, [2004] I.L.Pr. 6.

[69] See *Re Daisytek-ISA*, id at 13.

[70] Id at 13.1-13.8.

[71] Id at 14.

[72] Id at 15.

[73] Id at 16.

[74] Id at 17. Another recent case dealt with by English courts is Crisscross; see John Wilcock, 'How Europe Became the Capital of Forum Shopping (and How London Hopes to Become the Delaware of Europe)', (Third Quarter 2003) *INSOL World*, at 9 (available at www.insol.org); for the reference to a case in which an Italian court held that a Dutch subsidiary had its centre of main interests in Rome, see R.J. van Galen, 'The European Insolvency Regulation and Groups of Companies', paper presented at INSOL Europe Annual Congress, Cork, Ireland, October 16-13, 2003 (on file with the author).

Although the EC Regulation does not explicitly deal with bankruptcy of groups of companies, the English cases show that the *ex post* judicial interpretation of the home - country standard opens the door to forum shopping. *Ex ante* predictability to creditors – which is in line with the general purpose of the EC Regulation of fostering the proper functioning of the internal market – is, however, not served by such imprecise standards. In this, the inclusion of 'ascertainability by third parties' in the general description of the home-country standard in Recital (13) is the more puzzling. Not only is 'ascertainability by third parties' a fuzzy indicator, but also its qualities as proxy for predicting the applicable law are at the very least doubtful. Although it may follow from certain facts that the centre of gravity of a business is located in a certain jurisdiction, it does not necessarily follow that it would therefore be predictable to creditors *ex ante* – that is at the time they enter into their contracts with the debtor – that their debtor's insolvency is to be governed by that jurisdiction's insolvency laws. Yet, it is this ascertainability that has played a pivotal role in the English decisions. The point here is not whether in these specific cases bringing the companies within one forum would have been a good or bad thing[75], but more generally whether it follows from the fact that a business's centre of gravity is ascertainable by third parties that it is predictable *ex ante* to these third parties that the home-country law is the law of the centre of gravity's location. As such, in internationally oriented companies, and in companies belonging to international groups of companies, the choice of a foreign law to govern contracts is not unusual, nor is the involvement of employees of a foreign group company in the drafting, signing, and closing of contracts. This, however, does not immediately enable creditors to predict *ex ante* the home-country law. In other words, the fact that the centre of gravity of a business is ascertainable to third parties does not necessarily say much about the *ex ante* expectations of these third parties as to the laws that apply if the debtor becomes insolvent. Moreover, the *ex ante* expectations may differ among creditors introducing the risk that the ascertainability to only a subset of creditors constitutes a sufficient proof for a debtor's centre of main interests.[76]

In addition, the centre of main interests is a highly manipulative concept, especially by debtors. The interpretation is flexible as the EC Regulation does not indicate which facts courts should at least take into account, let alone that there are guidelines as to the weighing of different facts as indicators for a debtor's centre of main interests. As such, a court could decide to open main proceedings on the basis of an arbitrary set of

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[75] For instance, in the *Daisytek* case the UK administration ended with a full recovery for some 85% of the creditors in the UK and 100% of the creditors in Norway, Sweden and Northern Ireland, and 1200 jobs were save; see Edward Klempka, 'The Centre of Main Interests and the Administration of Daisytek', (2004) *International Corporate Rescue* (Volume1, Issue 1) at 28.

[76] Another English decision demonstrates that 'ascertainability to third parties' is indeed a fuzzy indicator and can easily lead to confusion if it comes to deciding to whom the debtor's 'centre of main interests' was actually ascertainable. Although this case involved an individual debtor, the concept of centre of main interests and Recital (13) apply here as well. In this case, the debtor's centre of main interests was held to be in Switzerland, so that the EC Regulation did not apply. However, excerpts of the court hearing contained in the judgment do not seem to support the view that it was ascertainable to third parties – and it apparently had not been ascertainable to the creditor petitioning for the bankruptcy order – that Switzerland had to be regarded as the debtor's centre of main interests. See *Geveran Trading Co. Ltd. v. Skjevesland,* [2003] BPIR 73.

facts or could even let one single fact determine its decision. Importantly, if great value is attached to where a company's main strategic decisions are taken, many group companies could be brought within the reach of the bankruptcy courts of the Member State where the parent company has its headquarters, regardless of the question where the company's employees are located, with whom its main creditors have contracted, where its daily operations are conducted, or what expectations the creditors had with respect to the applicable insolvency laws at the moment they contracted with the debtor.[77] The possibility for debtors and their counsel to tailor the facts to their own advantage is even greater if one considers that generally few or no possibilities exist for interested parties to object to such interpretation. Arguably, only few creditors know of the moment that the debtor files for bankruptcy, and the creditors that are informed thereof are likely to be such creditors as main bank financers, who support the filing.[78] Moreover, the decision to open main proceedings has to be challenged before the opening court itself, which may create an extra barrier to foreign creditors.

B The Territorial Elements of the EC Regulation

Even though the EC Regulation has considerably extended the jurisdictional scope of national bankruptcy courts in the Community, the scope of the home-country's jurisdiction is limited in two important ways in order to protect local interests and guarantee legal certainty. First, the EC Regulation makes several important territorial carve-outs for the protection of local assets and creditors. Second, it allows national secondary proceedings covering only the assets situated in the State of opening of such proceedings.[79]

First, a territorial carve-out is made with respect to security interests.[80] Because of their importance for the granting of credit, the EC Regulation provides that security interests in assets situated outside the territory of the home-country State are not affected by the main proceedings.[81] In essence, this means that secured creditors can still enforce their claims against the assets located outside the home-country's territory without being affected by provisions of the main proceedings that restrict creditors'

[77] See Ken Baird and Richard Tett, 'Arms of U.K. Administration Embrace U.S. Companies', (2003) 22 May *American Bankruptcy Institute Journal* 14, 61-62 (mentioning that in the unreported *Enron Directo Sociedad Limitada* case the English court accepted that the centre of main interests of the Spanish company Enron Directo was in England, because some of its strategic decisions were made at Enron's European headquarters in London and certain board meetings were held in London as well, but regardless of the fact that the company had Spanish employees and its day-to-day business operations took place in Spain). Enron Power Operations Limited, the European holding company of the Enron Group, petitioned as a creditor for the administration order of Enron Directo. The skeleton argument of the petitioner is available at www.iiiglobal.org.

[78] cf Baird and Tett, id (noting that the hearing to open administration proceedings is generally unopposed and that on a debtor's administration petition the company only needs to notify creditors that hold floating charges).

[79] Recital (11), Reg 1346/00.

[80] Other territorial carve-outs regard the right to set-off, reservation of title, contracts relating to immoveable property, payment systems and financial markets, the treatment of employment contracts, rights subject to registration, and detrimental acts, see Art 6, 7, 8, 9, 11, 10, and 13, Reg 1346/00.

[81] See also Virgós-Schmit, 'Report', n 55 above no. 97.

enforcement rights.[82] The fact that the scope of the stay provisions of the national bankruptcy laws considerably diverges is the likely reason for excluding the enforcement of security interests from the universal effect of the main insolvency proceedings. Moreover, under the national laws of Member States secured creditors' enforcement rights in bankruptcy may be perceived as an important part of the content of their rights, regardless of the fact that a stay of enforcement rights arguably is a typical bankruptcy issue.[83] In practice this means that if the main proceedings stay secured creditors' enforcement rights, they will only do so with respect to encumbered assets situated within the territory of the State of the main proceedings.[84] If encumbered assets are located in other Member States the insolvency proceedings of which stay the enforcement rights of secured creditors, the liquidator in the main proceedings can open secondary proceedings in these Member States only if the debtor has an establishment in such Member States. However, in all other situations the liquidator in the main proceedings cannot reach encumbered property located outside the territory of the home country. Clearly, the risk that the deployment of certain encumbered assets may fall outside the scope of the main proceedings could cause problems in the framework of restructuring efforts of transnational businesses.

Second, territorial proceedings can be opened in the Member State in which the debtor has an establishment. The effects of these proceedings are restricted to the assets located in that Member State.[85] Once main insolvency proceedings are opened, these territorial proceedings become secondary proceedings.[86] The EC Regulation defines an establishment as any place of operations where the debtor carries out a non-transitory economic activity with human means and goods.[87] The broad definition has been the result of a compromise with Member States that wished to have the possibility of basing territorial proceedings on the mere presence of assets in a Member State. The final consensus reached leaves out the presence of assets as a basis for starting a territorial proceeding, but nevertheless offers a basis for a broad interpretation of the concept of establishment.[88] The reference to 'human means and goods' implies that a minimum level of organization and a certain stability of the economic activities are required.[89] However, given the fact that legal entities are

[82] Art 5(1), (2) Reg 1346/00. The validity and the contents of security interests (rights *in rem*), however, continue to be determined by the *lex situs*, see Recital (25), Reg 1346/00.

[83] For instance, in the Netherlands mortgage holders (*hypotheekhouders*) and pledge holders (*pandhouders*) are considered to 'separate themselves' from the bankruptcy estate in that they can foreclose their collateral 'as if there were no bankruptcy proceeding' (they do have to turnover a surplus to the bankruptcy estate, but they do not have to cooperate with the court-appointed official in foreclosing their collateral). This 'separatism' is traditionally presented as an integral part of the content of a right of mortgage (*hypotheekrecht*) and a right of pledge (*pandrecht*).

[84] The local assets, however, remain part of the estate of the main proceedings so that any surplus remaining after the realisation of the rights *in rem* has to be turned over to the liquidator in the main proceedings. See also Virgós-Schmit, 'Report', n 55 above no. 99.

[85] Art 27, Reg 1346/00.

[86] Art 3(2), (3), Reg 1346/00. The liquidator in the main proceedings can request the opening of secondary insolvency proceedings; see Art 29(a), Reg 1346/00.

[87] Art 2(h), Reg 1346/00.

[88] See Virgós-Schmit, 'Report', n 55 above no. 70 (noting that the mere presence of assets, eg the existence of a bank account, is not sufficient for local territorial proceedings to be opened).

[89] See Virgós-Schmit, 'Report', n 55 above no 71.

assessed separately under the Regulation, a subsidiary would not constitute an establishment.[90]

The protection of local interests is one of the reasons for providing the possibility of secondary proceedings.[91] More specifically, secondary proceedings can be used to protect creditors holding local statutory priority rights.[92] For example, if creditors of an establishment located in another Member State have statutory priority rights that do not have equivalents under the home-country law, they can protect their priority position by filing for a secondary bankruptcy proceeding.

C The Development of Corporate Bankruptcy Law in the European Union

As the example of the EC Regulation demonstrates, substantial differences among Member States on such issues as security interests and statutory priority rights have led to the implementation of a weakened form of universalism. This posits the question whether the approach chosen by the EC Regulation is sufficient from the perspective of the 'proper functioning of the internal market', or whether such proper functioning would instead require that the Member States agree on the approximation of their laws in such fields as property law, statutory priority rights, and the treatment of employment contracts. Put differently, as long as Member States consider their local policies to diverge substantially any attempt to regulate cross-border insolvencies may turn out to be futile.

At the same time, recent case law has demonstrated that the vague home-country standard may strengthen the dominant position of American and English professionals in the field of large cross-border insolvencies. Given the fact that many US groups base their European headquarters in London, the English courts and professionals may as well consolidate their dominance in this field. Consequently, they have the opportunity to export their expertise and practices. Yet, their dominance does not automatically lead to more efficient bankruptcy laws. As such, the influence of these professionals on lawmakers is not based on their desire to make bankruptcy laws more efficient, but in the first place on their wish to increase their own rents.

In general, the issue of cross-border insolvencies begs the question at which level of lawmaking within a federal system bankruptcy should be regulated and by means of what regulatory process. As indicated, the reduction of the cost of capital for transnational firms requires an enhanced level of legal certainty for investors as well as lawmakers that are responsive to the governance needs and preferences of different kinds of firms. To be sure, it should not be taken as a given that within a federal system corporate bankruptcy law should be regulated at the federal level. For instance, the fact that the United States has federal bankruptcy laws may have been more the result of a political and historical process, than of a deliberate process of lawmaking aiming at the creation of efficient bankruptcy laws. Largely, Wall Street lawyers and investment bankers have influenced the development of the US federal reorganisation laws. This has led to a complex reorganisation procedure that may on the one hand be

[90] See Moss and Smith, n 59 above at 166 comment 8.31.
[91] Recital (19), Reg 1346/00; Virgós-Schmit, 'Report', n 55 above nos. 32, 92.
[92] Recital (11), Reg 1346/00; Moss and Smith, n 59 above at 197 comment 8.149.

a flexible procedure for large publicly held firms, but on the other hand is criticised for its lack of reorganisation provisions apt for smaller and medium sized businesses.[93]

The theory of regulatory competition suggests that free choice for firms would foster the development of more efficient bankruptcy laws. Even if regulatory competition in corporate bankruptcy law may not be foreseeable in the near future, discussing the possibility of regulatory competition could redirect the focus of the lawmaking process within the European Union. Fundamentally, the proper functioning of a free-choice regime in corporate bankruptcy requires national bankruptcy laws to focus on their main functions, namely that of providing regimes that foster optimal asset deployment decisions. This means that corporate bankruptcy laws should mainly deal with the issue of governance of the insolvent corporation. It should thus regulate such issues as who controls (the debtor or a court-appointed official), the powers of the person controlling the administration of the estate, the scope of the stay provisions, and the question whether the debtor and its creditors (including shareholders) may deviate from the non-bankruptcy priority scheme.[94] In this way, firms could choose a bankruptcy regime that fits their ownership structure, which in turn could potentially lead to pressure on state lawmakers to provide more flexible bankruptcy laws.

A regime of free choice in corporate bankruptcy thus requires a proper demarcation of bankruptcy law issues. Extending the scope of corporate bankruptcy law beyond issues related to the governance of the insolvent corporation blurs the distinction between corporate bankruptcy law and other areas of the law. If, as a result, the choice of firms for corporate bankruptcy regimes is no longer solely guided by the governance characteristics of a given bankruptcy regime, the process of convergence to more efficient bankruptcy laws may be hampered.

This raises the question whether regulatory competition in the field of corporate bankruptcy law would be an option for the development of bankruptcy laws within the EU. As such, this option is still open. Yet, a necessary condition in order for such a regime of free choice to work is a high degree of convergence on such issues as cross-border tax issues, a uniform system for the recognition and ranking of security interests as well as the ranking and recognition of statutory priority rights and liens.[95] Another condition to be met is universal access to the laws of competing jurisdictions. To be sure, many of these conditions are not met in the EU.[96] Yet, recent case law of the European Court of Justice has opened the door for state competition in corporate

[93] See, eg, Lisa Hill Fenning and Craig A. Hart, ‘Measuring Chapter 11: The Real World of 500 Cases’, (1996) 4 *American Bankruptcy Institute Law Review* 119, 120, 122; Elizabeth Warren and Jay Lawrence Westbrook, ‘Financial Characteristics of Businesses in Bankruptcy’, (1999) 73 *American Bankruptcy Law Journal* 499, 500; Brian A. Blum, ‘The Goals and Process of Reorganizing Small Businesses in Bankruptcy’, (2000) 4 *Journal of Small & Emerging Business Law* 181.

[94] The stay provisions as well as the question whether contractual deviation from the priority ranking is allowed affect control. For instance, secured creditors may have the possibility of influencing the asset deployment decision if their enforcement rights are not stayed and lower-ranking claim holders may gain leverage during bankruptcy if they can bargain for a distribution.

[95] cf Roy Goode, ‘Security in Cross-Border Transactions’, (1998) 33 *Texas International Law Journal* 47 (pointing out the need for harmonisation in the field of security interests).

[96] These conditions are more likely to be met in the United States. For the possibility of turning back bankruptcy regulation from the federal to the state level in the US see Skeel, ‘Rethinking the Line’, n 38 above.

law by giving more room to the incorporation doctrine.[97] Arguably, a move to regulatory competition in corporate law could make the case for free choice in corporate bankruptcy law more compelling. Whether free choice would also lead to competition among jurisdictions remains to be seen. Even if convergence on such issues as security interests and priority rights could be achieved, differences in language and legal culture among Member States may still constitute an important barrier to free choice. Therefore, jurisdictions that are more innovative and responsive to the demands of firms and the laws and practices of which are easier to access could stand a higher chance of attracting firms as well as exporting their laws to other jurisdictions. Notably, the Anglo-Saxon jurisdictions would stand to gain from free choice. Other jurisdictions may have to adjust their laws in order not to lose businesses, but may not be able to effectively compete with jurisdictions that already dominate business law and practice.

VI Conclusion

Universalism, territorialism and free choice all come with their own problems. Nevertheless, the comparative advantage of a universal approach to the insolvency problems of a single legal entity is its potential for *ex post* value maximisation of the firm. Free choice in bankruptcy could combine this advantage with a higher degree of *ex ante* predictability as well as with the possibility of aligning bankruptcy regimes to ownership structures. However, neither universalism nor a free-choice regime in corporate bankruptcy is likely to be adopted as long as state laws show considerable divergence in major areas of commercial law that are essentially regulated outside of bankruptcy law. Yet, introducing the concept of free choice to the debate on cross-border insolvency of firms may redirect the focus of the debate to the question at what lawmaking level in a federal system corporate bankruptcy law should be regulated in order to guarantee a development toward more efficient bankruptcy laws. With respect to the European Union, this might suggest that, as a next step in its lawmaking initiatives, it should not aim at harmonization of national bankruptcy laws, but instead focus on the identification and approximation of those national rules outside of bankruptcy law that at present negatively affect the proper functioning of the internal market. Moreover, leaving the development of bankruptcy laws to the Member States enables States to customise their bankruptcy laws to the needs and preferences of local firms while not closing the door for state competition in corporate bankruptcy law as an alternative means of lawmaking within a federal system.

[97] Case 212/97 *Centros Ltd.* v *Erthvervs-og Selskabsstryelsen* [1999] ECR I-1459; Case 208/00 *Überseering BV* v *Nordic Construction Company Baumanagement GmbH (NCC)* [2002] ECR I-9919; Case 167/01 *Kamer van Koophandel en Fabrieken voor Amsterdam* v *Inspire Art Ltd* [2003].