# Texas Law Review

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BANKRUPTCY'S UNIVERSAL PRAGMATIST: A CELEBRATION OF THE WORK OF JAY LAWRENCE WESTBROOK

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SYMPOSIUM:
BANKRUPTCY'S UNIVERSAL PRAGMATIST: A CELEBRATION OF THE WORK OF JAY LAWRENCE WESTBROOK

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# The Rise and Fall of Fear of Abuse in Consumer Bankruptcy: Most Recent Comparative Evidence from Europe and Beyond

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*Abstract: Prepared for a symposium celebrating the groundbreaking career of Jay Westbrook, this Article examines recent evidence of fear of abuse of the benefits of consumer bankruptcy and the gradual abatement of that fear in modern consumer insolvency law reform. It marshals evidence of a recent and accelerating retreat in both the judicial discretion that Westbrook attributed to lawmakers' fear of abuse and other more direct techniques to avoid abusive recourse to consumer discharge. Fear of abuse appears to be diminishing with accumulated experience as indicated by recent liberalizing reforms in Denmark, Slovakia, Poland, Austria, Russia, and Romania. At the same time, evidence from countries that have only begun to develop policies on personal insolvency and discharge—Croatia, Bulgaria, China, and Saudi Arabia—indicate that fear, or at least resistance to discharge relief, clearly persists.*

Law is fundamentally a social science. Its theories usually can and should be tested based not just on the behavior of appellate courts but also on anthropological evidence of the actual frontline form and effect of law's regulation of human behavior. Jay Westbrook has led the charge in an enormously fruitful campaign of discovery of such evidence in the United States.[1] Our federalist legal system offers a natural laboratory for comparison of different approaches and outcomes in a checkerboard of state and federal districts and their various actors' often widely divergent approaches to key issues. This is surprisingly true even in the supposedly unified federal

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1. *See, e.g.*, TERESA A. SULLIVAN, ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA 17–20 (1989) (describing the methodology behind the authors' Consumer Bankruptcy Project, a study of debtors in ten federal judicial districts across the United States); TERESA A. SULLIVAN, ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT 7–11 (2000) (discussing Phase II of the Consumer Bankruptcy Project, which focused on debtors in sixteen federal districts); Teresa A. Sullivan, Elizabeth Warren & Jay Lawrence Westbrook, *Consumer Debtors Ten Years Later: A Financial Comparison of Consumer Bankrupts 1981–1991*, 68 AM. BANKR. L.J. 121, 122–24 (1994) (same).

consumer bankruptcy system. Opportunities for comparative analysis are supercharged, however, when one moves outside the United States and beyond the Anglo-American context on which most consumer bankruptcy scholarship has focused.

Almost exactly twenty years ago, Jay extrapolated his research on U.S. consumer bankruptcy to the new frontier of emerging consumer insolvency systems in Europe. In so doing, he launched a field of scholarship that would yield rich rewards. Before the turn of the twenty-first century, there was all but nothing in Europe to compare with Anglo-American consumer bankruptcy practice.[2] By the late 1990s, however, the first consumer discharge procedures were emerging in Northern Europe and had produced a foundation of operational results for comparison. Jay was among the first Americans to seize this new opportunity.

In a short commentary on one of the earliest comparative consumer bankruptcy conferences in Europe, Jay noted the potential of comparative perspectives on the topic.[3] At that time, he was studying judicial discretion and a resulting pernicious phenomenon that he referred to as "local legal culture," marked by persistent disparate treatment of similarly situated consumer debtors across the United States.[4] The comparative conference offered Jay a chance to extrapolate his U.S. findings to the few emerging consumer discharge regimes in Europe and to develop hypotheses as to the causes of the phenomenon of local legal culture. He noted that even the sparse European data revealed the emergence of local legal culture as a consequence of judicial discretion, particularly in determining (1) whether certain debtors should have access to a discharge and (2) the duration of the payment plan imposed on debtors as a *quid pro quo* for earning discharge relief.[5]

In light of his U.S. research, augmented by this limited set of comparative observations, Jay tentatively suggested a cause for the discretion producing these local legal culture disparities on both sides of the Atlantic: he attributed this syndrome to a powerful fear of abuse by debtors of the benefit of consumer discharge relief, a benefit that was radical and revolutionary in Europe and still somewhat controversial in the United

2. When U.S. reformers were looking for comparative ideas for revision of the U.S. bankruptcy law in the 1970s, they concluded "the bankruptcy experience of other countries is not a useful resource." COMM'N ON THE BANKR. LAWS OF THE U.S., REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, at 66 (1973).

3. Jay Lawrence Westbrook, *Local Legal Culture and the Fear of Abuse*, 6 AM. BANKR. INST. L. REV. 25, 33–34 (1998).

4. *See* Teresa A. Sullivan, Elizabeth Warren & Jay Lawrence Westbrook, *The Persistence of Local Legal Culture: Twenty Years of Evidence from the Federal Bankruptcy Courts*, 17 HARV. J.L. & PUB. POL'Y 801, 803–07 (1994) (applying the concept of local legal culture to bankruptcy law); Westbrook, *supra* note 3, at 26–27 (elaborating upon the concept of local legal culture).

5. Westbrook, *supra* note 3, at 25, 32–33.

States.[6] He optimistically predicted "[f]urther research over the next several years in the various countries that have adopted these new laws could yield a rich harvest of new evidence and perhaps unexpected variations."[7]

This commentary was published just as I was beginning my academic career, and it inspired everything I have done since then. It is extremely gratifying to be able to celebrate Jay's career in this symposium issue by adducing recent comparative evidence in support of his thesis in that early commentary and by providing a small taste of the "rich harvest of new evidence"[8] from the most recent developments in consumer bankruptcy in Europe and beyond. As Jay predicted, European authorities have been extremely concerned about debtors abusing the new discharge regimes, and common impediments to relief have been far more obvious and imposing than the nuanced effects of discretion and the resulting local legal culture. Twenty years after Jay identified this fear of abuse, however, a thaw is manifest in the icy European attitude, as evidenced in particular by developments over just the past few months. Fear of abuse—and discretionary or statutory mechanisms for making the path to discharge narrower and more onerous—appears to be diminishing with time and experience. This message needs to be broadcast more effectively, as several projects for new consumer discharge laws reveal a resurgence of fear of abuse or at least reticence to embrace the notion of discharge relief. Thus, the vicious cycle repeats itself.

This Article presents the most recent evidence of these propositions in three segments. Part I discusses three regimes that exemplify the trends discussed above—that is, extremely fearful, highly discretionary procedures that abruptly reversed course on fear of abuse after a decade or two of operation but retained significant court discretion (Denmark, Slovakia, Poland). Part II announces some of the most recent developments, including notable harbingers of both a softening of fear of abuse and a reining-in of discretion across Europe (Austria, Russia, Croatia, Romania). Part III looks to the future of several nascent personal insolvency regimes-in-waiting, which evidence a return to square one and a high degree of fear or resistance to discharge (Bulgaria, China, Saudi Arabia). Like Jay's commentary, mine here is designed primarily to stimulate interest in and discussions of developments of which many followers of English-language legal scholarship will be unaware[9] but which hold great potential for revealing

6. *Id.* at 28.

7. *Id.* at 33–34.

8. *Id.* at 34.

9. *See id.* at 25–26 (noting that the value of the paper "will lie in stimulating discussion by referring the reader to a very interesting series of papers about consumer bankruptcy that many will not have read").

important cross-cultural trends about this important area of legal and social policy.

## I. From Fear and Discretion to Acceptance and Greater Standardization

### *A. Denmark 1984–2005*

The first story is a bit dated, but it is both closely connected to Jay's early foray into comparative consumer bankruptcy and perfectly revealing of the trend away from the discretion and fear he described. Denmark was the bellwether, adopting the very first consumer "debt adjustment"[10] law in Europe in 1984.[11] The Danish law was structured very much like the Norwegian law that caught Jay's interest,[12] as a persistent problem of local legal culture plagued Danish practice for two decades and led to the only major reform of this law in 2005. This syndrome of local legal culture resulting from judicial discretion was fairly clearly born of a powerful fear of abuse of this radical departure from the traditional *pacta sunt servanda* notion that debts must be paid. Trailblazing Danish lawmakers were expressly hesitant to undermine individual-payment morality, so they imposed strict, discretionary access controls at both the entry and exit points to discharge relief.

Simply to gain access to the relief process, debtors had to clear two hurdles. First, they had to exhibit "qualified insolvency," which implied a clear and doubt-free inability to regain financial footing in the foreseeable future, by reducing profligate living standards and redoubling efforts to service debts in full.[13] Second, as in Norway,[14] each court had to be convinced that offering relief in any particular case was subjectively appropriate in light of a series of enumerated factors, such as the debtor's efforts to manage debt problems and the makeup of the debt load (preferably relatively few fines, penalties, and "irresponsible" debts, such as debts for luxury consumption).[15] Predictably, the highly subjective and probing inquiries prompted by these two tests produced widely and persistently divergent results among debtors

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10. This is the usual language used to name these laws in continental Europe, eschewing both the stigma and the suggestion of an easy way out implicit in the word "bankruptcy."

11. Lov nr. 187 af 09.05.1984 om gældssaneringslov [Law No. 187 of 9 May 1984 on consumer debt adjustment], af konkurslov afsnit IV, kapitel 25–29 [at Bankruptcy Act Section IV, Chapters 25–29] (Den.) [hereinafter Konkurslov].

12. *See* Westbrook, *supra* note 3, at 32–33 (discussing the discretionary elements of Norwegian bankruptcy law, which produced local variations similar to those observed in the United States).

13. Konkurslov, *supra* note 11, § 197.

14. *See* Westbrook, *supra* note 3, at 32 (discussing the Norwegian law's requirement that the debtor's bankruptcy be "permanent in nature").

15. Jason J. Kilborn, *Twenty-Five Years of Consumer Bankruptcy in Continental Europe: Internalizing Negative Externalities and Humanizing Justice in Denmark*, 18 INT'L INSOLVENCY REV. 155, 168 (2009).

based on little more than the location of the governing court. In 2002, for example, while the court in Odense admitted approximately 66% of its 161 debt adjustment applications, "the court in Roskilde admitted only 39% of its 139 applicants, and the court in Copenhagen admitted a mere 25% of [its] 828 applications."[16] For debtors who navigated past this Scylla, the Charybdis of court confirmation of debtors' five-year debt adjustment plans presented an equally daunting and equally divergent challenge. While the court in Århus closed 41% of its 244 cases with a confirmed plan, "the courts in Ålborg and Randers confirmed plans in only 19% and 15%, respectively, of the 136 cases closed" by each of these courts, and "[a]s in most years, the Copenhagen court had a miserly success rate of only 13% of its 8,689 closed cases."[17]

For the few lucky debtors who cleared these two procedural hurdles, more local legal cultural variation plagued their pursuit of earned relief. Like the Norwegian law that Jay learned about,[18] the Danish law also left completely to court discretion the terms of debtors' payment plans to earn their discharge—both the length in years and the budget allocated to debtors for family support.[19] Unlike in Norway, the Danish courts quickly coalesced around a standard five-year term, but courts differed widely in their assessment of proper budgets to support, as the statute directed, a "modest" lifestyle. Some courts allowed supplementary budget items beyond a basic allowance (for things like eye and dental care and household appliance rental), while others did not.[20] Even the amount of the basic budget allowance varied widely and was not based on variances in local cost of living, as this allocation varied by 40%–50% among otherwise similar districts.[21] These varying perspectives on appropriate sacrifice and thrift led some debt counselors to suggest that their pre-bankruptcy clients engage in in-country bankruptcy tourism, moving what we would now call their "center of main

16. *Id.* at 174–75.

17. *Id.* at 175.

18. *See* Westbrook, *supra* note 3, at 33 (discussing the Norwegian courts' discretion regarding payment plans).

19. *See* Kilborn, *supra* note 15, at 172, 177 (stating that Danish law originally left questions of disposable income and plan length "open to individual case-by-case and court-by-court discretion" and that budgetary practices "varied widely" among local courts).

20. Kilborn, *supra* note 15, at 177.

21. *See* Betænkning nr. 1449 af august 2004 om gældssanering [Report No. 1449 of August 2004 on Debt Settlement] 144 (Den.) (reporting that in 1997–1998, budget allowances for singles varied from 2,500 kr. to 3,500 kr. and for couples from 4,000 kr. to 6,000 kr.); Dommerfuldmægtigforeningen & Advokatrådet, *Redegørelse Vedrørende Ændringer i Konkurslovens Bestemmelser om Gældssanering* [Statement Regarding Changes to the Bankruptcy Act's Debt Settlement Provisions] 34 (1999) (Den.) (same).

interest" (i.e., their home residence) from a miserly region to a more generous (reasonable?) region.[22]

After nearly twenty years of frustration with these overly restrictive and divergent court demands, the Danish government stepped back from fear of abuse and launched a reform process that culminated in 2005. While the reform did not deal directly with the regional variations in admission and plan confirmation rates, it relaxed access criteria and standardized plan terms.

In a technical but crucial about-face, the initial presumption of restricted access was reversed. That is, while debtors were originally presumed *not* admissible unless the court was convinced that the totality of the circumstances militated *in favor* of relief, after 2005 the presumption is *in favor* of admission unless consideration of a slightly reformulated list of factors "suggests decisively against" relief.[23] Also, at least for former small-business entrepreneurs, the "qualified insolvency" test was modified expressly to provide admission for debtors whose economic situation is "unclear,"[24] and the payment term for a discharge plan for these former small-business entrepreneurs was set by Justice Ministry regulation at three years, rather than the standard five years for consumers.[25]

For all debtors, the reform dealt head-on with the local legal cultural problem of vast differences in court parsimony in discharge plans. The Justice Ministry was tasked with establishing uniform, nationwide basic budgetary allowances, and the Ministry took a much more humane approach to debtor support. The new budget guidelines exceeded the upper range then applied by the courts in most debt adjustment cases by nearly 20%, and additional types of income were exempted entirely from distribution to creditors, such as state transfer payments for children.[26]

As Jay predicted, however, local legal culture is quite sticky. The Danish courts have continued their rigorous watch at the gates into and out of the discharge procedure. In the decade following the reform, fewer than half of all petitions for admission to the personal discharge procedure were granted (fewer than 40% in 2009 and 2010).[27] While the reasons for these rejections are not reported, anecdotes from other jurisdictions suggest that most of the

22. Kilborn, *supra* note 15, at 174.

23. Konkurslov, *supra* note 11, §§ 197(4), 231a(4).

24. *Id.* §§ 231b, 236a(2).

25. Bekendtgørelse nr. 894 af 22.9.2005 om gældssanering [Executive Order No. 894 of 22 September 2005 on Debt Settlement] § 2 (Den.).

26. Kilborn, *supra* note 15 at 1, 176–78.

27. *See* DANMARKS DOMSTOLE, STATISTIK FOR SKIFTESAGER M.V.: MODTAGNE SAGER OM INSOLVENSSKIFTE M.V., http://www.domstol.dk/om/talogfakta/statistik/Documents/Skiftesager/ [https://perma.cc/F6HX-JUNN] (reporting the number of debt adjustment applications received and the number of debt adjustment applications declined). Calculations were based on ten years of data from 2006 to 2016 (on file with author).

rejected applications involve paperwork errors rather than merit-based judgments. Of an average of just over 5,000 cases closed per year during this period, only about 30% (an average of about 1,680) concluded with an approved plan. Though again looking on the bright side, excluding the cases rejected at the entryway, this represents a 70% confirmation rate for admitted cases.[28]

### *B. Slovakia 2006–2017*

When Jay attended the comparative conference in 1997, Denmark's personal discharge regime and similar ones in neighboring Scandinavia were effectively the only games in town.[29] Since then, the dam has broken and new consumer discharge laws and experience have flooded into virtually every country in Europe,[30] often through multiple iterations and amendments of new laws.[31] Much of the intervening experience has been analyzed elsewhere,[32] so this paper will focus on the very latest developments.

The most exciting and bold departure from a system historically both quite discretionary and quite fearful of abuse occurred in Slovakia, whose consumer discharge system was entirely overhauled effective March 1, 2017.[33] This amendment was preceded by a long period of disappointment with the original quite restrictive law. The Slovak consumer discharge provisions were added to the Law on Bankruptcy and Restructuring 2005 with a delayed effective date of January 1, 2006.[34]

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28. Kilborn, *supra* note 15, at 173.

29. *See* Westbrook, *supra* note 3, at 31. Though Jay notes emerging systems in France and Germany as well, in 1997 the French law offered no discharge to consumers and the German consumer bankruptcy reforms would not become effective until 1999. *See* JASON J. KILBORN, EXPERT RECOMMENDATIONS AND THE EVOLUTION OF EUROPEAN BEST PRACTICES FOR THE TREATMENT OF OVERINDEBTEDNESS, 1984–2010, at 13 n.69, 14 (2011).

30. *But see* discussion *infra* subpart III(A) (addressing Bulgaria's hesitance to adopt consumer debt discharge procedures).

31. *See, e.g.*, GERARD MCCORMACK ET AL., STUDY ON A NEW APPROACH TO BUSINESS FAILURE AND INSOLVENCY: COMPARATIVE LEGAL ANALYSIS OF THE MEMBER STATES' RELEVANT PROVISIONS AND PRACTICES 333–48 (2016) (reviewing the variations among consumer discharge laws in EU member states).

32. *See generally, e.g.*, KILBORN, *supra* note 29 (tracing the evolution of consumer bankruptcy systems throughout Europe); WORLD BANK, REPORT ON THE TREATMENT OF THE INSOLVENCY OF NATURAL PERSONS (2013) (discussing laws of insolvency of natural persons throughout the world).

33. *See* Radovan Pala & Michal Michalek, *Long-Awaited Changes to Restructuring Rules in Slovakia*, TAYLOR WESSING LLP (Feb. 1, 2017), https://united-kingdom.taylorwessing.com/en/insights/rcr-update/long-awaited-changes-to-restructuring-rules-in-slovakia [https://perma.cc/FH6E-G8DF] (discussing the enactment of an amendment to Slovakia's bankruptcy law).

34. Zákon, č. 7/2005 Z.z. o konkurze a reštrukturalizácii a o zmene a doplnení niektorých zákonov z 9. decembra 2004 [Law on Bankruptcy and Restructuring and on Amendment and Supplementation of Several Other Laws of 9 December 2004] (Slovk.), http://ec.europa.eu/internal_market/finances/docs/actionplan/transposition/slovakia/d7.3-ml-sk.pdf [https://perma.cc/UN5B-VXKB].

A surprisingly imposing barrier to relief prevented all but a few cases from making their way past the admissions stage for the first decade of this new law. To access relief, debtors had to pay the equivalent of about $800 (€663.88) in filing and trustee fees and demonstrate that they had assets to liquidate that would produce the equivalent of about $2,000 (€1,659.70) in distributions for creditors.[35] Debtors who cleared this hurdle faced yet another: like most European consumer insolvency laws, the Slovak regime required debtors to earn their fresh start by complying with a three-year payment plan imposed by the court.[36] The amount of payment demanded of debtors was subject to the all-but-unfettered discretion of the court, guided only by a frightening suggestion that the payment obligation could be "up to 70% of the debtor's net income."[37]

Few debtors managed to clear the entry barrier to this new system, though those who did so seem largely to have succeeded in obtaining relief. It took seven years of operation for this new procedure to produce 100 cases admitted to the three-year payment plan phase, though 484 debtors had applied for such relief and only about 200 cases were fully administered (leaving a significant and persistent backlog).[38] By the end of 2016, the total number of discharge applications over the ten-year life of the regime had risen to 1,855, with administered cases still lagging far behind at 685, of which 478 had been admitted to the payment plan phase.[39] This methodical approach to case evaluation was apparently fairly successful, as only a handful of cases over the eleven-year life of this original procedure ended in default or withdrawal, and most admitted cases seem to have concluded with a granted discharge about three years later, suggesting that courts had exercised their discretion in imposing relatively judicious payment obligations.[40]

Digging a bit deeper reveals a stark local legal culture issue at the admissions stage. The admissions figures just mentioned produce an admissions rate of 70% of all administered cases from 2006 through 2016.

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35. *Id.* § 171(1) (repealed Mar. 1, 2017); Vladimír Kordoš & Filip Takáč, *Resurrection of Personal Insolvencies in Slovakia?*, EUROFENIX, Spring 2017, at 34.

36. Kordoš & Takáč, *supra* note 35, at 34.

37. *Id.*

38. These figures derive from annual bankruptcy case statistics published by the Slovak Ministry of Justice. *See Konkurzné konania na okresných súdoch SR*, MINISTERSTVO SPRAVODLIVOSTI SLOVENSKEJ REPUBLIKY (Slovk.), http://www.justice.gov.sk/Stranky /Informacie/Statistika-konkurznych-konani-OS.aspx [https://perma.cc/5J5Q-772X] [hereinafter Slovak Bankruptcy Statistics] (reporting discharge application and administration statistics in Slovakia from 2006 through 2012).

39. *See id.* (reporting discharge application and administration statistics in Slovakia from 2006 through 2016).

40. *See id.* (compiling bankruptcy proceeding outcome statistics in Slovakia from 2006 through 2016).

But in examining district-level rates among the eight districts adjudicating these cases, stark differences emerge. In the last six years of the original regime, the court in the capital region of Bratislava admitted 100% of administered cases, with the high-volume courts in Banská Bystrica and Žilina not far behind. The district court in Trenčín, in contrast, admitted only 33% of administered cases during this period (fewer than 20% before 2015).[41] The small number of cases makes these figures less compelling, but the differing admissions practices of these decision makers seem to fairly clearly reflect very different attitudes toward, most likely, quite similar debtors. Payment-plan practices likely also differed dramatically. Over the entire eleven-year period under the original law, only two debtors emerged with a discharge from the process in Trenčín, compared with five in Bratislava and thirty-eight in Banská Bystrica (percentages are difficult to determine here, but judging by any perspective, the ratios of success vary wildly across districts).[42]

The Slovak government set out in 2016 to rectify this sad situation and align Slovak practice with regimes that are more accommodating to debtors. The legislature quickly took up and adopted the Justice Ministry's bold revision of the bankruptcy law in November 2016, effective March 1, 2017.[43] Departing from the European standard and all but abandoning fear of abuse, the new Slovak regime offers debtors a free choice between asset liquidation and immediate discharge or a five-year payment plan,[44] parallel to the U.S. choice between chapters 7 and 13 of the Bankruptcy Code. Debtors must be represented by the publicly supported Centre for Legal Aid,[45] and the now reduced €500 application fee can be lent by the Centre (for repayment in installments over three years) to debtors unable to pay the fee immediately.[46] To make liquidation an even more attractive option, the range of debtors' property exempt from liquidation has been expanded with a homestead exemption of €10,000 in unencumbered value in a home.[47]

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41. *See id.* (providing discharge application and administration statistics by district from 2011 through 2016).

42. *See id.* (reporting discharge statistics by district from 2006 through 2016).

43. *See* Kordoš & Takáč, *supra* note 35, at 34 (describing the implications of the amendment).

44. Zákon, č. 7/2005 Z.z. o konkurze a reštrukturalizácii a o zmene a doplnení niektorých zákonov [Law on Bankruptcy and Restructuring and on Amendment and Supplementation of Several Other Laws] (Slovk.), https://www.noveaspi.sk/products/lawText/1/59304/1/2 [https://perma.cc/WKK2-D6D6] (current version).

45. *Id.* § 166k.

46. CENTRUM PRÁVNEJ POMOCI, OSOBNÝ BANKROT 4–5 (2017) (Slovk.), http://www.centrumpravnejpomoci.sk/wp-content/uploads/2014/03/Bro%C5%BE%C3%BAra-OB-02_2017.pdf [https://perma.cc/NFR3-4WHV].

47. Zákon, č. 7/2005, *supra* note 44, § 167h(4). The Justice Ministry issued a press release on the new law and homestead exemption. *Dostupnejší osobný bankrot*, MINISTERSTVO SPRAVODLIVOSTI SLOVENSKEJ REPUBLIKY (Mar. 1, 2017) (Slovk.), http://www.justice.gov.sk/Stranky/aktualitadetail.aspx?announcementID=2179 [https://perma.cc/XK7U-3L7G].

In stark contrast with recent U.S. practice, Slovak lawmakers embedded in their new system a clear preference for quick liquidation-and-discharge relief, actively discouraging debtors from pursuing the payment plan route. For debtors who choose to preserve their nonexempt assets and propose a payment plan, the reserved budget for family support must cover the debtor's family's housing and basic needs (still undefined in the law[48]) and offer creditors a minimum 30% dividend (and at least 10% more value than a liquidation would produce).[49] For debtors whose disposable income does not appear sufficient to meet these thresholds, the statute directs the trustee to recommend that the debtor file a petition for bankruptcy liquidation.[50]

By the end of November 2017, the Centre for Legal Aid had registered nearly 63,000 consultations with debtors interested in the new discharge procedure.[51] Over 8,000 petitions were filed in the first nine months of availability of the new processes, 7,800 seeking liquidation and discharge, and slightly more than 200 proposing a five-year payment plan.[52] The courts quickly accelerated their formerly languid administration process, granting admission to 6,454 bankruptcy cases and 117 payment plan cases.[53] Of these, about half of the bankruptcy cases have already closed with a discharge, while a payment plan has been confirmed in forty cases.[54] In the nine months from March to November 2017, the number of petitions for bankruptcy exceeded the entire number filed in the eleven-year period of the old law by a factor of four. The number of cases admitted in the first nine months of the new procedure was 13.5 times as large as the total number admitted over the previous ten years, and 17 times as as many discharges have been granted.[55] The new Slovak system is a unique example of the modern European retreat from fear of abuse and embrace of standardized, low-burden personal discharge.

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48. *See* Silvia Belovičová, *New Personal Insolvency Regime in Slovakia*, 0-1-CEE! CENT. EUR. LEGAL NEWS & VIEWS BLOG (Dec. 16, 2016), http://www.ceelegalblog.com/2016/12/857/ [https://perma.cc/7MQ7-98WR] (noting that debtor living expenses are to be determined by trustees and courts, "and let's hope they will use their discretion wisely").

49. Zákon, č. 7/2005, *supra* note 44, § 168c(4)–(5).

50. *Id.* § 168c(7).

51. *Rok 2017 na ministerstve spravodlivosti*, MINISTERSTVO SPRAVODLIVOSTI SLOVENSKEJ REPUBLIKY (Dec. 19, 2017) (Slovk.), http://www.justice.gov.sk/Stranky/aktualitadetail.aspx ?announcementID=2285 [https://perma.cc/2YWG-NALA] [hereinafter 2017 at the Ministry of Justice].

52. *Id.*

53. *Id.*

54. *Id.*

55. *See* Slovak Bankruptcy Statistics, *supra* note 38 (reporting bankruptcy admission and discharge statistics in Slovakia from 2006 through 2016); 2017 at the Ministry of Justice, *supra* note 51 (reporting bankruptcy admission and discharge statistics from March through November of 2017).

### C. *Poland 2009–2015*

A somewhat similar story played out in Poland, though over a shorter period of time. Poland's first consumer discharge law was adopted much later than the Slovak version, and it ran into serious trouble immediately. Effective at the end of March 2009,[56] the Polish Law on Bankruptcy and Rehabilitation was supplemented to allow consumers to seek discharge relief, but, again, fear of abuse compelled legislators to place two major obstacles in the way of access to this relief. First, debtors had to establish that their insolvency resulted from exceptional circumstances entirely beyond their control.[57] As if this were not sufficient to bar access to all but a small handful of applicants, admission also required a demonstration of sufficient assets to cover the costs of administration, which varied from case to case and were estimated at between €1,000 and €5,000.[58]

In the nearly four years from March 2009 through the end of 2012, just over 2,160 consumer debtors applied for discharge relief under the new law, but only sixty (2.8%) were admitted into the system.[59] The Justice Ministry was not pleased. The Ministry proposed a reform, expressing its feeling that these statistics "and legislative experiences of other countries show, the current restrictive approach envisaged in Polish law should be liberalized."[60] A little over a year later, a bill was on the floor of the legislature with an explanatory statement reminding lawmakers of the many benefits of consumer discharge law, observing that the Polish approach had failed due to the cost and qualification barriers noted above and aiming to "reduce or completely remove" these barriers.[61] The bill traveled through the legislative process quickly, and legislators put fear of abuse behind them as they passed the liberalizing amendments into law at the end of August 2014, effective December 31, 2014.[62] Meanwhile, statistics on the operation of the old law came to an ignominious end, with a total of 2,735 applications submitted over

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56. Marek Porzycki & Anna Rachwał, *Consumer Insolvency Proceedings in Poland* 5 (Instytut Allerhanda, Working Paper 12/2015, 2015).

57. Prawo upadłościowe [Bankruptcy and Reorganization Law] (2003 r. Dz. U. Nr 175, poz. 1361), Art. 1 (Pol.); Katarzyna Kołodziejczyk, *Consumer Bankruptcy in Poland*, MONEY MATTERS, no. 14, 2017, at 20, 20.

58. Kołodziejczyk, *supra* note 57, at 20.

59. *See Ewidencja spraw upadłościowych (w tym upadłości konsumenckiej "of") za lata 2005–2015*, INFORMATOR STATYSTYCZNY WYMIARU SPRAWIEDLIWOŚCI (Pol.), https://isws.ms.gov.pl/pl/baza-statystyczna/opracowania-wieloletnie/download,2853,56.html [https://perma.cc/GAN4-WSXM] (reporting bankruptcy applications and admissions in Poland from 2009 through 2012).

60. MINISTERSTWO SPRAWIEDLIWŚCI, REKOMENDACJE ZESPOŁU MINISTRA SPRAWIEDLIWOŚCI DS. NOWELIZACJI PRAWA UPADŁOŚCIOWEGO I NAPRAWCZEGO 270 (2012) (Pol.) (original in Polish).

61. O zmianie ustawy – Prawo upadłościowe i naprawcze oraz niektórych innych ustaw [Bill Amending the Bankruptcy and Reorganization Law] (2014 Nr 2265) (Pol.) (original in Polish).

62. Porzycki & Rachwał, *supra* note 56, at 5.

nearly six years and only 120 successfully admitted—an ultimate aggregate admission rate of just 4.4%.[63]

From 2015 forward, Polish debtors have been free to seek discharge relief so long as they did not cause their insolvency "intentionally or as a result of gross negligence."[64] For debtors with limited assets, administration costs are initially covered by the state treasury (and the costly formality of publication of case information in newspapers was scrapped in favor of electronic publication to reduce expense).[65] After liquidation of the debtor's assets, Polish practice still follows the European norm of imposing a payment plan on debtors to earn their discharge, but both the term (up to three years, down from five in the earlier law) and payment amount are still left to unfettered court discretion.[66] In a powerful move away from fear of abuse, however, the law explicitly recognizes that many debtors will lack payment capacity beyond meeting their basic needs, so it provides for an immediate discharge if the court finds that this is "clearly shown."[67] For cases where a payment plan is imposed, it can be amended for improvements in the debtor's payment capacity, but only for "reasons other than an increase in remuneration for work or services personally performed by the debtor."[68] This provides a creative incentive for debtors to maximize their productivity immediately following insolvency proceedings.

As in Slovakia, Polish debtors eagerly accepted the invitation to this newly liberalized relief. Already in the first year of the new Polish law, more than 5,600 debtors applied and 2,153 were admitted—nearly twenty times as many admitted cases as in the previous six years combined.[69] Those figures nearly doubled again in 2016, with almost 8,700 applications and 4,447 admission orders, and the acceptance rate rose above 50% for the first time.[70] Many applications are still being rejected, but largely for incorrect completion of the forms,[71] and the average four-month processing time for cases suggests that the admission rate will rise as the crush of new cases

63. *See* INFORMATOR STATYSTYCZNY WYMIARU SPRAWIEDLIWOŚCI, *supra* note 59 (presenting applications and admission statistics from 2009 through 2014).

64. O zmianie ustawy – Prawo upadłościowe i naprawcze, ustawy o Krajowym Rejestrze Sądowym oraz ustawy o kosztach sądowych w sprawach cywilnych [Amendment to the Bankruptcy and Reorganization Law] (2014 r. DZ. U. poz. 1306), Art. $491^4$(1) (Pol.) [hereinafter Prawo upadłościowe] (original in Polish).

65. *Id.*, Art. $491^7$(1), Art. $491^{16}$(2); Porzycki & Rachwał, *supra* note 56, at 10, 29.

66. Prawo upadłościowe, *supra* note 64, Art. $491^{14}$, Art. $491^{15}$.

67. *Id.* at Art. $491^{16}$(1) (original in Polish).

68. *Id.* at 64, Art. $491^{19}$(3) (original in Polish).

69. *See* INFORMATOR STATYSTYCZNY WYMIARU SPRAWIEDLIWOŚCI, *supra* note 59 (providing applications and admission statistics from 2009 through 2016).

70. *Id.* Admissions levelled off in 2017 at just over 5,500, though with a sharp turn upward in the last three months of the year. *2017 upadłość konsumencka*, CENTRALNY OŚRODEK INFORMACJI GOSPODARCZEJ, http://www.coig.com.pl/2017-upadlosc-konsumencka-lista_osob.php [https://perma.cc/SR3D-WPAU].

71. INFORMATOR STATYSTYCZNY WYMIARU SPRAWIEDLIWOŚCI, *supra* note 59.

makes its way through the procedure. Fear of abuse is in definite retreat in Poland.

## II. Most Recent Developments: Less Discretion, Less Fear of Abuse

### *A. Russia 2015–2017*

Only two years old, the new Russian consumer bankruptcy system has already encountered and addressed the same cost impediments that hindered the operation of the Slovak and Polish systems. It also confronted an unexpected form of resistance when lower courts creatively interpreted the new law to prohibit use by most consumer debtors. Here again, in a decisive rejection of fear of abuse, the Russian Supreme Court last year put the system back on track to achieve its primarily rehabilitative purposes.

In the transition back to a market-based economic system following decades of stagnation under Communism, Russia adopted a consumer bankruptcy law in December 2014, with a delayed effective date of October 1, 2015.[72] This law carried few of the hallmarks of fear of abuse seen elsewhere. Though it appears to follow European standards by requiring debtors to relinquish both nonexempt asset value and some amount of future income, the income expropriation period seems to last only six months, and debtors are entitled to a nondiscretionary exemption of a statutorily determined portion of their income.[73] So far so good.

The ironic problem, as in Slovakia and Poland, seems to be money, as debtors have struggled to afford the costs of the procedure. In the first year of the law, of an estimated avalanche of 670,000 potential overindebted applicants, only 33,000 debtors petitioned for relief, only 14,800 cases were opened, and fewer than 500 made their way completely through the complex, ten-month-long average procedure.[74] Lawmakers first thought cost barriers were keeping the sea of applicants back, so in November 2016 they reduced the filing fee from 6,000 rubles to a nominal 300 rubles (from about $244 to $12 at Purchasing Power Parity exchange rate (PPP)), effective January 1, 2017.[75] But by the end of the second year of the new law's operation, the total

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72. Jason J. Kilborn, *Treating the New European Disease of Consumer Debt in a Post-Communist State: The Groundbreaking New Russian Personal Insolvency Law*, 41 BROOK. J. INT'L L. 655, 686 (2016).

73. *Id.* at 698–700, 710–11.

74. Nataliia Shvabauėr, *Zhizn' vzaĭmy*, ROS. GAZ. (Nov. 7, 2016) (Russ.), https://rg.ru/2016/11/07/sredi-rossijskih-grazhdan-okazalos-bankrotov-bolshe-chem-sredi-kompanij.html [https://perma.cc/47DW-PL7X].

75. Georgiĭ Panin, *Kakie vazhnye zakony vstupiat v silu s 2017 goda*, ROS. GAZ. (Dec. 28, 2016) (Russ.), https://rg.ru/2016/12/28/kakie-vazhnye-zakony-vstupiat-v-silu-s-2017-goda.html [https://perma.cc/2YEA-JQTA].

number of consumer cases commenced had little more than doubled to just over 40,000.[76]

The reduction in filing fees was merely a drop in the bucket compared to the real problem: the cost of the required "financial administrator," set by statute at 25,000 rubles (about $1,000 at PPP) but in reality often higher, and other administrative expenses reportedly boost the total cost of a personal bankruptcy filing to at least 100,000 rubles in Moscow ($4,000 PPP) and at least 60,000 rubles in provincial regions (about $2,500 PPP).[77] This is in addition to the logistical challenge of filing a bankruptcy case in the often distant commercial courts, only one of which is located in each "subject" (governmental region) of Russia's expansive territory.[78]

Both the cost factor and another less obvious obstacle to relief were revealed as serious doctrinal problems when one of the first cases under the new law made its way to the Russian Supreme Court.[79] Two months after the effective date of the new law, the Commercial (*Arbitrazh*) Court in the remote Western Siberian Tyumen Oblast opened a personal bankruptcy case only to close it five months later on two grounds, both related to the absence of any substantial asset value in the case.[80] First, the court felt that the absence of sufficient asset value to offer even a partial distribution to unsecured creditors undermined the very purpose, in its view, of the bankruptcy law—that is, to offer proportionate satisfaction of creditors' claims from the debtor's assets.[81] Second, insufficient asset value to pay administrative costs constitutes a basis for case closure under Article 57 of the Law on Insolvency, and the court held that funds could not be advanced by a nondebtor to cover these costs.[82]

The Supreme Court struck back at these philosophical constraints on the new law and dealt another blow to fear of abuse of consumer discharge. Consumer bankruptcy has other purposes, the Court asserted, beyond satisfying creditors. Access to legislatively prescribed relief cannot be restricted simply on the basis that the debtor has no asset value to offer creditors, and this cannot be equated to "bad faith," more specific evidence

76. Tat͡iana Zamakhia, *Dobrosovestnym grazhdanam predlozhili spisat' dolgi*, ROS. GAZ. (Nov. 8, 2017) (Russ.), https://rg.ru/2017/11/08/dobrosovestnym-grazhdanam-predlozhili-spisat-dolgi.html [https://perma.cc/LVG2-P67P].

77. Tat͡iana Zykova, *Bol'she ne dolzhen*, ROS. GAZ. (Jan. 12, 2017) (Russ.), https://rg.ru/2017/01/12/chislo-bankrotov-v-rossii-za-poslednie-3-mesiaca-vyroslo-na-27.html [https://perma.cc/8RL9-VG29].

78. Kilborn, *supra* note 72, at 691–93.

79. Opredelenie Verkhovnyĭ Sud Rossiĭskoĭ Federat͡sii ot 23 i͡avara 2017 [Decision of the Russian Federation Supreme Court of Jan. 23, 2017], N. 304-ÉS16-14541, Delo N. A70-14095/2015. 2017 (Russ.).

80. *Id.* at 2–3.

81. *Id.* at 2.

82. *Id.*

of which is required to deny a discharge.[83] And while debtors must, indeed, somehow cover the administrative costs of the proceeding (which at the time were much smaller than now, with only a 10,000 ruble fee for the financial administrator), the Court pointed out that the law contained no provision forbidding debtors from seeking help from third parties in covering these fees.[84]

For debtors without generous friends, the law does indeed still require full payment of administrative costs,[85] which clearly remains a deterrent for many debtors, as it was in Slovakia and Poland. Fortunately, the Ministry of Economic Development has already proposed a simplification of the procedure—mainly exclusion of the costly financial administrator—for cases involving debtors with limited debts and assets (less than 900,000 rubles of debt, about $37,000 at PPP, fewer than ten creditors, and income less than the statutory minimum livable income).[86] This further step away from fear of abuse has been met with some resistance, so this will be a developing story to watch in 2018 and beyond. Incidentally, lawmakers in neighboring Ukraine have long agitated for a personal bankruptcy law as well, but to date, they have not progressed beyond the stage of a draft bill, the most notable of which has been pending for two years.[87]

### *B. Austria 1995–2017*

Perhaps the biggest change ushered in at the start of the new year is a major withdrawal from fear of abuse at the culmination of a long-fought battle in Austria. This is one of the small handful of consumer discharge regimes that was already in operation beginning in 1995, before Jay wrote his commentary, and it exemplifies the fear of abuse that he discerned in Europe at the time. For over twenty years, the Austrian procedure imposed three classic European hurdles to deter feared abuse by consumer debtors. After decades of criticism by counseling centers and other observers,[88] each

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83. *Id.* at 3 (original in Russian).

84. *Id.* at 4.

85. Federal'nyĭ Zakon o Nesostoi͡atel'nosti (Bankrotstve) [Federal Law on Insolvency (Bankruptcy)], N 127-FZ. st. 57(1) (Russ.); *see also* Zykova, *supra* note 77 (noting that the administrator can request case closure at any point if his fees and expenses are not paid by the debtor).

86. Elena Berezina & Irina Zhandarova, *Vernut' vse*, ROS. GAZ. (Mar. 13, 2017) (Russ.), https://rg.ru/2017/03/13/grazhdanam-uprostiat-bankrotstva.html [https://perma.cc/ZV55-Z7HH]; Zykova, *supra* note 77.

87. Natal'i͡a Myt͡skovskai͡a, *Kak stat' bankrotom: novyĭ zakon mozh͡het pomoch' yzbavyt'si͡a ot nevyplachennykh dolhov*, KOMSOMOL'SKAI͡A PRAVDA V UKRAYNE (Nov. 15, 2017) (Ukr.), https://kp.ua/print/economics/592146-kak-stat-bankrotom-novyi-zakon-mozhet-pomoch-yzbavytsia-ot-nevyplachennykh-dolhov [https://perma.cc/K28J-M8A5].

88. *E.g.*, ASB SCHULDNERBERATUNGEN, SCHULDENREPORT 2016 14, 18 (2016) (Austria) (calling for overdue reforms in Austrian insolvency law); Christiane Moser, *Österreich: Reform des*

of these three obstacles was cleared away by near-unanimous legislative reform effective November 1, 2017.[89]

First, like in Poland and Russia, the Austrian law originally required debtors to pay at least the administrative costs of the proceeding. For those unable to do so immediately upon applying for relief, such debtors had to comply with another prerequisite: a mandatory attempt to work out their debt problems privately through an out-of-court negotiation with creditors.[90] This negotiation was, unsurprisingly, very seldom successful, so in the reform it was finally scrapped.[91] Austria thus joins Sweden in having abandoned mandatory debt counseling and negotiation as a prerequisite for formal consumer insolvency relief.[92]

Second, like virtually every European consumer discharge regime, the Austrian procedure requires both a liquidation of nonexempt assets and a payment plan. Historically, most such plans were accepted by a vote of creditors. Debtors had to propose to pay creditors an amount equal to five years' worth of their projected nonexempt income, and they could string out those payments over as many as seven years to lighten the burden.[93] Such a plan is accepted by an affirmative vote of creditors who represent a majority in number and amount of the claims of all voting creditors.[94] While the great majority (70%) of Austrian personal insolvency cases in the past have concluded with such a court-mediated payment plan,[95] low-income debtors have been largely shut out of the process by the unique final minimum-payment hurdle discussed below. With the reform to allow low-income debtors realistic access to relief, the necessity to propose a payment plan for creditor voting has now been limited to debtors with substantial nonexempt

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*Privatkonkurses überfällig*, DAS BUDGET, no. 78, 2016, at 6, 6 (Austria) (noting that Austria is lagging behind in private bankruptcy reform).

89. Clemens Mitterlehner & Christa Kerschbaummayr, *Reform of Personal Bankruptcy Procedure in Austria*, MONEY MATTERS, no. 15, 2017, at 8, 8.

90. KONKURSORDNUNGS-NOVELLE 1993 [BANKRUPTCY AMENDMENT OF 1993] BUNDESGESETZBLATT [BGBL] No. 974/1993, § 183(2) (Austria), https://www.ris.bka.gv.at/Dokumente/BgblPdf/1993_974_0/1993_974_0.pdf [https://perma.cc/B79C-HTTF].

91. Philipp Wetter, *Austria: Major Changes in Personal Bankruptcy Law*, SCHOENHERR (July 4, 2017), https://www.schoenherr.eu/si/publications/publication-detail/austria-major-changes-in-personal-bankruptcy-law/ [https://perma.cc/32US-3T5X].

92. Jason J. Kilborn, *Out with the New, In with the Old: As Sweden Aggressively Streamlines Its Consumer Bankruptcy System, Have U.S. Reformers Fallen Off the Learning Curve?*, 80 AM. BANKR. L.J. 435, 458 (2006).

93. KONKURSORDNUNGS-NOVELLE 1993, *supra* note 90, §§ 193(1), 194(1).

94. INSOLVENZRECHTSÄNDERUNGSGESETZ 2010 [IRÄG 2010] [INSOLVENCY LAW AMENDMENT 2010] BUNDESGESETZBLATT [BGBL] No. 29/2010, § 147(1) (Austria), https://www.ris.bka.gv.at/Dokumente/BgblAuth/BGBLA_2010_I_29/BGBLA_2010_I_29.html [https://perma.cc/3JXX-4ALX].

95. GEORG KODEK, HANDBUCH PRIVATKONKURS: DIE SONDERBESTIMMUNGEN FUR DAS INSOLVENZVERFAHREN NATÜRLICHER PERSONEN 384 tbl.C.3 (2015).

income. That is, debtors with little or no nonexempt income can proceed immediately to the final stage, a court-imposed earned discharge period.[96]

This earned discharge period and its culmination were the subjects of the third and most substantial reform. Neither the length of this period nor the amounts demanded from debtors were ever subject to any notable degree of court discretion. Originally, debtors formally assigned to a trustee all of their actual income in excess of an objective statutory "existence minimum" amount for seven years.[97] An additional requirement echoed the sentiment of the Russian Tyumen Oblast Court discussed above regarding the purpose of bankruptcy: at the conclusion of this seven-year period, Austrian debtors received a discharge only if they had paid off administrative costs and produced a dividend of 10% of unsecured creditors' claims.[98] Debtors who missed this mark only slightly could hope for a hardship discharge at court discretion, perhaps after an additional three-year period of toil and sacrifice, but the discharge could be and sometimes was denied to debtors who failed to produce a satisfactory dividend for creditors.[99] Many more low-income debtors were doubtless deterred from even attempting to obtain discharge relief, knowing they likely could not cover costs and produce the minimum 10% dividend for creditors.[100]

As of November 1, 2017, in a tectonic shift from longtime fear to full acceptance of consumer discharge, Austrian legislators scrapped the 10% minimum dividend, softened the requirement to cover administrative costs, and reduced the earned discharge period from seven to five years.[101] At the conclusion of the now five-year period, the court enters a discharge regardless of whether the debtor has covered costs and produced a dividend for creditors.[102] Administrative costs that cannot be covered by debtors are advanced from the state Treasury, to be collected from the proceeds of liquidation of debtors' nonexempt assets or collection of nonexempt income.[103] If the debtor's asset value and five years of nonexempt payments

96. INSOLVENZRECHTSÄNDERUNGSGESETZ 2017 [IRÄG 2017] [INSOLVENCY LAW AMENDMENT 2017] BUNDESGESETZBLATT [BGBL] No. 122/2017, §§ 193(1), 194(1) (Austria), https://www.ris.bka.gv.at/Dokumente/BgblAuth/BGBLA_2017_I_122/BGBLA_2017_I_122.html [https://perma.cc/LWF7-RPRE].

97. KONKURSORDNUNGS-NOVELLE 1993, *supra* note 90, § 199(2).

98. *Id.* §§ 194, 213.

99. *Id.*

100. *See* ASB SCHULDNERBERATUNGEN, *supra* note 88, at 14–15 (discussing the 10% minimum); KODEK, *supra* note 95, at 165–202, 249–338.

101. INSOLVENZRECHTSÄNDERUNGSGESETZ 2017, *supra* note 96, §§ 199(2), 213(1).

102. *Id.* § 213(1).

103. INSOLVENZORDNUNG [INSOLVENCY CODE] BUNDESGESETZBLATT I [BGBL] no. 122/2017, as amended, § 184(1)–(2) (Austria) https://www.ris.bka.gv.at/GeltendeFassung.wxe?Abfrage=Bundesnormen&Gesetzesnummer=10001736&FassungVom=2017-10-31 [https://perma.cc/WEG7-86U2].

have not managed to cover administrative costs, the debtor remains liable to cover those costs only "if and when he is in a position to do so without impairment of his [and his family's] necessary support."[104] Even this obligation prescribes (i.e., is barred by a statutory limitations period) three years after the conclusion of the proceedings.[105] The Czech Republic now stands alone in the European Union with a law that requires a minimum dividend to unsecured creditors (30%) for consumer debtors to earn their discharge.[106] Perhaps not enough time has passed for fear of abuse to abate since the Czech consumer discharge became available in 2008, but one hopes the Czech Republic will follow Austria's example in far less than the twenty-two years it took for Austria to do so.

### *C. Croatia 2016, Romania 2018*

The two newest consumer discharge procedures in Europe reveal a bit of unfortunate backpedaling toward fear of abuse, though there is good reason to expect that discretion will be exercised sparingly and within relatively narrow boundaries in these two latecomer systems. Both will be unfolding stories to watch in the years to come.

*1. Croatia.*—Croatia was the most recent European Union Member State to adopt a consumer bankruptcy procedure, effective January 1, 2016.[107] It immediately took two steps backward toward fear of abuse by adopting the prereform Austrian procedure, minus the minimum dividend to creditors. Not learning from the repeated failures of these processes in neighboring regions, Croatian legislators reimposed two futile access restrictions just abandoned by Austria, along with what seems like a fairly menacing multiyear payment obligation.

First, Croatian debtors can gain entry to the in-court discharge procedure only after engaging a counseling center to propose an out-of-court settlement plan to creditors.[108] When the counseling center inevitably concludes that this effort is doomed to failure, it issues a certificate to that effect, which the debtor must present within three months with a petition for bankruptcy

104. *Id.* § 184(3).

105. *Id.*

106. KILBORN, *supra* note 29, at 30, 37.

107. *Zakon o stečaju potrošača* [Law on Consumer Bankruptcy], NN 100/2015 (1936) (Croat.); Emir Bahtijarevic & Ema Mendusic Skugor, *New Insolvency Legislation to Thoroughly Change Bankruptcy Procedures in Croatia*, CEE LEGAL MATTERS, Feb. 2016, at 88, 88.

108. OZREN IVKOVIĆ & MARKO KRUC, SCHONHERR, CROATIA: CONSUMER BANKRUPTCY ACT INTRODUCES CONSUMER BANKRUPTCY INTO THE LEGAL SYSTEM (2016), https://www.schoenherr.eu/uploads/tx_news/Croatia_Consumer_Bankruptcy_final_pdf3.pdf [https://perma.cc/W45U-U3KL].

relief.[109] The state agency that oversees these counselors, the Financial Agency (FINA), has released statistical data on the first two years of the new Croatian procedure indicating that a total of 1,159 debtors have engaged counseling centers to initiate the out-of-court process.[110] These debtors had an average of only six creditors and mostly quite small debts, but in only *one* case were all creditors somehow convinced to sign onto the debtor's proposed settlement plan (and in only sixteen cases was an agreement reached even with *some* of the debtor's creditors).[111] Certificates of failure had thus been issued to 795 debtors, with the same result most likely awaiting most or all of the remaining applicants.[112]

Second, to gain access to the formal discharge procedure, debtors must again present a settlement plan to creditors in an in-court process. Only after that effort inevitably fails again, a liquidation of the debtor's nonexempt assets ensues, and like in Austria, Croatian debtors are relegated to an additional "behaviour checking" period of between one and five years.[113] While the law appears to leave the precise duration of this period to judicial discretion, it seems likely that courts will in most cases choose the maximum five-year term. This was the result in the very first personal bankruptcy case in Croatia, where a fifty-one-year-old former entrepreneur with no assets and only pension income was assigned a five-year term from which she filed an appeal for a reduction to a year and a half.[114] During this period, debtors are subject to a nondiscretionary requirement of turnover of all income above the statutory exemption. The Croatian statutory minimum income figures seem far less livable than their Austrian equivalents, with one Croatian journalist characterizing them as "neoliberal euthanasia."[115] This likely explains why only a fraction of the expected 10,000–20,000 potential debtors have applied for relief.[116] In this respect, the newest European consumer discharge system

109. *Id.*

110. FINANCIJSKA AGENCIJA (FINA), PREGLED ZBIRNIH PODATAKA IZ SUSTAVA PROVEDBE STEČAJA POTROŠAČA ZA RAZDOBLJE OD 1.1.2016. DO 03.04.2018. GODINE 2 (2018) (Croat.), http://www.fina.hr/lgs.axd?t=16&id=19566 [https://perma.cc/J4YR-U2LM].

111. *Id.* at 2, 7.

112. *Id.* at 7.

113. IVKOVIĆ & KRUC, *supra* note 108.

114. *See* Ljubica Gatarić, *Prva u osobni bankrot otišla propala poduzetnica iz Krapine*, VEČERNJI LIST (Oct. 17, 2016) (Croat.), https://www.vecernji.hr/vijesti/prva-u-osobni-bankrot-otisla-propala-poduzetnica-iz-krapine-1121543 [https://perma.cc/7FKP-QUE9] (reporting the details of Croatia's first personal bankruptcy case).

115. *See* Leo Buljan, *Možete li preživjeti s 800 kuna mjesečno? Ako potpišete osobni stečaj, bolje da naučite!*, PORTAL DNEVNO (June 26, 2014) (Croat.), http://www.dnevno.hr/novac/mozete-li-prezivjeti-s-800-kuna-mjesecno-ako-potpisete-osobni-stecaj-bolje-da-naucite-126174/ [https://perma.cc/APA5-RYJR] (original in Croatian) (citing minimum income figures of $133 per month for the debtor, $80 for an adult family member, and $53 for each child (not at PPP)).

116. *See* IVKOVIĆ & KRUC, *supra* note 108 ("According to the Ministry, somewhere between 10,000 and 20,000 of the indebted citizens might take advantage of this opportunity.").

may reveal something of a resurgence of fear of abuse, though not in the guise of judicial discretion.

*2. Romania.*—Meanwhile, the latest European consumer discharge system to actually begin operations has just come online in Romania as of January 1, 2018. While the Romanian legislature unanimously adopted its Law no. 151/2015 "on the insolvency procedure of natural persons" in June 2015,[117] the government pushed back the effective date several times.[118] This delay was attributable in part to government efforts to constrain discretion in evaluating debtors' capacities to support settlement plans with creditors and to endure a multiyear earned discharge period.

The Romanian law adopts the French approach[119] of routing debtors through standing insolvency commissions, which evaluate whether cases should be directed to a negotiation with creditors and a potential five-year payment plan, or, for debtors whose financial situation is "irremediably compromised," to a liquidation-and-discharge procedure.[120] In performing the sensitive and critical evaluation of debtors' payment capacities that determines which path is pursued, the insolvency commissions are not left to their own devices; rather, the Ministry of Justice directed the chair of the central insolvency commission to publish detailed criteria for determining a "reasonable standard of living" for debtors in insolvency proceedings. These criteria must be based on a list of national economic benchmarks, including cost-of-living indices, various family and household compositions, and transportation and housing guidelines.[121] The publication of these criteria seems to have been delayed as of this writing, but the effort to constrain discretion and contain fear of abuse is manifest.

If Romanian institutions embrace the French approach to the notion of "irremediably compromised" debtors (as seems highly likely), many if not most debtors will be routed to an immediate liquidation-and-discharge

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117. Legii 151/2015 privind procedura insolvenței persoanelor fizice [Law on the Insolvency Procedure of Natural Persons] publicată în Monitorul Oficial al României, Partea I, nr. 464/26.06.2015 (Rom.); Mihaela Condrache & Liviana Andreea Nimineț, *Personal Bankruptcy and the Romanian Realities*, STUD. & SCI. RES., no. 22, 2015, at 7, 8.

118. *See, e.g.*, Ordonanță de urgență pentru prorogarea termenului de intrare în vigoare a Legii nr. 151/2015 privind procedura insolvenței persoanelor fizice [Government Emergency Ordinance for the extension of the entry into force of Law no. 151/2015 on insolvency procedure of natural persons] publicată în Monitorul Oficial al României, Partea I, nr. 962/24.12.2015 (Rom.).

119. *See* KILBORN, *supra* note 29, at 34–35 (tracing the development of France's commission-based approach to processing debtors' cases).

120. Condrache & Nimineț, *supra* note 117, at 9–11.

121. Hotărâre 419/2017 pentru aprobarea Normelor metodologice de aplicare a Legii nr. 151/2015 privind procedura insolvenței persoanelor fizice [Decision Approving Methodological Norms for the Application of Law on the Insolvency of Natural Persons] publicată în Monitorul Oficial al României, Partea I, nr. 436/13.06.2017, art. 2 (Rom.).

procedure.[122] The insolvency commissions can send particularly low-income, elderly debtors to simplified proceedings, which require a simple observation period of three years before a final discharge is granted.[123] For all others, the asset liquidation is followed by a payment period, during which a court-determined proportion of the debtor's income in excess of reasonable living expenses must be paid to creditors.[124] This proportion is determined in accordance with the published budgetary guidelines for a "reasonable standard of living."[125] The duration of the payment period is determined by the percentage of debts paid off—as little as one year if 50% of debts are paid within that time—but given the finances of most debtors, the most common objectively determined term will be five years for debtors unable to produce at least a 40% dividend.[126] These nondiscretionary and sensitive terms for earning discharge relief reflect further relaxation of fear of abuse at the most recent launch of a consumer insolvency system.

## III. Consumer Discharge-in-Waiting: Fear of Abuse Manifest in Laws in Development

In countries that have not by this point followed the personal bankruptcy trend sweeping across Europe, one would expect to find a great deal of resistance to the notion of offering such relief. A resurgence of fear of abuse is fairly obvious in the last European straggler, Bulgaria, where proposed bills reflect this fear in objective, but all-but-insurmountable, barriers to relief. Beyond Europe, advanced-stage proposals developing in China and Saudi Arabia confirm that newcomers to personal discharge approach the policy conversation with great hesitancy.

### *A. Bulgaria*

In 2000, household debt was hardly a blip on the social policy radar screen in Bulgaria. By 2008, household debt had exploded and while still not reaching the worrying levels of some other European states, had risen to and remained at a level that caught the attention of policymakers.[127] Concerned

122. *See* KILBORN, *supra* note 29, at 34–35 (describing the increasing number of cases administered under France's "personal recovery" procedure for debtors whose financial situation is "irremediably compromised"); Jason J. Kilborn, *Determinants of Failure . . . and Success in Personal Debt Mediation*, TRANSNAT'L DISP. MGMT. Nov. 2017 at 1, 11–12 (discussing the growth of France's bankruptcy commission regime).

123. Legii 151/2015 privind procedura insolvenței persoanelor fizice, *supra* note 117, arts. 65–70.

124. *Id.* art. 57(1)(b).

125. *Id.* art. 3(25) (original in Romanian).

126. *See id.* art. 72 (prescribing the procedure for determining the duration of a debtor's payment period).

127. *See* Miroslav Nikolov, *Households Indebtedness: State-of-the-Art*, MONEY MATTERS, no. 14, 2017, at 7, 8 fig.3 (illustrating the sizeable growth in Bulgaria's household debt between

Bulgarian legislators finally introduced a bill in February 2015 to provide "protection against overindebtedness of natural persons" in the form of a cost-free, European-style procedure of asset liquidation followed by a three-year earned discharge period of relinquishment of nonexempt income.[128] The explanatory note to the bill commented that "[t]he public interest requires 'eternal debtors' to be given an opportunity to engage anew in socially beneficial activity," consistent with European practice.[129]

This controversial bill made no progress before another was introduced on July 21, 2017. The tone and approach of this new bill are quite different from its predecessor's: debtors are deemed overindebted and allowed access to relief only if they have worked consistently during three of the preceding five years, their debts do not exceed 150,000 Bulgarian levs (about $95,000), and they nonetheless appear unable to pay their debts with *ten* years of expected income.[130] In such cases, the earned discharge period would be ten years on minimum income.[131] Moreover, during this ten-year period, debtors are prohibited from entrepreneurial activity as members or directors of companies.[132] Excluding retired people and long-term unemployed debtors and calling on ten years of earning capacity is sure to produce a remedy for very few maladies. One suspects Bulgaria is still some distance from a consumer discharge law of any kind, let alone an effective one. One can just picture the fear in legislators' eyes!

### *B. China*

A most exciting recent development in China comes not from a central government project, but from a controlled provincial experiment. While China is in principle a highly centralized state, central authorities often afford significant autonomy to regional governments to pursue large-scale trial runs of new policies. Nowhere is this trend more powerful and more obvious than in the "special economic zones" developed during the period of "reform and opening" initiated by Deng Xiaoping in 1979.[133] Deng's famous "southern

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2000 and 2008); *Bulgaria Household Debt 2000–2016*, CEIC, https://www.ceicdata.com/en/indicator/bulgaria/household-debt [https://perma.cc/STW7-L7ZN] (reporting that Bulgaria's household debt "reached an all-time high" in December of 2008).

128. Proekt, Zakon za zashtita pri svrŭkhzadŭlzhenost na fizicheskite litsa [Draft, Law of Protection Against Overindebtedness of Natural Persons], 554-01-30 ot 12/02/2015, arts. 3(2), 6, 16, 26 (Bulg.).

129. *Id.*, Notes at 12 (original in Bulgarian).

130. Bill, Zakon za zashtita pri svrŭkhzadŭlzhenost na fizicheskite litsa [Bill, Law of Protection Against Overindebtedness of Natural Persons], 754-01-46 ot 24/07/2017, arts. 4(1), 5 (Bulg.).

131. *Id.* art. 22(1), 30.

132. *Id.* art. 31.

133. ARTHUR R. KROEBER, CHINA'S ECONOMY: WHAT EVERYONE NEEDS TO KNOW 5 (2016).

tour" in 1992 took him to one of the most prominent of these zones, Shenzhen, just to the north of Hong Kong.[134]

This hotbed of economic development and local initiative appears to be the likely future birthplace of personal bankruptcy law in China. In June 2014, a subgroup of the Shenzhen Bar Association began developing a personal bankruptcy bill for the Shenzhen Special Economic Zone.[135] A draft law emerged by September 2015, with some unique and intriguing provisions that suggest Shenzhen authorities are stepping lightly into this new legal terrain.[136]

A preliminary review of the proposed law, working from this author's rather rudimentary foundation in Chinese, reveals what seem to be fairly rigorous and restrictive requirements for accessing the procedure and obtaining relief. To access the personal liquidation process, debtors must submit evidence of five years of income and expenditures (which presumably indicate their payment ability and substantiate their claimed inability to clear their debts timely), and their current standard of living must not exceed a level corresponding to the local minimum wage.[137] The draft law seems to require the debtor to pay creditors the value of any nonexempt property—including disposable income—the debtor reasonably anticipates receiving over the next two years, which must in any case suffice immediately to cover administrative costs.[138]

The discharge provision is a bit puzzling, but it seems to require a minimum distribution to creditors of at least the amount distributed to them by the debtor during the two-year period preceding the debtor's filing an application for liquidation; otherwise, a discharge is conferred only by the (extremely unlikely) unanimous vote of the creditors' committee.[139] This

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134. *Id.* at 7.

135. SHENZHEN JINGJI TEQU GEREN POCHAN TIAOLI CAO'AN JIANYI GAO FU LIYOU (深圳经济特区个人破产条例草案建议稿附理由) [SHENZHEN SPECIAL ECONOMIC ZONE PERSONAL BANKRUPTCY REGULATION DRAFT PROPOSAL WITH ACCOMPANYING REASONING] (Lu Lin (卢林), ed., 2016) (China) [hereinafter Shenzhen Draft Bankruptcy Proposal]; *see also "Shenzhen Jingji Tequ Geren Pochan Tiaoli" Dashiji* (《深圳经济特区个人破产条例》大事记) [*"Shenzhen Special Economic Zone Personal Bankruptcy Ordinance" Retrospective*], JIANGSU HUIJIN BANKR. LIQUIDATION FIRM LTD. (Mar. 3, 2016), http://www.js-hj.com/content/?190.html [https://perma.cc/MAC3-AMC7] [hereinafter JIANGSU HUIJIN] (China) (providing a timeline of the development of the Shenzhen bankruptcy proposal).

136. JIANGSU HUIJIN, *supra* note 135.

137. Shenzhen Draft Bankruptcy Proposal, *supra* note 135, arts. 95, 103.

138. *Id.* arts. 111, 113–16, 120.

139. *Id.* arts. 158–59. This unique discharge provision seems to be based on the discharge provision of the Taiwan Consumer Insolvency Act of 2008. Xiaofeizhe Zhaiwu Qingli Tiaoli (消費者債務清理條例) [Consumer Debt Clean-Up Regulation] (amended Dec. 26, 2010), art. 133 (Taiwan, officially Republic of China), https://law.moj.gov.tw/LawClass/LawParaDeatil.aspx?Pcode=B0010042&LCNOS=++80+++&LCC=2 [https://perma.cc/X5FR-ZEW9].

provision could spell trouble for any potential discharge procedure, and it suggests a deep fear of abuse by opportunistic debtors. Indeed, since 2013, the current nationwide approach to defaulting debtors in China has been a Supreme Court blacklist banning some debtors from using such "luxuries" as airplane and high-speed-train travel and hotels.[140] Time will tell whether the Shenzhen draft or something like it becomes law and, if so, how it is applied by Chinese courts who seem to be both wholly unaccustomed to and quite skeptical of the concept of relief for defaulting debtors.

### *C. Saudi Arabia*

The Saudi Ministry of Commerce and Industry delivered a bombshell when in April 2015 it released a policy paper on an initiative to revamp the Kingdom's insolvency law.[141] That paper projected that a new procedure would encompass all private individuals, including ordinary consumers, and would offer an automatic discharge of unpaid liabilities following a liquidation and waiting period of twelve months.[142] Another comment expectedly but ominously noted that "Shari'a compliance would be an important element when choosing public policies and the underlying rules."[143] This is ominous because no school of Islamic Law (shari'ah) seemed to support or even accept the notion of discharging debts without the consent of creditors.[144] An imprint of the name of a Western law firm (Clifford Chance) on every page of the English portion of the policy paper offered reason for hope, however, so the announcement of a potential Islamic discharge was both confusing and exciting.

As it turned out, the Western law firm had apparently not sufficiently appreciated the implications of shari'ah compliance. The ultimate draft law released in September 2016 indeed adhered to Islamic Law and did not offer a nonconsensual discharge.[145] The explanatory note to the new draft makes

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140. *See* Yongxi Chen & Anne Sy Cheung, *The Transparent Self Under Big Data Profiling: Privacy and Chinese Legislation on the Social Credit System*, 12 J. COMP. L., no. 2, 2017, at 356, 362, 370 (describing travel restrictions on judgment defaulters and public disclosures of public credit information); Yuan Yang, *China Penalizes 6.7m Debtors with Travel Ban*, FIN. TIMES (Feb. 15, 2017) (reporting that a man surnamed Liu "almost lost his bride after the man's father . . . was named on the local television as being blacklisted"), https://www.ft.com/content/ceb2a7f0-f350-11e6-8758-6876151821a6 [https://perma.cc/FUF3-AQSU].

141. MINISTRY OF COMMERCE & INDUS., THE KINGDOM OF SAUDI ARABIA INSOLVENCY LAW PROJECT, POLICY PAPER (2016) (Saudi Arabia), http://mci.gov.sa/LawsRegulations/Projects/Pages/ippd.aspx#1 [https://perma.cc/BV7Y-PQGH].

142. *Id.* §§ 4.1–4.5.

143. *Id.* § 1.2(b)(iii).

144. Abed Awad & Robert E. Michael, *Iflas and Chapter 11: Classical Islamic Law and Modern Bankruptcy*, 44 INT'L LAWYER 975, 981, 997, 999 (2010); Jason J. Kilborn, *Foundations of Forgiveness in Islamic Bankruptcy Law: Sources, Methodology, Diversity*, 85 AM. BANKR. L.J. 323, 347 (2011).

145. MINISTRY OF COMMERCE & INDUS., Mashru' Nizam al-Iflaas [Draft of the System of

no mention of the Western concept. The provisions on liquidation do apply to ordinary individuals, but the "rehabilitation" article is quite clear that following a liquidation of nonexempt assets, the debtor "is not discharged from his liability for remaining debt except for under a special or general discharge from creditors."[146] In other words, perfectly consistent with Islamic Law, the new Saudi bankruptcy law offers individual debtors a discharge only with the consent of creditors, which one suspects is unlikely to be forthcoming. The current draft is reportedly on its way to becoming law in early 2018,[147] leaving Saudi Arabia without consumer discharge. While adherence to Islamic Law may not be fairly equated with fear of abuse, there is a congruent reticence here to allow debtors to evade their obligations over creditor opposition—a reticence that appears likely to persist indefinitely in the Kingdom.[148]

## Conclusion

Virtually none of the developments described here would have a counterpart in U.S. experience. Even the advent of the infamous means test for constraining access to quick chapter 7 relief is of a very different nature than the aggressive constraints on consumer discharge access witnessed in Europe over the past twenty years. Following these comparative developments (in English) has allowed policymakers and academics worldwide to explore more deeply and in greater detail the fear of abuse that Jay observed in the United States and Europe in the late 1990s, along with its gradual but definite abatement in recent years. Comparative analysis has greatly enriched the conversation about the proper balance of relief, restriction, and responsibility with the "rich harvest of new evidence" that Jay predicted. I am thrilled to have been part of that harvest and to say, once again, thanks, Jay!

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Bankruptcy] (2016) (Saudi Arabia), http://mci.gov.sa/MediaCenter/elan/Documents/01.pdf [https://perma.cc/9E8P-KWSR].

146. *Id.* art. 160.

147. *Saudi Arabia Advisory Council Approves Draft Bankruptcy Law*, REUTERS (Dec. 13, 2017), http://www.reuters.com/article/saudi-bankruptcy/update-1-saudi-arabia-advisory-council-approves-draft-bankruptcy-law-idUSL8N1OD2IP [https://perma.cc/YF5A-8PYH].

148. The same is true elsewhere in the region, as the new United Arab Emirates bankruptcy law does not apply to nonmerchants at all, leaving overindebted consumers, particularly those who write NSF checks, still subject to arrest and imprisonment. *See* Qanun al'iiflas al-qanun al-aitihadaa raqm (9) lisanat 2016 [Bankruptcy Law] (Official Gazette 29 Sept. 2016, effective 29 Dec. 2016) (U.A.E.), https://www.mof.gov.ae/En/Lawsandpolitics/govlaws/pages/federalbankruptcy.aspx [https://perma.cc/M4KQ-A5DQ]; Issac John, *Why UAE's New Bankruptcy Law Is a Boon for Business*, KHALEEJ TIMES (Mar. 1, 2017), https://www.khaleejtimes.com/business/economy/uae-bankruptcy-law-boom-bust-bonanza [https://perma.cc/N64T-T98S].

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# Local Legal Culture from R2D2 to Big Data

Robert M. Lawless* & Angela Littwin**

## I. Introduction

If you ask Teresa Sullivan, Elizabeth Warren, or Jay Westbrook about the early years of their groundbreaking Consumer Bankruptcy Project (CBP), they eventually will tell you about R2D2, their mobile photocopier. They carted R2D2 across the country to copy the bankruptcy court records that formed the backbone of their examination of the lives of consumer bankruptcy filers. Courthouses charged twenty-five cents per page for photocopies, so it was cheaper to bring R2D2, although they had to purchase a separate airplane ticket for "him." Journeying to courthouses across the country resulted in several anecdotes, such as the time R2D2 "made a break for it" on Grand Avenue in Chicago by sliding out of the back of the station wagon rented for the purpose of transporting the machine or when they had to lug R2D2 up three flights of stairs in Danville, Illinois.[1] In 1981, gathering data on consumer bankruptcy filers in three states took a tremendous amount of time and effort.

Once they had the data, analyzing it posed another hurdle. At the time of the first study, Westbrook had just obtained his first Apple II Plus, which was an order of magnitude slower than even today's cell phones. To analyze their data, they used the campus mainframe. They could access it by telephone but had to hire a graduate student who knew how to operate it.

Fast-forwarding to today, we obtained a database with over 12.5 million records on every U.S. bankruptcy case that was pending sometime during the government fiscal years 2012–2016. We added Census Bureau data to estimate demographic and other characteristics by matching debtor zip codes to those in the Census database. We analyzed these data and obtained our results within weeks of formulating our analysis plan. We did this all without having to raise money or leave our offices.[2] Our world of ready data

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1. Telephone Interview with Professor Jay Lawrence Westbrook, Benno C. Schmidt Chair of Business Law, Univ. of Tex. Sch. of Law (Jan. 20, 2018).

2. That said, we both believe in the value of researchers leaving their offices to interact with the systems they are studying and to generate their own data. Lawless is a coprincipal investigator on the current CBP, which gathers court-record data and surveys consumer bankruptcy filers on an ongoing basis. *See, e.g.*, Pamela Foohey, Robert M. Lawless, Katherine Porter & Deborah Thorne,

availability and computers to analyze them compares to photocopier R2D2 about the same as the world of science-fiction R2D2 compares to the U.S. Space Shuttle program (a contemporary of photocopier R2D2).

We do not use the term "groundbreaking" lightly when describing the early CBP. Sullivan, Warren, and Westbrook changed the nature of the consumer bankruptcy field. They shattered myths such as the idea that debtors were marginalized workers rather than part of the middle class.[3] They developed the dominant framework of why consumers file for bankruptcy, as reported by the debtors themselves: job loss, medical problems, and divorce.[4] They were the first research team to discover that fewer than half of chapter 13 cases receive a discharge.[5] Most importantly, Sullivan, Warren, and Westbrook created the norm of empirical research in the field, making it unacceptable to write about consumer bankruptcy without engaging in real-world analysis.

One key contribution of Sullivan, Warren, and Westbrook was putting "local legal culture" on the scholarly map. Along with Professor Jean Braucher, who was writing contemporaneously,[6] the CBP researchers realized that debtors experienced a theoretically federal and theoretically uniform consumer bankruptcy law very differently based on where they lived.[7]

In some areas of the country, such as Alaska, Connecticut, and Indiana,[8] the overwhelming majority of debtors were filing under chapter 7 of the

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*"No Money Down" Bankruptcy*, 90 S. CAL. L. REV. 1055, 1071 (2017) (analyzing data from the 2007 and 2013–2015 CBP). Littwin has collected qualitative and quantitative data for analysis in recent years. *See, e.g.*, Angela Littwin, *Adapting to BAPCPA*, 90 AM. BANKR. L.J. 183, 189 (2016) (reporting data from fifty-three interviews with consumer bankruptcy attorneys); Angela Littwin with Adrienne Adams & McKenzie Javorka, *The Frequency, Nature, and Effects of Coerced Debt Among a National Sample of Women Seeking Help for Intimate Partner Violence*, VIOLENCE AGAINST WOMEN (forthcoming 2020). We are both nonetheless glad that we did not have to carry a copy machine up three flights of stairs.

3. TERESA A. SULLIVAN, ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT 238–52 (2000).

4. *Id.* at 73–74.

5. TERESA A. SULLIVAN, ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA 17, 217 (1989) (reporting that only one-third of chapter 13 debtors in their database completed their bankruptcy plans).

6. Jean Braucher, *Lawyers and Consumer Bankruptcy: One Code, Many Cultures*, 67 AM. BANKR. L.J. 501, 503 (1993).

7. Teresa A. Sullivan, Elizabeth Warren & Jay Lawrence Westbrook, *The Persistence of Local Legal Culture: Twenty Years of Evidence from the Federal Bankruptcy Courts*, 17 HARV. J.L. & PUB. POL'Y 801, 810–11 (1994). The Bankruptcy Code also incorporates some elements of state law, most notably state exemption law. 11 U.S.C. § 522(b) (2012). But the researchers found a wide variety of practices within states, which suggested that state law could not be driving regional differences. Sullivan et al., *supra* note 7, at 828–29; Braucher, *supra* note 6, at 515–16.

8. Sullivan et al., *supra* note 7, at 825 tbl.3.

Bankruptcy Code[9]—the quicker and cheaper consumer chapter that provides the majority of bankruptcy debtors the relief they need. Under chapter 7, debtors liquidate all of their nonexempt property and receive a discharge of most unsecured debts.[10] The liquidation requirement has little bite because very few chapter 7 filers have unencumbered, nonexempt assets that a bankruptcy trustee can sell to pay creditors.[11] Most chapter 7 debtors receive their discharge within a few months.[12]

In other areas of the country, such as Alabama and the Western District of Tennessee, most debtors were filing under chapter 13,[13] which requires debtors to pay all of their disposable income over a period of three to five years.[14] Chapter 13 does provide tools for some consumers trying to save their homes[15] and a broader discharge than chapter 7 (although Congress has narrowed this discharge since the time of the original CBP research).[16] Still, the differences in chapter 7 and chapter 13 were highly improbable sources for the huge variation in chapter choice bankruptcy scholars observed around the country.

Although the Bankruptcy Code leaves the decision of which chapter to use mostly in the debtor's hands,[17] the scholars argued that the results of this

9. 11 U.S.C. §§ 701–27 (2012).

10. *Id.* §§ 523, 727.

11. Dalié Jiménez, *The Distribution of Assets in Consumer Chapter 7 Bankruptcy Cases*, 83 AM. BANKR. L.J. 795, 797 (2009); LOIS R. LOPICA, AM. BANKR. INST. NAT'L CONFERENCE OF BANKR. JUDGES, THE CONSUMER BANKRUPTCY CREDITOR DISTRIBUTION STUDY 6, 44–45 (2013).

12. Dov Cohen & Robert M. Lawless, *Less Forgiven: Race and Chapter 13 Bankruptcy*, *in* BROKE: HOW DEBT BANKRUPTS THE MIDDLE CLASS 175, 175 (Katherine Porter ed., 2012); Katherine Porter, *The Pretend Solution: An Empirical Study of Bankruptcy Outcomes*, 90 TEXAS L. REV. 103, 116 (2011).

13. Sullivan et al., *supra* note 7, at 825–26 tbl.3. Consumers may also file under chapter 11, but only a tiny percentage of consumer debtors use this option. *See* ADMIN. OFFICE OF THE U.S. COURTS, CASELOAD STATISTICS DATA TABLES, http://www.uscourts.gov/statistics-reports/caseload-statistics-data-tables [https://perma.cc/4AN2-2LMN] (showing statistically that a minimal number of nonbusiness filings fall under chapter 11 while the majority fall under chapter 7 and chapter 13).

14. 11 U.S.C. § 1325(b)(4) (2012).

15. *Id.* § 1322(b)(5), (c).

16. *Id.* § 1328(a)(2) (incorporating some but not all of the nondischargeability provisions in § 523(a)).

17. In 2005, Congress added the means test to prevent high-income debtors from filing under chapter 7. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 102(h), 119 Stat. 23, 33–34 (2005). The change appears to have had little effect on the ratio of chapter 7 to chapter 13 filings. Chrystin Ondersma, *Are Debtors Rational Actors? An Experiment*, 13 LEWIS & CLARK L. REV. 279, 295–303 (2009).

choice and other choices[18] were, in fact, driven by local legal culture. As Professor Westbrook explained:

> The evidence strongly suggests that the "choices" given to debtors are often exercised in fact by creditors, lawyers, by judges through lawyers, and by judges through debtors. The average consumer debtor, faced with an extraordinarily complex statute at a moment of financial and personal crisis, will be guided by lawyers and pressures exerted through lawyers.[19]

Sullivan, Warren, and Westbrook identified local legal culture as "systematic and persistent variations in local legal practices" that arose because of "perceptions and expectations shared by many practitioners and officials in a particular locality."[20] Persistence over time was a key feature of their conceptualization, and their foundational article on the topic examined local culture features that persisted across 1970, 1980, and 1990.[21] Braucher similarly defined local legal culture as the "context created by" a locality's "administrative practices of judges and trustees, and prevailing professional attitudes,"[22] although she did not emphasize persistence. The CBP researchers and Braucher each used qualitative data to develop portraits of the complex interactions among judges, trustees, and debtor attorneys that shaped local legal culture.[23]

Authors working with the databases from the CBP since that time have produced findings on local legal culture, but the focus has shifted to race. Specifically, beginning with the 1991 CBP, researchers documented a disturbing trend. Black debtors, and sometimes Latino debtors, were overrepresented in chapter 13, the chapter that takes more time,[24] costs more money,[25] and has a significantly lower discharge rate.[26] These patterns

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18. Bankruptcy chapter is not the only debtor choice guided by local legal culture. Sullivan, Warren, and Westbrook also studied filing rates and proposed payments to creditors in chapter 13 plans. Sullivan et al., *supra* note 7, at 811. Braucher additionally studied repayment rates in chapter 13 cases. Braucher, *supra* note 6, at 530–34. We focus on chapter choice in this Article for two reasons. First, once a debtor decides to file for bankruptcy, the choice of chapter influences—and frequently determines the outcome of—the other choices in the case. Second, most of the recent research on local legal culture has focused on chapter choice because of the disturbing racial trends associated with that decision. *See infra* subpart II(B).

19. Jay Lawrence Westbrook, *Local Legal Culture and the Fear of Abuse*, 6 AM. BANKR. INST. L. REV. 25, 30 (1998).

20. Sullivan et al., *supra* note 7, at 804.

21. *See generally* Sullivan et al., *supra* note 7.

22. Braucher, *supra* note 6, at 503.

23. *See infra* subpart II(A).

24. *See supra* Part I.

25. Lois R. Lupica, *The Consumer Bankruptcy Fee Study: Final Report*, 20 AM. BANKR. INST. L. REV. 17, 58 fig.4, 69 fig.7 (2012).

26. SULLIVAN ET AL., *supra* note 5, at 222; Sara S. Greene, Parina Patel & Katherine Porter, *Cracking the Code: An Empirical Analysis of Consumer Bankruptcy Outcomes*, 101 MINN. L. REV.

remained even when controlling for income, homeownership, and a variety of other factors associated with chapter 13.[27] Research from the 2007 CBP additionally controlled for judicial district and found that the correlations between chapter 13 and black debtors remained significant.[28] An article based on the 2007 and 2013–2015 CBPs found that judicial districts with high chapter 13 rates significantly correlated with the overrepresentation of black debtors in chapter 13—and that the effect of judicial district became more pronounced once researchers controlled for debtor financial variables associated with chapter 13.[29]

The current study adds to this recent work with new methods. Using a public database collected by the Administrative Office of the U.S. Courts, we analyzed chapter choice in consumer bankruptcies filed from fiscal years 2012–2016.[30] We developed three sets of factors expected to influence chapter choice in a consumer bankruptcy case: (1) case characteristics, particularly features of the debtor's economic situation that make chapter 7 or 13 more appropriate; (2) a debtor's geographic community based on demographics of her zip code; and (3) judicial district. We analyzed both geographic community and legal district to shed light on an ambiguity in the scholarship of local legal culture—what does "local" mean? Is it the debtor's neighborhood or the debtor's legal neighborhood that counts?

Our results support and extend the prior research. Race, once again, matters. More specifically, race, case characteristics, and judicial district are the only variables that matter. We find that case characteristics are significantly associated with each bankruptcy chapter in the expected ways. For example, real property correlates with chapter 13, almost certainly because of the tools chapter 13 provides for saving debtors' homes.[31] Unsecured debt correlates with chapter 7, which provides a more effective mechanism for discharging it.[32] At the community level, the most interesting point is what we do not find. Although most of the community variables we tested are statistically significant when the regression includes only case and community variables, once we add judicial district to the regression, the only variable that retains its statistical significance is race, specifically the percentage of the debtor's zip code that is black. The disappearance of significance for most of the community variables once we add district fixed effects suggests that the "work" of local legal culture is being done at the legal level rather than at the community level. Finally, most judicial districts in the United States are statistically significant at a very high level. The

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1031, 1042 (2017).

27. *See infra* Part II.

28. Cohen & Lawless, *supra* note 12, at 185.

29. Foohey et al., *supra* note 2, at 1088.

30. *See infra* subpart III(A).

31. *See* 11 U.S.C. § 1322(b)(5) (2012) (providing an option to cure a mortgage in default).

32. Foohey et al., *supra* note 2, at 1093 tbl.5.

pattern we find among judicial district chapter 13 rates both confirms and complicates the conventional wisdom of chapter 13 as a southern phenomenon.

This Article makes several contributions. First, we use observational data on the universe of bankruptcy filers. All of the recent CBPs are surveys of a national random sample, which means that participation in them is voluntary. Thus, researchers using the CBP data could never rule out nonresponse bias, the possibility that study participants somehow differed from debtors who chose not to participate.[33] Second, although the prior research, especially that of the early CBP and Braucher, leaves little doubt that local legal culture exists, the phrase contains ambiguities. This study considers competing definitions of "local" and thus provides quantitative evidence suggesting that legal boundaries may be more relevant than geographic ones. Third, our finding that race is the only community-level variable that retains significance when we add judicial districts to the regression provokes more questions than it addresses. This unsettling result, combined with the importance of judicial districts, suggests directions for future research. Legal professionals and their attitudes need further examination. A return to the qualitative methods of Braucher and the early CBP may be a particularly fruitful line of inquiry.

The rest of this Article proceeds as follows. Part II is a literature review. Part III provides our methodology, results, and interpretation of findings. Part IV concludes with more directions for future research.

## II. Literature Review

### *A. What Is Local Legal Culture? Definitions and Origins in the Literature*

The first study to probe local legal culture, although it did not use the term, was Stanley and Girth's seminal Brookings Institution study. They found wide variation in chapter XIII rates—the predecessor to chapter 13—among the seven districts they studied.[34] Chapter XIII cases ranged from 76% of all filings in the Northern District of Alabama to 52% in Maine to 11% or fewer in four districts.[35] Their "unit of locality" was district, but they did not study any districts within the same state,[36] limiting their ability to identify judicial district or state as the level of locality for the effect.

Sullivan, Warren, and Westbrook began to fill this gap by examining

33. Jean Braucher, Dov Cohen & Robert M. Lawless, *Race, Attorney Influence, and Bankruptcy Chapter Choice*, 9 J. EMPIRICAL LEGAL STUD. 393, 423–24 (2012).

34. DAVID T. STANLEY & MARJORIE GIRTH, BANKRUPTCY: PROBLEM, PROCESS, REFORM 74–75 (Brookings Inst. ed., 1971).

35. *Id.* at 74.

36. *See id.* at 41–42 (studying districts of Northern Ohio, Northern Alabama, Maine, Northern Illinois, Oregon, Western Texas, Southern California, and Southern New York).

the variation between judicial districts within the same state, using survey and court-record data from ten judicial districts studied in the CBP. They argued that because bankruptcy is federal law and incorporates some state law, variations between districts within a state that persist over time must be due to local culture.[37] Their examination of chapter choice found tremendous variation between states as well as judicial districts within states. For example, 20% of the filings in the Southern District of Alabama were chapter 13 cases compared to 66% in the Middle District of Alabama.[38] Moreover, the authors found statistically significant persistence in the district rates over time.[39]

Sullivan, Warren, and Westbrook argued that the complex and numerous decisions that went into a bankruptcy case made the consumer bankruptcy system particularly susceptible to the development of local legal cultures.[40] They also argued that influential individuals in a legal community changed over time and thus were an unlikely source for their findings about patterns that had held up over twenty years.[41]

Braucher studied four bankruptcy divisions[42] from two pairs of cities that shared a federal judicial district.[43] The two pairs of cities were in two parts of the country—Ohio and Texas—that had distinct chapter 13 rates.[44] Braucher demonstrated the existence of local legal culture through in-depth qualitative interviews with legal professionals.[45] She showed how judges and especially trustees shaped local legal culture by imposing requirements not in the Bankruptcy Code and incentivizing attorneys to use chapter 7 or chapter 13.[46] She also analyzed the complex interactions among the incentives of attorneys and their clients that led to the use of one bankruptcy chapter or another.[47]

Taken together, the Sullivan, Warren, and Westbrook and Braucher studies left little doubt that many local legal cultures existed in the

37. Sullivan et al., *supra* note 7, at 812.

38. *Id.* at 828.

39. *Id.* at 829–30 (basing this finding on data from the Administrative Office of the U.S. Courts covering 1970, 1980, and 1990).

40. *Id.* at 836–39.

41. *Id.* at 839.

42. A division is a subunit within a judicial district. *See, e.g.*, 28 U.S.C. § 124 (2000) (dividing the Northern District of Texas into seven divisions).

43. Braucher, *supra* note 6, at 515.

44. *Id.*

45. *Id.* at 512–13.

46. *See, e.g.*, *id.* at 546–47 (finding that, while consumer attorneys earned higher fees for chapter 13 cases than chapter 7s in all four divisions, the divisions with higher chapter 13 rates featured larger differences in the amount by which the attorney fees for a chapter 13 exceeded those for a chapter 7 case).

47. *Id.* at 562–63.

bankruptcy system. Using different research methods, two sets of scholars had come to the same fundamental conclusions about the existence and nature of the local legal cultures. The idea was on the scholarly map, and many scholars both replicated and expanded their findings.

Using data from the Administrative Office of the U.S. Courts (AO), Whitford showed wide variation in chapter 13 rates among judicial districts in 1990, 1992, and 1993.[48] Whitford later updated these findings using 1993, 2002, 2009, and 2010 data, suggesting that the percentage of chapter 13 cases in each district had remained relatively consistent across these four years.[49] Bermant, Flynn, and Bakewell drilled down to divisions as the unit of locality. They used 2001 AO data to demonstrate that state chapter 13 rates masked variations among districts and that district chapter 13 rates masked variation among divisions.[50] Norberg and Schreiber Compo found widespread disparities in chapter 13 rates among seven judicial districts in the South and mid-Atlantic regions and that the high-chapter 13 districts tended to have fewer chapter 13 debtors with mortgages than the other districts, suggesting that debtors without mortgages were filing under chapter 13 in the former districts due to local legal culture.[51] Ondersma replicated Sullivan, Warren, and Westbrook's analysis of the persistence of local legal culture with an expanded dataset that included data on exemption laws, poverty and unemployment rates, and foreclosure rates, none of which could explain the variation of chapter 13 choice across localities.[52]

### *B. Race and Ethnicity*

The concept of "local legal culture" was at the same time both pathbreaking and incomplete. As one of this Article's authors put it:

> "Local" is a problem because it is generally taken to mean areas defined by political boundaries . . . rather than boundaries that are psychologically meaningful to people. "Legal" is a problem because the cultural values we discuss may be a product of broad community sentiment, rather than ones unique to the local legal community. "Culture" is a problem because . . . we have no measures of the attitudes, values, and beliefs of professionals in the legal system. On

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48. William C. Whitford, *The Ideal of Individualized Justice: Consumer Bankruptcy as Consumer Protection, and Consumer Protection in Consumer Bankruptcy*, 68 AM. BANKR. L.J. 397, 411–14 (1994).

49. William C. Whitford, *Small Ball*, 90 TEXAS L. REV. SEE ALSO 9 app. A (2011).

50. Gordon Bermant, Ed Flynn & Karen Bakewell, *Bankruptcy by the Numbers: Thoughts on the "Local Legal Culture"*, AM. BANKR. INST. J., Feb. 2002, at 24, 24.

51. Scott F. Norberg & Nadja Schreiber Compo, *Report on an Empirical Study of District Variations, and the Roles of Judges, Trustees and Debtors' Attorneys in Chapter 13 Bankruptcy Cases*, 81 AM. BANKR. L.J. 431, 436–37 (2007).

52. Ondersma, *supra* note 17, at 303–05.

> the other hand, the advantage of the present definition is that it fits with a common conception of the term that many people have—local legal culture is what the people in a local legal community "do"; it is their practices that define them.[53]

Thus, scholars needed to and did start to unpack the constituent parts of what made for a "culture" that was both "local" and "legal." The most widely known of these efforts have focused on racial and ethnic differences in who files chapter 13. In her original study, Braucher noted that Ohio standing trustees were concerned that black debtors were overrepresented in chapter 13, with one stating that black debtors were possibly "being taken advantage of."[54]

The earliest efforts appeared either as byproducts of research with other goals or based on nonrandom samples that limited statistical inference. In a paper about the rise of filings after the 1978 implementation of the Bankruptcy Code, White found that the percentage of African-American debtors in a county's population was associated with a statistically significant increase in the proportion of chapter 13 cases.[55] Interestingly, she found no statistically significant relationship between African-Americans and chapter 7 filings, but the proportion of Spanish-speaking debtors in a county was significantly negatively associated with chapter 7 filings.[56]

Using data from the 1991 CBP, Chapman found that although African-Americans appeared to be overrepresented in consumer bankruptcy, they were not overrepresented in chapter 7, which implied that they were overrepresented in chapter 13.[57] Specifically, his data analysis found that non-Hispanic whites were statistically significantly more likely to file under chapter 7 than other racial and ethnic groups.[58] Chapman found that this effect was uniform in all but one of the studied districts that yielded data appropriate for his analysis.[59] Van Loo used data from the 2001 CBP to find 61.8% of black debtors used chapter 13 compared to 29.4% of Hispanic and 20.5% of white debtors.[60] After controlling for the influence of income, education, and employment, he found that only 19.8% of blacks and 19.4% of Hispanics in chapter 13 obtained a discharge compared to 28.3% of non-

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53. Cohen & Lawless, *supra* note 12, at 180.

54. Braucher, *supra* note 6, at 559–60.

55. Michelle J. White, *Personal Bankruptcy Under the 1978 Bankruptcy Code: An Economic Analysis*, 63 IND. L.J. 1, 48 (1987).

56. *Id.* at 47.

57. Robert B. Chapman, *Missing Persons: Social Science and Accounting for Race, Gender, Class, and Marriage in Bankruptcy*, 76 AM. BANKR. L.J. 347, 387 n.226 (2002).

58. *Id.*

59. *Id.*

60. Rory Van Loo, *A Tale of Two Debtors: Bankruptcy Disparities by Race*, 72 ALB. L. REV. 231, 234 (2009).

Hispanic whites.[61] Van Loo attributed the lower discharge rates to more aggressive uses of motions to dismiss in the chapter 13s of black debtors as compared to debtors of other races.[62] Although doing more extensive data analysis than the previous articles, the Chapman and Van Loo studies relied on earlier iterations of the CBP that were not national random samples, limiting the statistical inferences that could be drawn.

Using CBP data from 2007 that was collected from a national random sample, Braucher, Cohen, and Lawless found that blacks were disproportionately likely to file under chapter 13.[63] This effect held even when controlling for twenty variables that theoretically should determine a filing under chapter 13 including: home ownership, pending foreclosure, legal representation, monthly income, asset levels, total debt, priority debt, the percentage of debt that was secured or credit card debt, and demographic variables such as marital status and education. The study also developed a control variable that effectively isolated the effects of geography from those of race, and yet race was still a statistically significant determinant in chapter choice.[64] Even after controlling for the variables that should determine chapter choice, blacks were roughly twice as likely to file chapter 13 as debtors of other races. The authors also found that blacks did not receive more favorable treatment in chapter 13 and were indeed slightly more likely to have their cases dismissed. In articles for a symposium discussing this paper, Doherty[65] and Eisenberg[66] reanalyzed the authors' data and confirmed their findings.

The same Braucher, Cohen, and Lawless paper also included an experimental vignette that asked consumer bankruptcy attorneys to select a bankruptcy chapter for a hypothetical couple with a mix of financial characteristics that could suggest chapter 7 or 13.[67] The only variations were the race of the couple (white, black, no race identified) and the couple's expressed chapter preference (chapter 7, chapter 13, no preference).[68] Attorneys who thought they were counseling a black couple were about twice

61. *Id.*

62. *Id.* at 237. He was not able to analyze Hispanic debtors because the sample of those receiving a discharge was too small. He limited this analysis to discharged debtors because almost all of the debtors with dismissed cases were subject to motions to dismiss. *Id.* at n.28.

63. Braucher et al., *supra* note 33, at 400–04.

64. *Id.* at 403; *see also* Cohen & Lawless, *supra* note 12, at 186–87 (reporting an earlier version of the study).

65. Joseph W. Doherty, *One Client, Different Races: Estimating Racial Disparity in Chapter Choice Using Matched Pairs of Debtors*, 20 AM. BANKR. INST. L. REV. 651, 678 (2012).

66. Theodore Eisenberg, *The CBP Race Study: A Pathbreaking Civil Justice Study and Its Sensitivity to Debtor Income, Prior Bankruptcy, and Foreclosure*, 20 AM. BANKR. INST. L. REV. 683, 700 (2012).

67. Braucher et al., *supra* note 33, at 405.

68. *Id.* at 406–07.

as likely to recommend chapter 13 as attorneys who thought they were counseling a white couple.[69] Attorneys were less likely to say that a black couple who wanted chapter 7 were persons of "good values" or were "competent" but had directly the opposite reaction to a white couple who wanted chapter 7.[70]

Greene, Patel, and Porter found that the debtor's race had a major impact on chapter 13 plan completion.[71] Using data from the 2007 CBP, they found black debtors were 17% less likely to receive a discharge than their non-black counterparts when controlling for all the other statistically significant variables in the study.[72] The authors concluded: "More than amount of debt, prior bankruptcies, trying to save a home from foreclosure, or having a job—all features that are imbedded in chapter 13 of the Bankruptcy Code—race matters."[73]

Using a sample from Cook County, Illinois, Morrison and Uettwiller found many of the same racial pathologies that other researchers have documented.[74] But they provided a new possible explanation for the high chapter 13 rates and poor chapter 13 outcomes among black debtors—parking tickets and related government fines, which are dischargeable in chapter 13 but not chapter 7.[75] Blacks were overrepresented among bankrupt debtors with more than $500 in fines, the group of filers that had the highest termination rates. Within this group, blacks and debtors of other races had similar chances of having their cases terminated.[76] Moreover, when the authors excluded the "fines" group from the population of bankruptcy filers, blacks remained disproportionately represented but at smaller rates.[77] Morrison and Uettwiller suggest that government fines may be driving the chapter 13 racial disparities in Cook County because African-Americans appear to be particularly vulnerable to receiving these fines, and debtors

69. *Id.* at 411–12.

70. *Id.* at 413–15.

71. Greene et al., *supra* note 26, at 1086. Race appeared to be the second most important factor. Slightly edging out race, the variable with the largest impact (a 19% difference) was amount of unsecured debt. *Id.* The greater the amount of non-priority unsecured debt, the more likely the debtor was to receive a discharge. *Id.* at 1051. The authors argue that debtors with high levels of unsecured debt have increased incentives to complete their plans. *Id.* at 1089.

72. *Id.* at 1060, 1086.

73. *Id.* at 1086.

74. Edward R. Morrison & Antoine Uettwiller, *Consumer Bankruptcy Pathologies*, 173 J. INSTITUTIONAL & THEORETICAL ECON. 174, 176 (2017).

75. *See* 11 U.S.C. § 523(a)(7) (2012) (prohibiting discharge of government fines); *id.* § 1328(a)(2) (incorporating several nondischargeability provisions from § 523(a) into the chapter 13 discharge but excluding § 523(a)(7)). In addition, bankruptcy's automatic stay prevents creditor collection activity while a debtor is in bankruptcy and lasts for the duration of a chapter 13 case. *Id.* §§ 362(a), 1301.

76. Morrison & Uettwiller, *supra* note 74, at 187 fig.1.

77. *Id.* at 185 tbl.4, 186.

within the "fines" group have low incomes that make it challenging to complete chapter 13 plans.[78]

Foohey, Lawless, Porter, and Thorne have found blacks disproportionately represented among so-called "no money down" chapter 13s, where the entire attorney's fee is funded through the chapter 13 plan. Indeed, the largest determinants of a no-money-down chapter 13 are the judicial district where the case is filed and the race of the debtor. Using data from the 2007 and 2013–2015 CBPs, they found that the financial characteristics of debtors filing no-money-down chapter 13 cases resembled those of chapter 7 debtors more than those of debtors filing "traditional chapter 13s."[79] They tied these findings to local legal culture by demonstrating that, when controlling for other relevant factors, the higher the chapter 13 rate in a district, the higher the use of no-money-down plans and the higher the racial difference in chapter use.[80] In fact, much of the racial disparity in chapter use in high-chapter 13 districts may be accounted for by no-money-down cases.

In an article for *ProPublica*, Kiel and Fresques used AO data supplemented by demographic data via zip codes to find that nationally the odds of filing under chapter 13 were twice as high for debtors living in a mostly black area.[81] Compared to black debtors who filed under chapter 7, the black chapter 13 debtors had less income, fewer assets, lower secured debts, and dramatically lower unsecured debts.[82] The authors did an in-depth study on two districts with especially troubling disparities—the Northern District of Illinois and the Western District of Tennessee.[83] In both districts, Kiel and Fresques found that a handful of law firms accounted for a significant number of all chapter 13 filings, and, at least in Tennessee, the practice "nearly always" was to file with no money down. Like Morrison and Uettwiller, Kiel and Fresques found many black debtors were filing under chapter 13 to avoid suspension of their driver's licenses.[84]

Most recently, Cohen, Lawless, and Shin replicated the 2007 CBP findings about racial disparities in chapter use with 2013–2015 data from the current CBP.[85] Further, the authors surveyed a national random sample of

78. *Id.* at 194.

79. Foohey et al., *supra* note 2, at 1077–80.

80. *Id.* at 1089 fig.4. It is important to note that, even in low-chapter 13 districts, African-Americans are approximately 10% less likely to file chapter 7 as debtors of other races in the presence of controls. *Id.*

81. Paul Kiel & Hannah Fresques, *Data Analysis: Bankruptcy and Race in America*, PROPUBLICA (Sept. 27, 2017), https://projects.propublica.org/graphics/bankruptcy-data-analysis [https://perma.cc/KK6C-K75X].

82. *Id.*

83. *Id.*

84. *Id.*

85. Dov Cohen, Robert M. Lawless & Faith Shin, *Opposite of Correct: Inverted Insider*

consumer bankruptcy attorneys and found that their beliefs about the percentage of African-Americans and whites who filed under chapter 13 was exactly reversed from the real-world percentages.[86] On average, attorneys believed that whites were more than twice as likely to file under chapter 13 as African-Americans when in fact the opposite is true.[87]

## III. Data and Analysis

### *A. Methodology*

Our theory conceptualizes the chapter choice decision as being the result of three different dynamics: (1) the individual debtor's circumstances; (2) the community from where the debtor comes; and (3) the legal norms and rules of the debtor's judicial district. The first idea captures traditional explanations for chapter choice, such as the idea that homeowners will be more likely to file chapter 13 because it offers greater protections to homeowners than chapter 7. Because these determinants are individual to the debtor, they would not represent a "local culture." The second idea is that certain communities may offer financially distressed debtors fewer options or constrain debtors' bankruptcy choices. Given the previous findings, the racial composition of a community may be a particularly important factor. The third idea is that the legal professionals—lawyers, trustees, and judges—implement formal rules or have informal norms that direct bankruptcy debtors to a particular chapter choice.

Our data came from the Integrated Database assembled by the AO and made available through the Federal Judicial Center.[88] Specifically, we used the "Bankruptcy Snapshot 5-year File" for the governmental fiscal years 2012–2016.[89] This file contains all bankruptcy cases filed, pending, or terminated at any point from October 1, 2011 to September 30, 2017; although, we only used cases filed on January 1, 2012, and after. The database contains (1) much of the information found in the bankruptcy petition—such as chapter choice, legal representation, method of paying filing fees, debtor's zip code, case status (pending/dismissed)—and (2) the information found in the summary of schedules on asset, debt, income, and expense levels.[90]

It is possible for a case to appear more than once in the database if it is

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*Perceptions of Race and Bankruptcy*, 91 AM. BANKR. L.J. 623, 630–32 (2017).

86. *Id.* at 638. The authors surveyed these attorneys before publishing the results of their original work on race and chapter 13 in *Less Forgiven: Race and Chapter 13 Bankruptcy*. Cohen & Lawless, *supra* note 12, at 175.

87. Cohen et al., *supra* note 85, at 638.

88. *Integrated Database*, FED. JUDICIAL CTR., https://www.fjc.gov/research/idb [https://perma.cc/ZSF6-PR4S].

89. *IDB Bankruptcy 2008–Present*, FED. JUDICIAL CTR., https://www.fjc.gov/research/idb/interactive/IDB-bankruptcy [https://perma.cc/88VF-VV4W].

90. *Id.*

pending for more than one year. The full database contains 12,502,973 records of 6,675,597 unique bankruptcy cases. Because we are interested in the filing decision for chapter 7 and chapter 13, we used the case record from the year of filing. We further eliminated (1) cases filed outside the fifty states and the District of Columbia; (2) records representing a reopened case; (3) cases where the debtor's bankruptcy petition identified the debts as predominately business in nature; (4) cases filed by nonindividuals; and (5) cases filed by persons who were not U.S. residents. Our final database had 4,343,794 unique bankruptcy cases filed from fiscal year 2012–2016.

We then downloaded zip-code level data using the U.S. Census Bureau's American FactFinder website.[91] The American Community Survey (ACS)[92] provided data on population by race, Hispanic/Latino origin, owner- vs. renter-occupied housing units, and income. We used ACS five-year estimates for the years 2012–2016, exactly overlapping with our bankruptcy data.

The U.S. Census Bureau's County Business Patterns[93] series provided zip-code level data on consumer-lending storefronts as a measure of constrained financial advice and lending within a community. We used the 2014 data from this series because that year is the midpoint of our bankruptcy database. Consistent with Bhutta,[94] we downloaded the count of establishments identified in two North American Industry Classification System (NAICS) codes:[95]

- 522390 Other Activities Related to Credit Intermediation: This code provides information on services such as "Check cashing services, Money order issuance services, Loan servicing, Travelers' check issuance services, Money transmission services, Payday lending services."
- 522291 Consumer Lending: This code provides information on "establishments primarily engaged in making unsecured cash loans to consumers. *Illustrative Examples:* Finance companies (i.e., unsecured cash loans), Personal credit institutions (i.e., unsecured cash loans), Loan companies (i.e., consumer, personal, student, small), Student loan companies."

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91. *American FactFinder*, U.S. CENSUS BUREAU, https://factfinder.census.gov [https://perma.cc/6VAN-WRLW].

92. *American Community Survey*, U.S. CENSUS BUREAU, https://www.census.gov/programs-surveys/acs/ [https://perma.cc/WEV6-9D4D].

93. *County Business Patterns*, U.S. CENSUS BUREAU, https://www.census.gov/programs-surveys/cbp.html [https://perma.cc/G5KQ-XEUD].

94. Neil Bhutta, *Payday Loans and Consumer Financial Health*, J. BANKING & FIN., Oct. 2014, at 230, 235.

95. OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, NORTH AMERICAN INDUSTRY CLASSIFICATION SYSTEM (2017), https://www.census.gov/eos/www/naics/ [https://perma.cc/99S2-W2NQ].

For a shorthand reference, we call the sum of these counts "fringe lending," although the term is overinclusive. We used the zip-code level population counts from the ACS to construct a measure of fringe lending storefronts per 1,000 residents in the zip code.

We merged the zip-code level data from the U.S. Census with the bankruptcy database using the zip code for the first debtor listed in the bankruptcy petition. This method has two complications. First, the ACS uses zip-code tabulation areas (ZCTAs), which in most instances are identical to the corresponding zip code, but ZCTAs can sometimes diverge from exact contiguity with a zip code depending on where census tract boundaries fall. Second, in 2.9% of the joint cases, the second debtor listed a zip code different from the first debtor. As a robustness check, we reran our regressions omitting these cases, and the results did not change.

### *B. Results*

To test our theories, we constructed a series of regressions on the determinants of the bankruptcy chapter choice between chapter 7 and chapter 13. Because the outcome is a binary variable, we ran a logistic regression, and for ease of interpretation we report odds ratios. The odds ratio can be interpreted as the effect of the variable on the probability of filing chapter 13. Table 1 reports the regression results with an expanded table of the odds ratios for the fixed effects of each judicial district appearing in the Appendix.

The first regression captures case characteristics. The second regression adds zip-code level data as our measure of the debtor's community. The final regression then adds fixed effects for each judicial district. Our measures are not perfectly mutually exclusive. For example, the racial composition of a neighborhood tells us something both about the probability of the debtor's race and perhaps the socioeconomic status of the neighborhood.

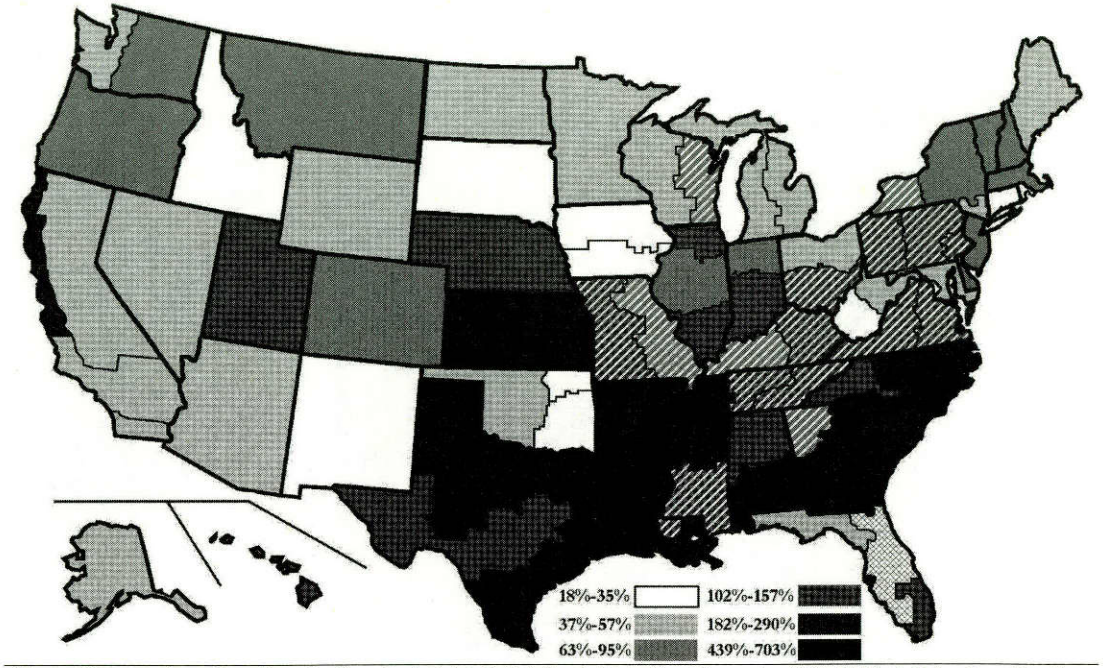
Finally, we created a map (Figure 1) grouping the judicial districts into six clusters based on the final regression. The map reports the odds ratio and thus can be interpreted as the probability of observing a chapter 13 filing in each district as compared to the median district, the Middle District of Florida, after controlling for the variables in the regression. The map provides a visual overview of the wide variation in chapter 13 use across the country and within many states as well as the regional clustering of many of the high-chapter 13 districts.

Table 1. Logistic Regression on Probability of Filing Chapter 13, Odds Ratios

| | (1) | (2) | (3) |
|---|---|---|---|
| ***Case Characteristics*** | | | |
| Real Property (ln) | 1.02* | 1.03* | 1.03* |
| Personal Property (ln) | 1.01 | 1.03 | 1.05* |
| Secured Debts (ln) | 1.10* | 1.09* | 1.08* |
| Priority Debts (ln) | 1.11* | 1.11* | 1.10* |
| Unsecured Debts (ln) | 0.58* | 0.59* | 0.60* |
| Income (ln) | 1.72* | 1.78* | 1.88* |
| Filing Fee (Reference Category: Installments Completed) | | | |
| Installments in Progress | 2.05* | 1.95* | 1.76* |
| Full at Filing | 0.47* | 0.53* | 0.55* |
| Fee Not Paid | 0.31 | 0.33 | 0.31 |
| Waived (IFP) | 0.002* | 0.002* | 0.002* |
| Prior Bankruptcy | 5.20* | 4.81* | 4.68* |
| Joint Filing | 0.87* | 0.95 | 0.95 |
| Pro Se Filer | 0.21* | 0.26* | 0.37* |
| Filing Year (Reference Category: 2012) | | | |
| 2013 | 1.03* | 1.02 | 1.01 |
| 2014 | 1.13* | 1.10* | 1.10* |
| 2015 | 1.22* | 1.18* | 1.18* |
| 2016 | 1.24* | 1.20* | 1.21* |
| ***Zip-Code Characteristics*** | | | |
| Black Percent in Zip Code | | 5.00* | 3.06* |
| Latino Percent in Zip Code | | 1.01 | 1.09 |
| Mean Income ($1,000s) | | 0.99* | 1.00 |
| Mean Income Squared ($1,000s) | | 1.00* | 1.00 |
| "Fringe Lending" (per 1,000) | | 2.29* | 1.05 |
| Renter-occupied Property Percent | | 0.40* | 0.96 |
| ***Judicial District Fixed Effects*** | | | Yes |

NOTES: The table reports odds ratios for the probability of filing a chapter 13 out of a database composed of all chapter 7 and chapter 13 cases filed from FY 2012 to 2016. Standard errors are clustered at the judicial district level in all three regressions. For the case characteristic and zip-code characteristic variables, an asterisk indicates statistical significance where $p < .05$. Full results for the district fixed effects are presented in the Appendix.

**Figure 1. Judicial District Fixed Effects from Regression, Probability of Filing Chapter 13 vs. Chapter 7 Relative to Median Judicial District**




NOTES: The map shows the odds ratios from the judicial district-fixed effects from Regression (3) in Table 1. Using the odds ratios, the map shows the judicial district's fixed effect on the probability of a bankruptcy debtor choosing chapter 13 as compared to the median judicial district, which is the Middle District of Florida where 29.9% of the cases are chapter 13s. As the probabilities come from the Regression (3), they represent the probabilities after controlling for the case characteristic variables and zip-code characteristic variables of the debtor. Judicial districts with striped fill did not differ from the Middle District of Florida at a statistically significant level ($p < .0006$, using a Bonferroni adjustment).

### C. *Discussion*

The most striking finding is that, at the zip-code level, the only variable that matters consistently is the zip code's racial composition. At the case level, the characteristics that one would expect to drive chapter 13 filings are in fact associated with chapter 13 cases. Chapter 13 is more likely with higher amounts of real property, secured debts, priority debts, unsecured debts, and income, as well as paying the filing fee in installments, prior bankruptcy, and retaining an attorney. Higher amounts of real property, secured debt, and priority debt are likely to make chapter 13 attractive to debtors because that chapter provides tools for managing real estate and those debts.[96] A higher income increases a debtor's ability to propose and complete a feasible chapter 13 plan.[97] Chapter 13 is associated with debtors paying legal fees in installments,[98] so the chapter's correlation with debtors paying filing fees in installments is not surprising. Prior bankruptcy is strongly associated with chapter 13, partly because debtors face longer waiting periods after an earlier discharge to file again under chapter 7 than under chapter 13.[99] In addition, chapter 13 debtors who drop out prior to discharge because they cannot afford the payments often try again later.[100] Finally, given the greater complexity of chapter 13 and the dismal track record of pro se filers in confirming chapter 13 plans,[101] it makes sense that being represented is positively associated with filing chapter 13.

But once we move to the zip-code level, the logical connection between chapter 13 and factors associated with it becomes more complex. We tested

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96. *See* 11 U.S.C. § 1322(a)(2) (2012) (stating that, unless the creditor consents, all priority debts must be paid in full, although without interest); *id.* § 1322(b)(5) (providing an option to cure mortgage in default).

97. Although the requirement that debtors pay all of their disposable income in chapter 13 would appear to lessen the relevance of income level to plan success, a debtor's income also must be high enough to pay the required thresholds of secured and priority debt. *Id.* § 1325(b); *see id.* § 506(a)(2) (valuing collateral on secured debts); *id.* § 1322(a)(2) (requiring full payment of priority debts, although without interest); *id.* § 1322(b)(2) (prohibiting modification of mortgages on primary residences); *id.* § 1325(a)(5) (prohibiting modification of many secured debts in personal property). In addition, some districts require a certain percentage payment to the general unsecured creditors beyond the disposable-income requirement. Morrison & Uettwiller, *supra* note 74, at 189.

98. Foohey et al., *supra* note 2, at 1074.

99. *Compare* 11 U.S.C. § 727(a)(8) (2012) (listing an eight-year waiting period if prior discharge was in a chapter 7 case), *and id.* § 727(a)(9) (prescribing a six-year waiting period if prior discharge was in a chapter 12 or chapter 13 case), *with id.* § 1328(f) (requiring a two-year waiting period if prior discharge was in a chapter 13 case and a four-year waiting period if discharge was obtained via any other bankruptcy chapter).

100. Sara Sternberg Greene, *The Failed Reform: Congressional Crackdown on Repeat Chapter 13 Bankruptcy Filers*, 89 AM. BANKR. L.J. 241, 252 (2015).

101. *See* Angela Littwin, *The Do-It-Yourself Mirage: Complexity in the Bankruptcy System*, *in* BROKE: HOW DEBT BANKRUPTS THE MIDDLE CLASS 157, 160 tbl.9 (Katherine Porter ed., 2012) (finding that represented debtors were approximately 45 times more likely to confirm chapter 13 plans than their pro se counterparts when controlling for demographic and bankruptcy variables).

zip-code income, Latino percentage of the zip code, black percentage of the zip code, fringe lending, and percentage of zip-code housing that is rental units. The fringe-lending variable examines the effects of living in lower-quality neighborhoods. Because we used racial percentages in zip codes as a proxy for race, we needed to consider the possibility that black neighborhoods were associated with chapter 13 rather than black debtors. African-Americans tend to live in poorer-quality neighborhoods due to decades of housing discrimination during and after the Jim Crow Era.[102] Zip-code percentage of housing that is rented was another proxy for neighborhood quality, but this variable's inclusion also reflects our thinking that homeowners are more likely to file under chapter 13. At the zip-code level, both of these variables were significant. Fringe lending was positively associated with chapter 13. When interpreting that result, it is important to note that most zip codes have zero or one fringe lender per thousand residents, with more than half of zip codes having no fringe lenders. So the odds ratio of 2.21 means that the difference between having zero and one fringe lender per thousand people in a zip code is a 221% increase in the likelihood of a debtor in that zip code filing under chapter 13. Percentage of property in a zip code that was renter-occupied is negatively correlated with chapter 13, supporting the classic association of chapter 13 with homeowners. Income was negatively correlated with chapter 13, which is surprising because it was positively correlated with chapter 13 at the case level. Reconciling the findings suggests that, all else equal, an increase in an individual debtor's income is an indicator of chapter 13, while a decrease in zip-code income is an indicator of chapter 13. The latter result supports Kiel and Fresques' counterintuitive finding that, in high-chapter 13 districts, lower incomes were associated with chapter 13.[103]

The only variable that was not significant at the zip-code level was Latino percentage. On one hand, this result is surprising. Like African-Americans, Latinos experience lending discrimination,[104] so we might expect them to be steered into chapter 13 the way that black debtors appear to be.[105] And the analyses of data from early CBPs identified Latino as well as black disparities in chapter use[106] and case outcomes.[107] In addition, Puerto Rico

102. MEHRSA BARADARAN, THE COLOR OF MONEY: BLACK BANKS AND THE RACIAL WEALTH GAP 141–42 (2017).

103. Kiel & Fresques, *supra* note 81.

104. Ethan Cohen-Cole, *Credit Card Redlining*, 93 REV. ECON. & STAT. 700, 700 (2011); Simon Firestone, *Race, Ethnicity, and Credit Card Marketing*, 46 J. MONEY, CREDIT & BANKING 1205, 1206 (2014).

105. Braucher et al., *supra* note 33, at 417–18.

106. Chapman, *supra* note 57, at 387 n.226.

107. Van Loo, *supra* note 60, at 234.

has a long-standing history as a high-chapter 13 district,[108] which may result from some of the same implicit racial associations found with respect to blacks in the attorney-vignette study.[109] On the other hand, neither of the two most recent CBP studies found a Latino effect,[110] and this study's lack of Latino findings supports those results.

More interesting than the significance of income, fringe lending, and rental housing at the zip-code level is the fact that none of these variables retain their significance once we control for judicial district by adding fixed effects in the third regression. Our database contained the universe of over 4.3 million bankruptcy filings in the study period. Although we are cautious to interpret from a null result, we believe our finding suggests that the geographic pattern of chapter use is being determined by legal boundaries rather than neighborhood boundaries.

The one variable that remains significant even when controlling for district fixed effects is the black percentage in a zip code. It is positively correlated with the chapter 13 rate, and the effect is strong. The difference between a debtor living in a zip code that is 0% black and 100% black is a 306% increase in likelihood of that debtor filing under chapter 13.[111] Of course, we cannot rule out the possibility that debtors of other races living in predominantly black zip codes also have high odds of filing under chapter 13. There could be unobserved characteristics of black neighborhoods that are associated with chapter 13. Our attempts to control for neighborhood quality provide some evidence that neighborhoods are not the issue but cannot fully address this concern.

Prior studies also give us more confidence that our racial finding is hardly spurious. The 1991, 2001, 2007, and current iterations of the CBP all found racial disparities in chapter use,[112] and this study provides important support for these findings. However, all of these CBPs were surveys and are thus subject to the critique of nonresponse bias.[113] A major contribution of this study is to provide support for the racial disparities found by the CBP using data that did not require voluntary participation by respondents.

While the most important characteristic of the results of adding the district fixed effects is the effect that the addition has on other variables, the distribution of chapter 13 filings among judicial districts also sheds light on

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108. Bermant et al., *supra* note 50, at 24; Whitford, *supra* note 48, at 406–07.

109. Braucher et al., *supra* note 33, at 415–16.

110. *Id.* at 400; Foohey et al., *supra* note 2, at 1081.

111. We also ran the same regressions with a binary variable for whether the zip code was majority black. We get a similar result: a 170% increase in the probability of filing under chapter 13 for persons living in majority-black districts.

112. Braucher et al., *supra* note 33, at 404; Chapman, *supra* note 57, at 389; Foohey et al., *supra* note 2, at 1086; Van Loo, *supra* note 60, at 234.

113. Braucher et al., *supra* note 33, at 423–24.

the relationship between chapter 13 and the South. The South has been viewed as the chapter 13 belt since at least 2002.[114] As Figure 1 shows, our results support this finding in interesting ways. First, the South appears to be committed to chapter 13. With the exception of Kansas, all of the states that have a majority of districts in the top two chapter 13 clusters were part of the Confederacy during the U.S. Civil War.[115] Conversely, Florida is the only former Confederate state that does not have a majority of districts with greater-than-median chapter 13 filing rates, although several Southern districts have chapter 13 rates that are not significantly different from that of the reference, median district, the Middle District of Florida. On the other hand, there are several high-chapter 13 districts in other parts of the country, such as the Northern District of California, the District of Kansas, and the District of Utah. However, most of the non-Southern states with high chapter 13 rates have districts that fall in the third-highest cluster, meaning that their chapter 13 percentages are 102% to 157% greater than the reference district. And none of these states have any districts in the highest cluster, with chapter 13 rates that are 439% to 703% greater than those in the Middle District of Florida.

This map also sheds interesting light on Sullivan, Warren, and Westbrook's original findings. The 1981 CBP covered three states: Illinois, Pennsylvania, and Texas.[116] Illinois and Pennsylvania have turned out to be two of the non-Southern states that contain above-median chapter 13 districts. This may have made it more difficult to notice the concentration of the chapter 13 belt in the South until relatively recently.

## IV. Conclusion

Our research builds on and extends prior studies. We confirmed CBP findings on race and chapter choice with a non-survey database. Specifically, we found that race and judicial district appear to be the key factors in chapter choice beyond the economic profile of a bankruptcy case. We began to address the question of whether the "local" in "local legal culture" is shaped by legal geography or general geography. Our findings suggest that legal boundaries are playing a more important role.

This study also points to directions for future research. We obtained one finding on the meaning of "local" in "local legal culture." Additional research would make the relationship between "local" and "legal" clearer. For

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114. *See* Bermant et al., *supra* note 50, at 24 (noting an "intensive chapter 13 practice runs in a broad band across the South and includes Puerto Rico").

115. Alabama, Arkansas, Florida, Georgia, Louisiana, Mississippi, North Carolina, South Carolina, Tennessee, Texas, and Virginia. *See, e.g.*, G. Edward White, *Recovering the Legal History of the Confederacy*, 68 WASH. & LEE L. REV. 467, 482, 495 (2011).

116. Sullivan et al., *supra* note 7, at 834 n.105.

example, it could examine places where zip codes span more than one judicial district to see if the changes in chapter 13 rate are occurring at the zip-code or district boundaries. Already, our finding on the meaning of "local" suggests the need to explore the roles of professionals more deeply. One possibility is to examine law-firm patterns in districts with varying chapter 13 rates. Kiel and Fresques's study of Tennessee suggests that law-firm concentration may be playing a role in the relationship between race and chapter 13.[117] Finally, this study points in the direction of returning to the methods of Sullivan, Warren, and Westbrook and Braucher's original scholarship on local legal culture by supplementing big data with in-depth qualitative research with judges, lawyers, trustees, and other bankruptcy actors.

117. Kiel & Fresques, *supra* note 81.

## Appendix

Table 2. Judicial District Level Fixed Effects from Logistic Regression (Reference District = Middle District of Florida, median district)

| *DC Circuit* | *Odds Ratio* |
|---|---|
| District of Columbia | 0.21* |
| *First Circuit* | |
| Maine | 0.48* |
| Massachusetts | 0.63* |
| New Hampshire | 0.69* |
| Rhode Island | 0.35* |
| *Second Circuit* | |
| Connecticut | 0.24* |
| New York, Eastern | 0.18* |
| New York, Northern | 0.63* |
| New York, Southern | 0.52* |
| New York, Western | 0.91 |
| Vermont | 0.68* |
| *Third Circuit* | |
| Delaware | 0.75* |
| New Jersey | 0.70* |
| Pennsylvania, Eastern | 1.13 |
| Pennsylvania, Middle | 1.10 |
| Pennsylvania, Western | 1.13 |
| *Fourth Circuit* | |
| Maryland | 0.37* |
| North Carolina, Eastern | 4.39* |
| North Carolina, Middle | 2.36* |
| North Carolina, Western | 1.41* |
| South Carolina | 2.38* |
| Virginia, Eastern | 1.17 |
| Virginia, Western | 1.04 |
| West Virginia, Northern | 0.42* |
| West Virginia, Southern | 0.32* |
| *Fifth Circuit* | |
| Louisiana, Eastern | 1.94* |
| Louisiana, Middle | 1.16 |
| Louisiana, Western | 7.01* |
| Mississippi, Northern | 2.07* |
| Mississippi, Southern | 1.23 |
| Texas, Eastern | 1.92* |
| Texas, Northern | 2.47* |
| Texas, Southern | 2.44* |
| Texas, Western | 1.57* |
| *Sixth Circuit* | |
| Kentucky, Eastern | 1.10 |
| Kentucky, Western | 0.95 |
| *Sixth Circuit (continued)* | *Odds Ratio* |
| Michigan, Eastern | 0.53* |
| Michigan, Western | 0.49* |
| Ohio, Northern | 0.45* |
| Ohio, Southern | 1.02 |
| Tennessee, Eastern | 1.40 |
| Tennessee, Middle | 1.22 |
| Tennessee, Western | 2.87* |
| *Seventh Circuit* | |
| Illinois, Central | 0.63* |
| Illinois, Northern | 1.35* |
| Illinois, Southern | 1.32* |
| Indiana, Northern | 0.83* |
| Indiana, Southern | 1.21* |
| Wisconsin, Eastern | 0.92 |
| Wisconsin, Western | 0.47* |
| *Eighth Circuit* | |
| Arkansas, Eastern | 2.01* |
| Arkansas, Western | 1.84* |
| Iowa, Northern | 0.21* |
| Iowa, Southern | 0.33* |
| Minnesota | 0.53* |
| Missouri, Eastern | 0.83 |
| Missouri, Western | 1.05 |
| Nebraska | 1.35* |
| North Dakota | 0.44* |
| South Dakota | 0.32* |
| *Ninth Circuit* | |
| Alaska | 0.53* |
| Arizona | 0.46* |
| California, Central | 0.44* |
| California, Eastern | 0.43* |
| California, Northern | 2.01* |
| California, Southern | 0.46* |
| Hawaii | 1.16* |
| Idaho | 0.23* |
| Montana | 0.67* |
| Nevada | 0.49* |
| Oregon | 0.70* |
| Washington, Eastern | 0.81* |
| Washington, Western | 0.50* |

| *Tenth Circuit* | | *Eleventh Circuit* | |
|---|---|---|---|
| Colorado | 0.71* | Alabama, Middle | 5.86* |
| Kansas | 1.82* | Alabama, Northern | 1.43* |
| New Mexico | 0.22* | Alabama, Southern | 4.85* |
| Oklahoma, Eastern | 0.25* | Florida, Northern | 0.44* |
| Oklahoma, Northern | 0.30* | Florida, Middle | *omitted* |
| Oklahoma, Western | 0.57* | Florida, Southern | 1.40* |
| Utah | 1.34* | Georgia, Middle | 2.90* |
| Wyoming | 0.42* | Georgia, Northern | 0.92 |
| | | Georgia, Southern | 4.53* |

NOTES: Odds ratios are reported for each judicial district's fixed effect on the probability of filing chapter 13 as compared to the median district, the Middle District of Florida. Standard errors are clustered at the judicial district level in the regressions. The table is an expansion of Regression (3) from Table 1. For the district-fixed effects, an asterisk indicates statistical significant where $p < .0006$, using a Bonferroni adjustment from the standard statistical significance threshold of $p < .05$ for the 90 districts.

# A Functional Analysis of SIFI Insolvency

Stephen J. Lubben*

In a 1989 article that remains one of the clearest, most sensible explications of an especially tricky point of bankruptcy law, Jay Westbrook announced a forthright methodology: "I call my approach 'functional,' because it proceeds by working through the problem from first principles."[1] The same basic technique can tell us a lot about how banks—and other bank-like creatures or SIFIs,[2] to use the industry lingo—should fail.

Since the disgrace of Lehman, the question of how to handle failing SIFIs has been quite vexed.[3] On the one hand, governmental rescue of shareholders and other investors is beyond annoying, and there is some intuitive sense that if management does a poor job, they and their investor backers should face the consequences just like any other firm.[4] That bank managers would have the temerity to pay themselves large bonuses shortly after a taxpayer rescue only emphasizes the point.[5]

On the other hand, there is a widespread understanding that a large bank, or a sufficiently interconnected one, is not quite like Kmart, Enron, or even American Airlines, in that when the bank fails, it tends to take a large chunk of the economy along with it.[6] Pre-failure regulation can mitigate some of the

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1. Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 230 (1989). In a recent article, Professor Westbrook abandoned the phrase "Functional Analysis" in favor of the alternative "Modern Contract Analysis," but I take that change to be limited to the specific context of § 365 of the Bankruptcy Code. Jay Lawrence Westbrook & Kelsi Stayart White, *The Demystification of Contracts in Bankruptcy*, 91 AM. BANKR. L.J. 481, 484 n.16 (2017).

2. Systemically Important Financial Institutions.

3. Kathryn Judge, *The First Year: The Role of a Modern Lender of Last Resort*, 116 COLUM. L. REV. 843, 849 (2016).

4. *See* Arthur E. Wilmarth, Jr., *Turning a Blind Eye: Why Washington Keeps Giving In to Wall Street*, 81 U. CIN. L. REV. 1283, 1379–81 (2013) (noting that major banks have entered relatively modest settlements with the SEC without admitting liability—a practice that one judge criticized as "half-baked justice at best" because it fails to impose sanctions on specific individuals).

5. Saule T. Omarova, *Wall Street as Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PA. L. REV. 411, 415 (2011).

6. Kathryn Judge, *Interbank Discipline*, 60 UCLA L. REV. 1262, 1272 (2013); *see also* Henry T.C. Hu, *Swaps, the Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm*, 138 U. PA. L. REV. 333, 367–70 (1989) (contending that there is widespread belief that the collapse of a financial institution "could cause the money supply to drop unexpectedly, thereby causing unemployment to rise and output to fall").

effects,[7] but by the time we get to insolvency—or "financial distress," if we want to acknowledge that here we are talking as much about liquidity as balance sheets[8]—the regulatory string has pretty much played out.[9] And in the end, we have trouble deciding if we really mean to treat large financial institutions like normal failed firms.[10]

Thus, the 2010 legislative response to Lehman, and AIG, and Bank of America, and Citibank, and every other large financial institution that almost failed (or did, in the case of Lehman) was notably wobbly on the question of "how will a big bank fail?" Dodd-Frank created a new, FDIC-focused "orderly liquidation authority" (OLA) to handle these cases but then made it incredibly difficult to actually use OLA.[11] Instead, banks are told to plan for failure under the Bankruptcy Code, and this time they should not expect any of the help that Lehman got.[12]

When, if ever, the new system will be used is left uncertain, particularly given that the ability to invoke the process is left in the hands of a politically appointed Treasury Secretary after consultation with the President.[13] In past administrations we might have assumed that, when push came to shove, the Secretary would do the right thing. Present-day developments might leave us a bit more circumspect on this point.[14]

Ultimately, after nearly a decade of waffling between "special" and "normal" bankruptcy for banks, I believe we are now ready to build upon

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7. *See* Martin Wolf, *Banking Remains Far Too Undercapitalised for Comfort*, FIN. TIMES, Sept. 21, 2017, at 9 ("Banking remains less safe than it could reasonably be. That is a deliberate decision.").

8. *See* Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 455–56 (2011) (explaining how a "domino effect" can exist among financial firms, expanding financial distress beyond insolvency and into liquidity).

9. *See* Peter Conti-Brown, *Elective Shareholder Liability*, 64 STAN. L. REV. 409, 419 (2012) (highlighting the fact that Dodd-Frank is a preventative regulatory measure that seeks to prevent financial crises and taxpayer-funded bailouts).

10. Anat R. Admati, *Financial Regulation Reform: Politics, Implementation, and Alternatives*, 18 N.C. BANKING INST. 71, 74–75 (2013).

11. *See* David A. Skeel, Jr. & Thomas H. Jackson, *Transaction Consistency and the New Finance in Bankruptcy*, 112 COLUM. L. REV. 152, 196 (2012) (explaining that the trigger for using the OLA is "more complex—calling for U.S. Treasury initiation with the concurrence of the Federal Reserve and FDIC . . .").

12. Stephen J. Lubben, *Transaction Simplicity*, 112 COLUM. L. REV. SIDEBAR 194, 203 (2012).

13. 12 U.S.C. § 5383(b) (2012).

14. *Cf.* Barry Schwartz, *George Washington and the Whig Conception of Heroic Leadership*, 48 AM. SOC. REV. 18, 26 (1983). Schwartz observes:

> At a time when most Americans take for granted their government's ability to outlive its unscrupulous leaders and protect individual liberties, it is difficult to appreciate the whiggish obsession about abuse of power, or to take seriously the conviction that government stands or falls on the virtues of its leaders.

*Id.*

what we have learned and to take the necessary further step: stop feigning that bank insolvency can or should happen in bankruptcy court.

I reach this conclusion through application of Professor Westbrook's functional analysis. Namely, we need to consider what it is that we are trying to achieve in a bank-insolvency case and how that compares with bankruptcy law in general. Bank insolvency, I submit, is all about special priorities: both ordinal and temporal. The Bankruptcy Code, on the other hand, takes an "equality is equity" approach to priorities as a baseline, mostly using state law to draw the claim–asset border.[15] Bargaining for results within the general "equality" framework is another key feature of traditional insolvency law.[16]

Financial institution insolvency law expressly rejects this model; it instead is all about protecting some favored group from the effects of insolvency.[17] There is no equality here, and it was never intended that there would be equality.[18] And thus it is time to stop pretending SIFI insolvency is "normal" corporate insolvency—it is bigger.

## I. The Problem

Large American financial institutions are typically made up of a holding company and several additional key pieces.[19] Each piece of the financial institution, including the holding company, is subject to a different regulatory and insolvency regime.[20]

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15. *See, e.g.*, Westbrook, *supra* note 1, at 252 (characterizing the principle that "all creditors be treated equally" as the "most universal of all insolvency principles throughout the world"). For more on the stated goals of chapter 11, see Sarah Pei Woo, *Regulatory Bankruptcy: How Bank Regulation Causes Fire Sales*, 99 GEO. L.J. 1615, 1621–22 (2011).

16. Thomas S. Green, Comment, *An Analysis of the Advantages of Non-Market Based Approaches for Determining Chapter 11 Cramdown Rates: A Legal and Financial Perspective*, 46 SETON HALL L. REV. 1151, 1155 (2016).

17. *See* Daniel R. Fischel et al., *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 318 (1987) ("The primary difference is that the thrust of bankruptcy laws is to ensure that creditors of the same class are treated equally, whereas federal deposit insurance ensures that certain classes of creditors are paid in full."). The authors of the foregoing argue that "the economic functions of bankruptcy laws and federal deposit insurance are very similar." *Id.* In this Paper, I argue otherwise.

18. In an earlier era, the bank and bankruptcy systems may have had similar goals, but that was before the advent of deposit insurance and the general move away from creditor equality in the financial context. *See* Davis v. Elmira Sav. Bank, 161 U.S. 275, 284 (1896) ("[O]ne of the objects of the national bank system was to secure, in the event of insolvency, a just and equal distribution of the assets of national banks among all unsecured creditors, and to prevent such banks from creating preferences in contemplation of insolvency.").

19. This part of the paper draws heavily on my forthcoming book: STEPHEN J. LUBBEN, THE LAW OF FAILURE: A TOUR THROUGH THE WILDS OF AMERICAN BUSINESS INSOLVENCY LAW (forthcoming 2018).

20. *See* John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 719–20 (2009) (describing the United States' unique approach to

For example, in a June 2017 report to the Federal Reserve and the FDIC, JPMorgan Chase & Co. noted that it is "supervised by multiple regulators."[21] The Report describes the domestic front as follows:

- The Federal Reserve acts as an umbrella regulator . . . .
- The firm's national bank subsidiaries, JPMCB and CUSA, are subject to supervision and regulation by the OCC and, with respect to certain matters, by the Federal Reserve and the FDIC.
- Nonbank subsidiaries, such as JPMS LLC, are subject to supervision and regulation by the SEC and, with respect to certain futures-related and swaps-related activities, by the CFTC.
- The firm conducts securities underwriting, dealing[,] and brokerage activities in the United States through JPMS LLC and other broker–dealer subsidiaries, all of which are subject to SEC regulations, the Financial Industry Regulatory Authority[,] and the New York Stock Exchange, among others.
- Certain of the firm's subsidiaries are registered with, and subject to oversight by, the SEC as investment advisers.
- In the United States, one subsidiary is registered as a futures commission merchant, and other subsidiaries are either registered with the CFTC as commodity pool operators and commodity trading advisors or exempt from such registration. These CFTC-registered subsidiaries are also members of the National Futures Association.
- JPMCB, J.P. Morgan Securities LLC, J.P. Morgan Securities, PLC[,] and J.P. Morgan Ventures Energy Corporation have registered with the CFTC as swap dealers.
- The firm's commodities business is also subject to regulation by the Chicago Mercantile Exchange, London Metals Exchange[,] and the Federal Energy Regulatory Commission.[22]

Other large American financial institutions would also be subject to insurance regulators, typically at the state level. Most, of course, are also subject to foreign regulation.[23]

There are historical reasons for this fragmentation, mostly tied to the tendency to develop American financial law in times of crisis, beginning with

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regulation: three different agencies oversee banks, while another agency oversees securities and yet another oversees futures); Patricia A. McCoy et al., *Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure*, 41 CONN. L. REV. 1327, 1343 (2009).

21. JPMORGAN CHASE & CO., RESOLUTION PLAN PUBLIC FILING 134 (2017).

22. *Id.*

23. JPMorgan Chase specifically mentions regulators in England, Japan, and Hong Kong. *Id.*

the Civil War, with new laws being added piecemeal to address then-recent events.[24] As with most American legislation, particularly at the federal level, there has never been a single reform law enacted to consolidate the whole. The result is that both pre-failure regulation and post-failure "resolution" of a large financial institution is typically achieved piece by piece, with one regulator taking an arm while another takes a leg. As discussed below, Dodd-Frank only partially improves on this situation.

### *A. The Fundamentals of Financial Institution Insolvency*

A prototypical large American financial institution or SIFI is comprised of four basic regulated pieces: a holding company, one or more depository banks, a broker–dealer, and insurance companies.[25] Interspersed between is the "dark matter" of global banks: unregulated subsidiaries. These allow banks to do financy stuff outside the regulatory architecture of the core parts of the bank, although in theory they remain subject to the umbrella regulation of the Federal Reserve.[26]

In a world before Dodd-Frank, or in a world where OLA is not invoked, the holding company is subject to the normal Bankruptcy Code process, presumably chapter 11.[27] While the Federal Reserve has regulatory powers over the holding company under the Bank Holding Company Act of 1956,[28] that Act contains no insolvency provisions.[29] Thus, we fall back on the business insolvency system of general applicability. Recent examples have

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24. *See* Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States*, 102 YALE L.J. 1927, 1948–49 (1993) (introducing the development of American banking regulation); Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 225–27, 313–14 (2002) (summarizing the restructuring of the banking industry, including the passage of the FDICIA in 1991 in response to banking failures); *see also* Kenneth E. Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 STAN. L. REV. 1, 9 (1977) (stating that "the national banking system was created during the Civil War"); Edward L. Symons, Jr., *The "Business of Banking" in Historical Perspective*, 51 GEO. WASH. L. REV. 676, 698–99 (1983) (discussing the National Bank Act).

25. Howell E. Jackson, *The Expanding Obligations of Financial Holding Companies*, 107 HARV. L. REV. 507, 509 (1994).

26. Michael S. Barr, *The Financial Crisis and the Path of Reform*, 29 YALE J. ON REG. 91, 99 (2012).

27. *See* Cassandra Jones Havard, *Reconciling the Dormant Conflict: Crafting a Banking Exception to the Fraudulent Conveyance Provision of the Bankruptcy Code for Bank Holding Company Asset Transfers*, 75 DENV. U. L. REV. 81, 81–82, 89–92 (1997) (clarifying that the "Bankruptcy Code . . . governs the insolvency proceedings of the bank holding company" and providing examples of holding companies filing under chapter 11).

28. 12 U.S.C. § 1841 (2012).

29. *Cf.* Henry N. Butler & Jonathan R. Macey, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677, 697–98 (1988) (noting that "[t]he Bank Holding Company Act regulates the activities of any company that controls a bank" without mention of insolvency proceedings).

included the notorious September 15, 2008, chapter 11 filing of Lehman Brothers Holdings, Inc. and the chapter 11 filing of Washington Mutual's parent company.[30]

Most depository banks are insured by the FDIC.[31] Whenever the Comptroller of the Currency appoints a receiver for an insured national bank, the Comptroller must appoint the Federal Deposit Insurance Corporation receiver.[32] As the exclusive statutory receiver of any insolvent insured national bank, the FDIC cannot be removed as receiver, and the courts have no ability to interfere with the process.[33] Likewise, even under the old pre-New Deal rules, and those still applicable to uninsured national banks (mostly trust companies), the Comptroller has the ability to appoint the receiver without ever going to court.[34]

Recent examples of the modern FDIC approach include the aforementioned Washington Mutual primary operating subsidiary and the banks shown on the table, which includes all the FDIC receiverships in 2017.[35] Note the inevitable resolution of these banks by transferring the deposits to a healthy institution;[36] the FDIC pursued a similar strategy with Washington Mutual, where Chase took over its branches and deposits.[37]

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30. *See* Diane Lourdes Dick, *The Chapter 11 Efficiency Fallacy*, 2013 BYU L. REV. 759, 790 (2013) (describing the Washington Mutual bankruptcy); *see also* Stephen J. Lubben & Sarah Pei Woo, *Reconceptualizing Lehman*, 49 TEX. INT'L L.J. 297, 303 (2014) (describing the Lehman bankruptcy).

31. Key exceptions include certain financial technology companies (at this point, more potential than real) and trust companies, both of which might operate under a national bank charter without deposit insurance. *See, e.g.*, 12 U.S.C. § 27(a) (2012) (outlining when the comptroller may authorize an association to commence banking).

32. 12 U.S.C. § 1821(c)(2)(A)(ii) (2012); *see also* Edward H. Klees, *How Safe Are Institutional Assets in a Custodial Bank's Insolvency?*, 68 BUS. LAW. 103, 108–09 (2012) (explaining that the FDIC acts as receiver for insolvent national banks).

33. 12 U.S.C. § 1821(j) (2012).

34. HIRSCH BRAVER, LIQUIDATION OF FINANCIAL INSTITUTIONS: A TREATISE ON THE LAW OF VOLUNTARY AND INVOLUNTARY LIQUIDATION OF BANKS, TRUST COMPANIES, AND BUILDING AND LOAN ASSOCIATIONS § 1015, at 1182 (1936).

35. FED. DEPOSIT INS. CORP., FAILED BANK LIST, https://www.fdic.gov/bank/individual/failed/banklist.html [https://perma.cc/AU5F-9LVM].

36. Cheryl D. Block, *A Continuum Approach to Systemic Risk and Too-Big-to-Fail*, 6 BROOK. J. CORP. FIN. & COM. L. 289, 334–35 (2012).

37. Dick, *supra* note 30, at 793–94.

| Bank Name | City | State | Acquiring Bank | Closing Date |
|---|---|---|---|---|
| Washington Federal Bank for Savings | Chicago | IL | Royal Savings Bank | 15-Dec-17 |
| The Farmers and Merchants State Bank of Argonia | Argonia | KS | Conway Bank | 13-Oct-17 |
| Fayette County Bank | Saint Elmo | IL | United Fidelity Bank, fsb | 26-May-17 |
| Guaranty Bank | Milwaukee | WI | First-Citizens Bank & Trust Company | 5-May-17 |
| First NBC Bank | New Orleans | LA | Whitney Bank | 28-Apr-17 |
| Proficio Bank | Cottonwood Heights | UT | Cache Valley Bank | 3-Mar-17 |
| Seaway Bank and Trust Company | Chicago | IL | State Bank of Texas | 27-Jan-17 |
| Harvest Community Bank | Pennsville | NJ | First-Citizens Bank & Trust Company | 13-Jan-17 |

Normally broker–dealers are handled under SIPA—the Securities Investor Protection Act. SIPA created SIPC—the Securities Investor Protection Corporation—a quasi-private company that oversees an insurance fund for customers.[38] Although SIPC is an independent body, the SEC has oversight power over its bylaws and rules and may compel SIPC to promulgate regulations to effectuate the purposes of SIPA.[39] The insurance in this case, unlike the more familiar FDIC deposit insurance, protects only against securities or cash that are missing at the point of insolvency; there is no guarantee of value.[40]

The law provides that SIPC or the SEC may file an application for a protective decree with a federal district court if SIPC determines that any member has failed or is in danger of failing to meet obligations to customers and meets one of four worrisome conditions.[41] Upon filing, the case is

38. Onnig H. Dombalagian, *Substance and Semblance in Investor Protection*, 40 J. CORP. L. 599, 600 (2015).

39. 15 U.S.C. § 78ccc(e) (2012).

40. *See* Jeanne L. Schroeder, *Is Article 8 Finally Ready This Time? The Radical Reform of Secured Lending on Wall Street*, 1994 COLUM. BUS. L. REV. 291, 463–64 ("SIPC buys [unsatisfied customer] claims . . . up to the statutory maximum amount . . . and is subrogated to the customers' general credit claims against the debtor.").

41. 15 U.S.C. §§ 78eee(a)(3)(A), 78eee(b)(1), 78ggg(b) (2012). The institution of a case under the SIPA brings any pending bankruptcy case to a halt. Irrespective of the automatic stay, the SIPC may file an application for a protective decree under SIPA. 11 U.S.C. § 742 (2012).

quickly referred to the bankruptcy court.[42] The powers of the trustee in a SIPA case are essentially the same as those vested in a chapter 7 trustee appointed under the Bankruptcy Code, but the SIPA trustee operates with somewhat less judicial oversight.[43] Before the case even gets underway before the court, customers will have their accounts transferred to a healthy broker.[44]

While the holding company is in chapter 11, the depository bank is handled by the FDIC, the broker–dealer is liquidated by a SIPA trustee, and the insurance companies will be subject to state court receiverships under the oversight of the state insurance commissioner.[45] Insurance companies, no matter what size, are regulated by the states, and thus their insolvencies are also a question of state law.[46]

The basic structure of insurance failure is fairly uniform across the states: the insurance regulator goes to court and gets a receiver appointed, often the regulator itself,[47] to take control of the insurance company.[48] State guaranty funds, set up and paid for by solvent insurance companies operating within the jurisdiction, pay covered policyholder claims up to certain limits, which are often rather low.[49]

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42. 15 U.S.C. § 78eee(b)(4) (2012).

43. 15 U.S.C. § 78fff-1(a) (2012); *see also id.* § 78fff-1(b)(2) (describing trustee's conditional authority to guarantee all or part of the indebtedness of the debtor to a lender).

44. Dombalagian, *supra* note 38, at 605.

45. Stephen J. Lubben, *Financial Institutions in Bankruptcy*, 34 SEATTLE U. L. REV. 1259, 1274 (2011).

46. *See generally, e.g.*, CAL. INS. CODE, §§ 1064.1–1064.13 (West 2012) (giving examples of insolvency under California state law).

47. IOWA CODE ANN. § 505.9 (West 2015). In New York, the regulator acting as receiver has a separate, dedicated staff, collectively known as the New York Liquidation Bureau. *See also* State *ex rel.* ISC Financial Corp. v. Kinder, 684 S.W.2d 910, 913 (Mo. Ct. App. W.D. 1985) ("The director of insurance is to be the receiver and he is to conduct the affairs of the receivership under the supervision of the court, in accordance with the statutory system.").

48. *See* ALA. CODE § 27-34-50 (2007) (fraternal benefit societies); DEL. CODE ANN. tit. 18, § 5906 (West 2015) (domestic insurers); HAW. REV. STAT. ANN. § 432:2-606 (LexisNexis 2014) (domestic societies); IOWA CODE ANN. § 508.22 (West 2015) (life insurance companies); NEV. REV. STAT. ANN. § 696B.220 (West 2015) (domestic insurers); N.Y. INS. LAW § 7405 (McKinney 2016) (domestic insurers); UTAH CODE ANN. § 31A-27a-401 (LexisNexis 2017) (domestic insurers); W. VA. CODE ANN. § 33-10-6 (LexisNexis 2017) (domestic insurers).

49. *See, e.g.*, ALA. CODE § 27-44-8 (2007) (capping liability at $100,000 in cash values per insured); CAL. INS. CODE § 1063.2 (West 2014) (describing the mechanics of compensating insured persons in case of an insurance company's insolvency); KY. REV. STAT. ANN. § 304.36-020 (LexisNexis 2011) (establishing funding for insured persons in cases of insurers' insolvency); MASS. GEN. LAWS ANN. ch. 175D, § 5 (West 2007) (same); 27 R.I. GEN. LAWS ANN. § 27-34.3-8 (West 2017) (discussing the association's ability to pay the impaired insurer's contractual obligations); WYO. STAT. ANN. § 26-42-106 (2018) (same); *see also* de la Fuente v. Fla. Ins. Guar. Ass'n, 202 So. 3d 396, 401 (Fla. 2016) (describing and applying Florida's statutory fund for claims against insolvent insurance companies). In New York, there are three distinct, statutory security funds, known as the Property/Casualty Insurance Security Fund, the Public Motor Vehicle Security

And then the unregulated bits of a big financial institution bring us back to chapter 11 of the Bankruptcy Code. At least the holding company and the "extra" bits of the financial institution end up in the same process; the other pieces are in a variety of forums—some in courts, some not.

### *B. Dodd-Frank's OLA Solution*

Recognizing that this overall system was somewhat less than ideal, the drafters of Dodd-Frank created a new super bankruptcy system, OLA. But OLA only partially solves the problem of an integrated financial institution being pulled apart by regulatory (and insolvency) balkanization.[50] And it does nothing to address the issue of cross-border SIFIs, which is rather important, considering that every SIFI is, almost by definition, a cross-border SIFI.[51]

First, Dodd-Frank's drafters had no stomach for a fight with state insurance regulators, and thus insurance company insolvency remains outside the new order.[52] Broker–dealers are swept up in the process, but in an opaque way: the OLA receiver can take whatever assets it wants, leaving the residue behind. And the entire process is extremely difficult to commence and operates only as a backstop to the normal rules.[53]

In particular, to invoke OLA, the FDIC needs the agreement of the Federal Reserve Board of Governors (by a two-thirds majority) and the Treasury Secretary, who is required to consult with the President.[54] If the SIFI in question is more broker–dealer than depository bank—Goldman Sachs might be an example here—the SEC takes over the FDIC's role in initiation, but the FDIC will, nonetheless, become the receiver if the process goes

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Fund and the Workers' Compensation Security Fund. In addition, life insurance policy holders are protected by the Life Insurance Company Guaranty Corporation of New York, created under Article 77 of the State's insurance law. *See* Ky. Ins. Guar. Ass'n v. Nat. Res. & Envtl. Prot. Cabinet, 885 S.W.2d 315, 316, 318 (Ky. Ct. App. 1994) (construing broadly Kentucky's statutory fund for claims against insolvent insurance companies).

50. Lubben, *supra* note 45, at 1268.

51. Edward F. Greene & Joshua L. Boehm, *The Limits of "Name-and-Shame" in International Financial Regulation*, 97 CORNELL L. REV. 1083, 1106 (2012); *see also* Oscar Couwenberg & Stephen J. Lubben, *Corporate Bankruptcy Tourists*, 70 BUS. LAW. 719, 722 (2015) (stating that "most large corporate groups have at least some international operations").

52. *See* Stavros Gadinis, *From Independence to Politics in Financial Regulation*, 101 CAL. L. REV. 327, 371 (2013) ("Because insurance companies are state-regulated, the Act does not change states' insolvency regimes but establishes a mechanism that allows the federal government to trigger the insolvency process at the state level."); *see also* Matthew C. Turk, *The Convergence of Insurance with Banking and Securities Industries, and the Limits of Regulatory Arbitrage in Finance*, 2015 COLUM. BUS. L. REV. 967, 1007 (2015) (explaining how Dodd-Frank maintains a "decentralized state-led system").

53. *See* David Zaring, *A Lack of Resolution*, 60 EMORY L.J. 97, 124 (2010) (detailing the complexity of commencing the resolution-powers process).

54. 12 U.S.C. § 5383(a)(1)(A) (2012).

forward.[55] The statute expressly provides that the regulators must consider the effect of default on financial stability, on low income, minority, or underserved communities, and on creditors, shareholders, and counterparties.[56]

The Treasury Secretary is separately charged with evaluating the use of OLA under a two-part test.[57] First, the Secretary looks at whether the SIFI is in default or in danger of default.[58] A bank is in default when it is likely to file for bankruptcy, has incurred debts that will deplete all or most of its capital, has more debts than assets, or will likely be unable to pay its debts in the normal course of business.[59] In essence, a bank is insolvent if it is insolvent under any reasonable definition of the term.

Second, the Secretary must evaluate the systemic risk involved in the potential default of the SIFI in question.[60] The Secretary also must find that "no viable private sector alternative is available to prevent the default of the financial company."[61]

If the SIFI clears these hurdles, the company's board is presented with a choice: consent (and be exculpated from any potential liability to shareholders) or we, the regulators, will go to court.[62] Presumably, the board consents in most cases, and the FDIC is appointed as a receiver for the company.

As a receiver, the FDIC takes on the duties of transferring or selling assets, creating bridge financial organizations that can help assume assets or liabilities during the liquidation process, and approving valid claims against the company that will need to be paid.[63] The Orderly Liquidation Fund acts as a government-run DIP loan[64] throughout the process.[65] The Treasury lends

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55. *See id.* § 5383(a)(1)(B). The statute provides:

> In the case of a broker or dealer, or in which the largest United States subsidiary (as measured by total assets as of the end of the previous calendar quarter) of a financial company is a broker or dealer, the Commission and the Board of Governors, at the request of the Secretary, or on their own initiative, shall consider whether to make the written recommendation . . . .

56. *Id.* § 5383(a)(2)(A)–(C), (G).

57. *Id.* § 5383(b).

58. *Id.* § 5383(b)(1).

59. *Id.* § 5383(c)(4).

60. *Id.* § 5383(b)(2).

61. *Id.* § 5383(b)(3).

62. *Id.* §§ 5387, 5382(a)(1)(A)(i).

63. *See generally id.* § 5390 (outlining the powers and duties of the FDIC once appointed as receiver).

64. Companies that enter chapter 11 continue to be run by their existing management in almost all cases. The ongoing entity is known as the debtor in possession (DIP). DIP loans are typically asset-based, revolving working-capital facilities agreed to at the start of a chapter 11 case to provide both immediate cash as well as ongoing working capital during the process.

65. *Id.* § 5390(n).

the FDIC money to resolve the institution.[66] If there is a net cost, the FDIC then recoups the money spent by imposing a fee on surviving large, complex financial institutions.[67]

OLA provides a set of basic rules for all proceedings.[68] All action under OLA must be taken to preserve the financial stability of the economy as a whole, not merely to preserve the specific company in question.[69] Shareholders cannot receive payment until all other claims are paid—that is, the normal priority rules apply.[70] Management "responsible" for the SIFI's failure must be "removed."[71] Presumably, that means they must be fired—and not banished, or transported to Australia, or something like that. The FDIC is also prohibited from providing equity financing to the SIFI, which makes sense, given that other parts of Title II also call for liquidation of the defaulting SIFI.[72]

### *C. SPOE and "Chapter 14"*

Because the application of OLA to an entire financial institution would appear to be unwieldly and would not cover the international aspects of the corporate group, a new approach was needed.[73] Single point of entry (SPOE) was that new strategy.

The SPOE idea benefits from a simple elegance: insolvency should only involve the holding company and no other part of the institution.[74] All problems would be solved at the holding-company level by having the holding company take on the burdens of financing the entire operation.[75] Other subsidiaries might interact with the outside world as part of their normal trading operations—the swaps subsidiary would continue to engage in trading, for example—but the holding company would be in charge of all general finance.[76]

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66. *Id.* § 5390(n)(1).

67. *Id.* § 5390(o).

68. *Id.* § 5386.

69. *Id.* § 5386(1).

70. *Id.* § 5386(2)–(3).

71. *Id.* § 5386(4).

72. *Id.* § 5384(a).

73. *See generally* Stephen J. Lubben, *Resolution, Orderly and Otherwise: B of A in OLA*, 81 U. CIN. L. REV. 485 (2012) (examining the complexity of resolving Bank of America under OLA and accompanying issues).

74. For a critical review of SPOE, see Stephen J. Lubben & Arthur Wilmarth, Jr., *Too Big and Unable to Fail*, 69 FLA. L. REV. 1205 (2017).

75. Kwon-Yong Jin, *How to Eat an Elephant: Corporate Group Structure of Systemically Important Financial Institutions, Orderly Liquidation Authority, and Single Point of Entry Resolution*, 124 YALE L.J. 1746, 1751–52 (2015).

76. Jeffrey N. Gordon & Wolf-Georg Ringe, *Bank Resolution in the European Banking Union: A Transatlantic Perspective on What It Would Take*, 115 COLUM. L. REV. 1297, 1325 fig.3 (2015).

Thus, if the financial institution were to encounter financial distress, its equity interests in its subsidiaries would quickly move to a new "bridge bank," while its bondholders would look to the equity of that new holding company for their recovery.[77] Shareholders in the old institution—"to use an expression more forcible and familiar than elegant"[78]—would be wiped out. At the same time, the subsidiaries would benefit from forgiveness of their liabilities to the parent company, providing a source of relief for strained balance sheets.

SPOE itself addresses the problems of using OLA, but there remains the issue of Dodd-Frank's stated preference for normal bankruptcy procedures. To meet this challenge, a variety of parties have come forth with proposals to amend the Bankruptcy Code to facilitate a SPOE-style bankruptcy proceeding.[79] Lumped under the general heading of "chapter 14," after one of the early Hoover Institute proposals,[80] these plans would allow a quick holding-company-only bankruptcy case for a financial institution. In some cases, the new chapter 14 would replace OLA entirely, while in others it would simply make the Bankruptcy Code a more attractive alternative to OLA.[81]

Most of the recent versions of chapter 14 have been designed to use SPOE within a procedure that at least resembles chapter 11. The debtor holding company would file a petition and would initiate a near immediate

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77. Catherine Gallagher Fauver, *The Long Journey to "Adequate": Wells Fargo's Resolution Plan*, 36 REV. BANKING & FIN. L. 647, 658 (2017).

78. Adrian H. Joline, *Railway Reorganizations*, 8 AM. LAW. 507, 508 (1900) (referring to shareholders in railroad foreclosure cases).

79. Edward J. Janger & John A.E. Pottow, *Implementing Symmetric Treatment of Financial Contracts in Bankruptcy and Bank Resolution*, 10 BROOK. J. CORP. FIN. & COM. L. 155, 180 (2015); Jodie A. Kirshner, *The Bankruptcy Safe Harbor in Light of Government Bailouts: Reifying the Significance of Bankruptcy as a Backstop to Financial Risk*, 18 N.Y.U. J. LEGIS. & PUB. POL'Y 795, 831 (2015).

80. Stephen J. Lubben, *What's Wrong with the Chapter 14 Proposal*, DEAL BOOK, N.Y. TIMES (Apr. 10, 2013), https://dealbook.nytimes.com/2013/04/10/whats-wrong-with-the-chapter-14-proposal/?mcubz=3 [https://perma.cc/D97Z-U5SW].

81. Stephanie P. Massman, *Developing a New Resolution Regime for Failed Systemically Important Financial Institutions: An Assessment of the Orderly Liquidation Authority*, 89 AM. BANKR. L.J. 625, 637 (2015). One early version, which would have replaced Title II entirely, is reviewed in Bruce Grohsgal, *Case in Brief Against "Chapter 14,"* AM. BANKR. INST. J., May 2014, at 44, 113. Instead of creating a new chapter 14 of the Code to deal with large financial institutions that seek bankruptcy protection, the Financial Institution Bankruptcy Act of 2014, passed by the House but never acted upon by the Senate, sought to create a new Subchapter V of the Code to deal with such entities. *Compare* H.R. 5421, 113th Cong. (2014) (enacted) *with* Financial Institution Bankruptcy Act of 2014, H.R. REP. NO. 113-630, at 11 (2014). The pending CHOICE Act, discussed later in this Paper, would combine the latter approach with a full repeal of Title II of Dodd-Frank. Financial CHOICE Act of 2017, H.R. 10 § III (as passed by House, June 18, 2017), https://www.congress.gov/bill/115th-congress/house-bill/10/text#tocHF34EA86F881447208D253C613F969973 [https://perma.cc/TRC2-32M9].

363 sale of its assets to a buyer–trust.[82] The debtor would then move toward confirmation of a liquidating plan that would distribute interests in the trust as payment to creditors.[83]

Chapter 14 thus tethers the Bankruptcy Code to the SPOE approach to bank resolution. The vital question then is whether SPOE will work, or, more aptly, whether it will work most of the time.[84] Undoubtedly, there is something odd about fixing a shortcoming in a financial institution through the holding company when the holding company itself is probably the least likely place for such a flaw to develop.[85] Almost like doing a root canal by way of orthoscopic surgery on the knee—it could work, but it seems terribly indirect.

And the notion that all the operating subsidiaries throughout the world will continue business as usual in the days after the parent company has failed assumes a high degree of rationality in the midst of financial collapse. It is almost as if the proponents of SPOE have already forgotten what happened in 2008. At the very least, they assume that the presence of Dodd-Frank will provide the assurance and calm that was rather obviously lacking before.

And while US regulators seem to be in favor of SPOE for domestic SIFIs, they seem quite happy to force "multiple points of entry" on international banks operating in the United States through mechanisms such as the Fed's foreign bank (intermediate) holding company rules.[86] This has the predictable effect of undermining resolution planning at the international level as regulators jockey for position in anticipation of the next Lehman Brothers Europe.[87]

Overall, SPOE has something of the character of a parlor trick or one of those 1980s law review articles that suggested that chapter 11 could be replaced with a few simple contracts. One is left with the nagging feeling that it's all a bit too crafty to actually work outside the parlor or the slide deck.

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82. For more on the 363 sale process, evaluated from a comparative perspective, see Stephanie Ben-Ishai & Stephen J. Lubben, *Involuntary Creditors and Corporate Bankruptcy*, 45 U.B.C. L. REV. 253, 256, 272 (2012).

83. *Id.* at 272.

84. Lubben & Wilmarth, *supra* note 74.

85. John Crawford, *"Single Point of Entry": The Promise and Limits of the Latest Cure for Bailouts*, 109 NW. U. L. REV. ONLINE 103, 107 (2014); Nizan Geslevich Packin, *Supersize Them? Large Banks, Taxpayers and the Subsidies that Lay Between*, 35 NW. J. INT'L L. & BUS. 229, 276 (2015).

86. Press Release, Board of Governors of the Federal Reserve System, Fed. Reserve, Federal Reserve Board Approves Final Rule Strengthening Supervision and Regulation of Large U.S. Bank Holding Companies and Foreign Banking Organizations (Feb. 18, 2014), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20140218a.htm [https://perma.cc/BZD5-CAWP].

87. *See* Lubben & Woo, *supra* note 30, at 326–27 (predicting international regulators' responses to banking regulations in the United States and the United Kingdom).

### *D. The Fundamental Problem*

Chapter 14, SPOE, and OLA contain a stated preference for the Bankruptcy Code that papers over the reality that this country does not typically address bank insolvency under the Code. Rather, a receiver, appointed by a regulator, runs the show when a bank fails.

And while broker–dealers, insurance companies, and SIFIs more generally may not be "banks" in the narrow, legalistic sense, they are banks in the economic sense.[88] They take in funds with the promise of liquidity and invest those funds in longer-term assets, like loans, mortgage-backed securities, and the like.[89] And "when short-term debt funds longer-term liabilities, a defining characteristic of banks and much of the shadow banking system, the institutions that result are inherently fragile."[90]

The fundamental problem, then, is what to make of the conflicting approach to bank insolvency. I address that issue in the next part of this Paper and argue that at heart this represents a confusion of bank insolvency and bankruptcy.

## II. Functional Analysis

"Whenever an area of law has become conceptually and doctrinally confused, it is always helpful to return to first principles."[91] With regard to bank or SIFI failure, such a return to core principles is long overdue.

"Equality of distribution among creditors is a central policy of the Bankruptcy Code. According to that policy, creditors of equal priority should receive pro rata shares of the debtor's property."[92] That is, traditional business bankruptcy is focused on questions of creditor rank and equality within ranks.[93]

Rank questions have both temporal and ordinal components. For a variety of practical reasons, some creditors get paid before others.[94] And

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88. Karl S. Okamoto, *After the Bailout: Regulating Systemic Moral Hazard*, 57 UCLA L. REV. 183, 195 (2009); Morgan Ricks, *Regulating Money Creation After the Crisis*, 1 HARV. BUS. L. REV. 75, 97 (2011).

89. Jeffrey N. Gordon & Christopher Muller, *Confronting Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insurance Fund*, 28 YALE J. ON REG. 151, 158, 162 (2011).

90. Kathryn Judge, *The Importance of "Money,"* 130 HARV. L. REV. 1148, 1150 (2017) (reviewing MORGAN RICKS, THE MONEY PROBLEM: RETHINKING FINANCIAL REGULATION (2016)).

91. Westbrook, *supra* note 1, at 243.

92. Begier v. IRS, 496 U.S. 53, 58 (1990).

93. *See* Chrystin Ondersma, *Shadow Banking and Financial Distress: The Treatment of "Money-Claims" in Bankruptcy*, 2013 COLUM. BUS. L. REV. 79, 106 ("[Not] all creditors have always been treated equally without exception; secured creditors are protected up to the value of their collateral . . . .").

94. *See* Stephen J. Lubben, *The Overstated Absolute Priority Rule*, 21 FORDHAM J. CORP. &

negotiations over a chapter 11 plan hinge on who gets paid what within those classes that have yet to be paid when it comes time to formulate a plan.[95] What counts as a "claim" and what counts as an "asset" for purposes of bankruptcy is determined by reference to underlying state law, sometimes with a federal Bankruptcy Code overlay.

While the Code provides the framework of rank, the precise treatment of creditors within those ranks is a matter of negotiation. In a traditional chapter 11 case, this negotiation results in a reorganization plan that provides an outline of the reorganized debtor.[96] The plan can radically alter the debtor's management, its ownership, its tax profile, its relationship with employees and future claimants, and perhaps even the type of business the debtor performs.[97] In place of a reorganization plan, the debtor might file a liquidation plan or a plan containing features of both.

Consider a recent example. Teen-apparel specialty chain rue21, Inc. emerged from bankruptcy on September 22, 2017.[98] Under the confirmed plan, prepetition holders of the $538.5 million term loan received about two-thirds of the equity in the reorganized company.[99] Holders of the $250 million 9.0% senior unsecured notes due in 2021, and all other unsecured claims, received a 4% equity stake.[100] The remainder of the new equity went to a DIP lender.[101]

In all cases, the distribution of the new equity was the product of negotiation between the various creditor groups, each trying to get as much as possible. Those negotiations happen within the equality framework established by the Bankruptcy Code.[102]

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FIN. L. 581, 605 (2016) ("Operating companies pay creditors according to business needs, without regard for actual priority.").

95. *See* Maxx M. Johnson, *The Not-So-Settled Absolute Priority Rule: The Continued Threat of Priority-Deviation Through Interim Distributions of Assets in Chapter 11 Bankruptcy*, 13 SETON HALL CIR. REV. 291, 294 (2017) ("Priority for creditors could mean the difference between getting paid in full and not getting paid at all.").

96. *See* Michelle M. Harner, *The Search for an Unbiased Fiduciary in Corporate Reorganizations*, 86 NOTRE DAME L. REV. 469, 494 (2011) ("The creditor's objective and pursuit of control . . . might conflict with the debtor's restructuring plan or the efforts of other creditors or shareholders to influence the process.").

97. *See* Chrystin Ondersma, *Employment Patterns in Relation to Bankruptcy*, 83 AM. BANKR. L.J. 237, 247 (2009) (finding that companies lose around fifty percent of employees in the years near bankruptcy filing).

98. Rue21, Inc., *rue21 Completes Financial Restructuring Process*, PR NEWSWIRE (Sept. 22, 2017), https://www.prnewswire.com/news-releases/rue21-completes-financial-restructuring-process-300524488.html [https://perma.cc/JQA3-5Q66].

99. First Amended Debtors' Disclosure Statement for the Debtors' First Amended Joint Plan of Reorganization Pursuant to chapter 11 of the Bankruptcy Code at 10, 25, *In re* rue21, Inc., 575 B.R. 90 (Bankr. W.D. Pa. 2017) (No. 17-22045).

100. *Id.* at 12, 26.

101. *Id.* at 16–17.

102. On the general construction of corporate bankruptcy systems, see Oscar Couwenberg &

That stands in direct contrast to financial institution insolvency, where the key decisions about who gets what have already been made before the case commences.[103] In particular, financial institution insolvency mechanisms decide in advance that certain favored creditors will receive priority at the expense of the remaining creditors. Indeed, what happens after those favored creditors are taken out of the insolvency process is typically of lesser concern.

We see this most directly in broker–dealer liquidations where customers are made whole—through a segregated fund of customer property and a gap-filling insurance scheme—before any other creditor is even considered.[104] To the same effect are insurance receiverships, where policyholders are expressly elevated under the law of every state to an elite status that precedes all others.

Depository banks operate under a similar regime, through a combination of deposit insurance and, more recently, a federal depositor preference statute. More practically, the frequent use of purchase and assumption—or "P and A"—transactions, where depositors are transferred over to an acquiring bank, represents an even more obvious means of excluding a special class from an insolvency process.[105]

The "safe harbors" in the Bankruptcy Code provide a similar status for repo and derivatives trades, excepting them from all of the key provisions of the Bankruptcy Code.[106] To be sure, the safe harbors are far sloppier in providing their priority—in that they extend far beyond what is needed to protect the financial institutions engaged in these trades.[107] But whatever we think about the merits, they represent a policy decision by Congress to ditch

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Stephen J. Lubben, *Essential Corporate Bankruptcy Law*, 16 EUR. BUS. ORG. L. REV. 39, 42–44 (2015).

103. Richard M. Hynes & Steven D. Walt, *Why Banks Are Not Allowed in Bankruptcy*, 67 WASH. & LEE L. REV. 985, 989 (2010).

104. *See In re* Bernard L. Madoff Inv. Sec. LLC, 654 F.3d 229, 240 (2d Cir. 2011) (noting that the "SIPC provides advances on customer property"). To be sure, if we view broker–dealers as holding assets in custody on behalf of their clients, they are somewhat different from the other financial institutions because it is not that clients receive preferential treatment vis-à-vis other creditors. Rather, it is that their assets never formed part of the bankrupt broker–dealer's estate in the first instance. Of course, we also backstop that segregation from the estate with a special insurance fund, which then pushes broker–dealers a bit closer to the traditional financial institutions. Perhaps it is best to admit that they operate under a somewhat mixed model.

105. Paul Lund, *The Decline of Federal Common Law*, 76 B.U. L. REV. 895, 950–51 (1996).

106. Stephen J. Lubben, *Failure of the Clearinghouse: Dodd-Frank's Fatal Flaw?*, 10 VA. L. & BUS. REV. 127, 152 (2015); Rizwaan J. Mokal, *Liquidity, Systemic Risk, and the Bankruptcy Treatment of Financial Contracts*, 10 BROOK. J. CORP. FIN. & COM. L. 15, 43 n.21 (2015).

107. Edward J. Janger, Response, *Arbitraging Systemic Risk: System Definition, Risk Definition, Systemic Interaction, and the Problem of Asymmetric Treatment*, 92 TEXAS L. REV. SEE ALSO 217, 228–29 (2013).

the normal insolvency rules in favor of a system in which a certain preferred group prevails over the default rule of creditor equality.[108]

What, then, are the first principles of business insolvency at play here? At heart, business bankruptcy, and most of business insolvency, is aimed at recognizing a standard set of creditor priorities and ensuring creditor equality within those priorities. Creditors are urged to bargain for their specific treatment.

Bank insolvency, on the other hand, is about advancing legislatively defined policy goals that have been set in advance of insolvency.[109] We may disagree about the wisdom of certain of those goals, but they are set through a legislative process and not within the framework of creditor bargaining so familiar to bankruptcy attorneys.[110]

On the surface, bank insolvency thus looks like normal insolvency, but it is really quite different.[111] The next part of this Paper, thus, looks at the implications of that conclusion for one key aspect of insolvency law: the role of bankruptcy courts.

## III. The Problem of Courts

In one of their myriad attempts to replace Dodd-Frank's OLA with a new chapter of the Bankruptcy Code, House Republicans argued that:

> [T]he bankruptcy process is administered through the judicial system, by impartial bankruptcy judges charged by the Constitution to guarantee due process in public proceedings under well-settled rules and procedures. It is a process that is faithful to this country's belief in the Rule of Law.[112]

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108. John J. Chung, *From Feudal Land Contracts to Financial Derivatives: The Treatment of Status Through Specific Performance*, 29 REV. BANKING & FIN. L. 107, 136, 138–39 (2009). For a general critique of the policymaking behind the safe harbors, see Stephen J. Lubben, *Subsidizing Liquidity or Subsidizing Markets? Safe Harbors, Derivatives, and Finance*, 91 AM. BANKR. L.J. 463, 472–77 (2017).

109. Helen A. Garten, *A Political Analysis of Bank Failure Resolution*, 74 B.U. L. REV. 429, 445 (1994).

110. For key insights into the tensions that naturally exist between the bank and bankruptcy frameworks, see Sarah Pei Woo, *Simultaneous Distress of Residential Developers and Their Secured Lenders: An Analysis of Bankruptcy & Bank Regulation*, 15 FORDHAM J. CORP. & FIN. L. 617, 664–76 (2010).

111. *See* Thomas W. Joo, *Who Watches the Watchers? The Securities Investor Protection Act, Investor Confidence, and the Subsidization of Failure*, 72 S. CAL. L. REV. 1071, 1105 (1999) ("SIPA's goals are very different. It is concerned primarily with the health of the securities industry. SIPA does not attempt to maximize the debtor's estate . . . but only liquidation procedures.").

112. STAFF OF H. COMM. ON FIN. SERVS., 114TH CONG., THE FINANCIAL CHOICE ACT: A REPUBLICAN PROPOSAL TO REFORM THE FINANCIAL REGULATORY SYSTEM 26 (Comm. Print 2016), http://financialservices.house.gov/uploadedfiles/financial_choice_act_comprehensive outline.pdf [https://perma.cc/3HU3-Y4F8].

It is hard to quarrel with the rule of law, capitalized or not. Nonetheless, I use this part of the paper to explain why courts are an uneasy fit in the case of a SIFI insolvency.

As a starting point, "corporate bankruptcy scholars tend to characterize bankruptcy as an extension of the private transactional realm, with judges external to that world."[113] This conception of business bankruptcy, although clearly overstated and even wrong, presents a problem for efforts to apply the "normal rules" to SIFI insolvency. In short, given the broad public effects and regulatory considerations tied to a SIFI's failure, the notion that a system of private bargaining could or should address the matter is nonsensical.[114]

Financial institutions create debt instruments that are something more than debt, and indeed become valuable social products.[115] More broadly,

> financial markets are integral to the production of commercial goods, public goods, and social services. Many businesses and individuals regularly rely upon financial institutions to provide short-term loans when the individual or business experiences temporary cash management difficulties.[116]

In addition, financial institutions play key roles in the creation of money.[117] About 70% of the U.S. money supply is in the form of deposits.[118] For deposits to perform this function—and more broadly for banks to function as the institutional backbone of the payment system—depositors need to be reasonably confident that: (1) there will not be a significant delay in transferring or withdrawing deposited funds (illiquidity) and (2) these funds will not be written down or converted into equity in the context of any bankruptcy proceeding (loss of value).[119]

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113. Melissa B. Jacoby, *Federalism Form and Function in the Detroit Bankruptcy*, 33 YALE J. ON REG. 55, 69 (2016).

114. *See* Anna Gelpern, *Common Capital: A Thought Experiment in Cross-Border Resolution*, 49 TEX. INT'L L.J. 355, 356 (2014) ("Like the public-policy functions, government commitments permeate the bank balance sheet. Central-bank liquidity support, deposit insurance, regulatory valuation of assets and liabilities, and resolution procedures all represent government commitments that shape the way in which a bank does business.").

115. *See* Donald F. Turner, *The Scope of Antitrust and Other Economic Regulatory Policies*, 82 HARV. L. REV. 1207, 1233 (1969) ("In short, if banking is peculiar in that bank failures pose a particularly serious problem, it is also peculiar in that competition in lending performs a uniquely valuable function.").

116. Kristin N. Johnson, *Things Fall Apart: Regulating the Credit Default Swap Commons*, 82 U. COLO. L. REV. 167, 185 (2011).

117. *See* Adam J. Levitin, *Safe Banking: Finance and Democracy*, 83 U. CHI. L. REV. 357, 361 (2016) (discussing ways in which banks' lending practices aid in wealth creation).

118. Money Stock & Debt Measures-H.6 RELEASE, Fed. Res. Sys., https://www.federalreserve.gov/releases/h6/current/default.htm [https://perma.cc/FL8L-EBFM].

119. *See* Dan Awre & Kristin van Zwieten, *The Shadow Payment System*, 43 J. CORP. L. (forthcoming 2018) (manuscript at 31–32), http://dx.doi.org/10.2139/ssrn.2843772 [https://perma.cc/7LUQ-3XBA] (making this argument with regard to shadow payment

All would tend to argue against some sort of closed insolvency system where the public interest is shut out in favor of bilateral or even multiparty private negotiation.

And indeed the entire notion of systemic importance undermines the basis for private bargaining.[120] That the failure of a SIFI affects not only the bank itself or its investors, but also other companies and individuals, inherently takes it out of the realm of private bargain and into a more general, public sphere.[121]

Turning to a more sensible conception of corporate bankruptcy, we have to acknowledge that modern bankruptcy courts play an active role in moving the case to confirmation of a plan.[122] Thus, chapter 11 is a multifaceted competition between various stakeholder groups and the debtor, with the court pushing the entire thing forward within a framework that we shorthand by reference to the "*pari passu* principle."[123]

A full theoretical conception of judging within chapter 11 is beyond the scope of this Paper. But the aim here is to contrast any reasonable conception of chapter 11 with the aims of financial institution insolvency. In short, we have to consider chapter 11, a multiparty negotiation conducted within the structure of creditor equality, with the policy aims of bank insolvency, broadly defined. A bankruptcy proceeding:

> is a specialized process for dispute resolution in connection with firms and individuals in financial or economic distress, but it is hardly narrow, technical, or specialized in substance. Bankruptcy cases frequently raise a broad range of legal issues beyond the intricacies of bankruptcy-specific doctrine. They routinely implicate non-bankruptcy-specific rules of decision and have done so throughout the modern history of federal bankruptcy law. Both as a matter of doctrine and theory, bankruptcy law aims to honor to the greatest extent

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systems).

120. *See* Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 198 (2008) (explaining the wide-ranging economic consequences of failed financial institutions and the resultant need to account for systemic risk).

121. *See* Saule T. Omarova, *Bankers, Bureaucrats, and Guardians: Toward Tripartism in Financial Services Regulation*, 37 J. CORP. L. 621, 627 (2012) ("Thus, financial crises directly implicate virtually every area of public concern, including housing, education, health care, labor markets, and environmental protection.").

122. *See* Melissa B. Jacoby, *What Should Judges Do in Chapter 11?*, 2015 U. ILL. L. REV. 571, 580–81 (chronicling the widespread nature of "active case management" by judges in chapter 11 proceedings).

123. *Cf.* Samuel L. Bufford, *Coordination of Insolvency Cases for International Enterprise Groups: A Proposal*, 86 AM. BANKR. L.J. 685, 692 (2012) (discussing the application of the *pari passu* principle to international insolvency cases); Christoph G. Paulus, *The Interrelationship of Sovereign Debt and Distressed Banks: A European Perspective*, 49 TEX. INT'L L.J. 201, 205 (2014) (highlighting the negative consequences of failing to follow the *pari passu* principle in international bankruptcy proceedings).

> possible the parties' non-bankruptcy entitlements. Typically, state common law or statutory rights make up those non-bankruptcy entitlements, and bankruptcy courts therefore must decide matters that require application of non-bankruptcy-specific common law or statutory provisions.[124]

In contrast, financial institution insolvency advances the policy goals of the legislature and financial regulators. Specifically, it advances the policy of regulators—including the legislature—at the point of financial distress.[125] Its primary aim is not adjudicatory, but rather regulatory.

The fact that bank insolvency has specific policy aims itself suggests an immediate point of difference with chapter 11. Whereas normal corporate insolvency provides a framework for negotiation, SIFI insolvency aims to preordain the outcome of the process.

A bankruptcy judge is an uneasy fit in such a process, inasmuch as the judge is left with little to do when the key decisions have all been made in advance by statute or regulation. An example is seen in OLA itself, where the court's sole role is to determine whether the Treasury Secretary's determination on two points—"that the covered financial company is in default or in danger of default and satisfies the definition of a financial company under § 5381(a)(11)"—was arbitrary and capricious.[126] After that the court is essentially told to "go away."[127]

The still-pending Financial CHOICE Act, a sweeping chapter 14-style bill that the House passed in June 2017,[128] follows a more extreme path. Although it purportedly replaces OLA with normal bankruptcy procedures, one of the first things to happen in a bank bankruptcy under the Act is the removal of all of the debtor's assets from the bankruptcy estate.[129] Essentially, the bankruptcy court is left to sort out a fight over the residue, while the bulk of the action happens off stage.

Indeed, after the initial transfer, everything will apparently be resolved under state trust law, presumably New York State's law. The bill provides that "[a]fter a transfer to the special trustee under this section, the special trustee shall be subject only to applicable nonbankruptcy law, and the actions

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124. Troy A. McKenzie, *Judicial Independence, Autonomy, and the Bankruptcy Courts*, 62 STAN. L. REV. 747, 773–74 (2010).

125. *See* Jonathan C. Lipson, *Against Regulatory Displacement: An Institutional Analysis of Financial Crises*, 17 U. PA. J. BUS. L. 673, 710 (2015) (arguing that financial institution insolvencies are regulated to achieve the policy goals of legislative bodies and regulatory agencies).

126. 12 U.S.C. § 5382(a)(1)(A)(iv) (2012).

127. *E.g.*, *id.* §§ 5382(a)(1)(B), 5388, 5390(a)(9)(D).

128. Financial CHOICE Act of 2017, H.R. 10, 115th Cong. Sec. 122, §§ 1181–1192 (2017) (as passed by the House June 8, 2017), https://www.congress.gov/bill/115th-congress/house-bill/10/text/eh? [https://perma.cc/Y6EN-YU5H].

129. *Id.* § 1186.

and conduct of the special trustee shall no longer be subject to approval by the [bankruptcy] court in the case under this subchapter."[130]

The CHOICE Act provides that the trust:

> shall be a newly formed trust governed by a trust agreement approved by the court as in the best interests of the estate, and shall exist for the sole purpose of holding and administering, and shall be permitted to dispose of, the equity securities of the bridge company in accordance with the trust agreement.[131]

Thus, the bankruptcy court has some fleeting power before approval of the trust, but that must be exercised under extreme time limits—perhaps as little as one day.[132]

The terms of the trust are only subject to a few vague rules, and the pronouncement that "the trustee shall confirm to the court that the [Federal Reserve] Board has been consulted regarding the identity of the proposed special trustee and advise the court of the results of such consultation."[133] The latter leaves open at least the theoretical possibility that a trustee could be appointed in the face of Fed objections—so long as the bankruptcy court is willing to sign the order.

The only other express role for regulators is a requirement that the trustee consult with the FDIC and the Fed before selling the shares of the debtor, and, again, the trustee must disclose the results of those discussions to the bankruptcy court.[134] The court, however, has no actual power over the trustee at this point.

Thus, an elected New York Supreme Court judge and (perhaps) the state attorney general will exercise some loose oversight over the process, but otherwise, the assets will largely disappear from the public eye. If that looks too menacing to management, the trust could be formed under the law of some other jurisdiction—indeed, there appears to be no express requirement that the trust be formed under domestic law. Thus, the bankruptcy court might have twenty-four hours to approve a trust governed by Manx law, to take one possible example.

The trust might even avoid application of the Bank Holding Company Act if it were established with a term of less than twenty-five years.[135] The underlying holding company that the trust owns would be subject to

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130. *Id.* § 1186(d).

131. *Id.* § 1186(a)(1).

132. *Id.* § 1185.

133. *Id.* § 1186(a)(2).

134. The regulators are given general standing to appear before the bankruptcy court. *Id.* § 1184.

135. 12 U.S.C. § 1841(b) (2012) (excluding any trust with terms of less than twenty-five years from the definition of "company," resulting in such trusts not being subject to BHCA regulation). Presumably the bankruptcy court, particularly if asked by regulators, could order compliance with the BHCA when transferring estate assets to the trust.

regulation, but the trust has the potential to be entirely opaque. This from legislation that is sold as increasing transparency.

In short, while a modern chapter 11 case features "hands on" judicial involvement, and that is a key feature of chapter 11 as practiced, such a role is inconsistent with the policy goals of a financial institution insolvency case. The CHOICE Act, the most prominent of the recent chapter 14 proposals, is at best a pretend bankruptcy case for financial institutions.

## IV. Facing Facts

At a broad level, the global financial system is designed to fail.[136] The very structure of SIFIs and the nature of the explicit and implicit governmental backstops baked into the system will always encourage banks to take ever-larger risks.[137] But this is inextricably linked to my earlier observation that banks supply social goods; as a nation, we like money and credit, but using the same institutions to provide both presents us with some important and awkward policy trade-offs.

Regulators inevitably find it impossible to keep up, since bankers will always beat them in resources and influence.[138] Nevertheless, because we worry about a world without big banks, and what it would look like, we tolerate this death-defying condition.[139]

In this context, the insolvency system for SIFIs matters quite a bit.[140] A bank near insolvency must not be allowed to operate, since shareholders have nothing left to lose from taking ever riskier bets, and have every incentive to leave taxpayers "holding the bag." The credibility of the threat to take the SIFI away from its owners—the shareholders and managers—and run it in the public interest is vital if this downward spiral is to be avoided.

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136. *See generally* ANAT ADMATI & MARTIN HELLWIG, THE BANKERS' NEW CLOTHES: WHAT'S WRONG WITH BANKING AND WHAT TO DO ABOUT IT (2013) (arguing that despite superficial reforms in the wake of the recent recession, the banking industry still practices risky financial behaviors that reflect a fragile banking system).

137. *See* Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem*, 89 OR. L. REV. 951, 1023–24 (2011) (arguing that Dodd-Frank fails to eliminate the incentive for large banks to rely on federal bailout programs when considering risky activities).

138. Henry T.C. Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457, 1463 (1993); *cf.* Frank Pasquale, *Law's Acceleration of Finance: Redefining the Problem of High-Frequency Trading*, 36 CARDOZO L. REV. 2085, 2114 (2015) (describing "the bleak realities at resource-starved agencies").

139. *See* Helen A. Garten, *Regulatory Growing Pains: A Perspective on Bank Regulation in a Deregulatory Age*, 57 FORDHAM L. REV. 501, 536–37 (1989) (describing different capital-regulation approaches aimed at motivating banks to avoid risk-taking behavior).

140. *But see* Jonathan R. Macey & Geoffrey P. Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153, 1157 (1988) ("Despite the surface plausibility of this theory, it is unlikely that a generalized bank panic like that which occurred during the Depression would occur today.").

One fundamental aspect of a credible SIFI insolvency system is that, upon activation, the outlines of "what will happen" are both clear and credible.[141] One part of that certainty traditionally comes from the complete protection of certain favored classes of creditors—that is, in bank insolvency, priority dominates over equality.

Another aspect of the clarity that SIFI resolution requires is an understanding at the outset of the process of how the resolution case will proceed.[142] Bank, broker–dealer, and insurance company resolutions all follow formally distinct insolvency models in this country, yet any such entity works through its insolvency with similar goals. For example, when a broker–dealer fails, customer accounts are moved to a healthy broker, any gap in customer assets is made up by SIPC, and the typical customer ceases to concern itself with the insolvency process.[143] Stockbrokers from the local Main Street broker to Lehman Brothers have followed this model.

Chapter 11 offers no similar certainty at inception. First, the parties might dispute and litigate the question of what "equality" looks like in any particular chapter 11 case. Next, the precise form of the reorganization plan is up for grabs in every case. Plans in one case are often modeled on what "worked" in a prior case, but the precise contours of the plan are largely unknown at the commencement of the case.

This uncertainty does not work in the context of financial institution insolvency.[144] And thus, banks are resolved without court involvement, and broker–dealers and insurance companies are resolved with court involvement only in the later stages of the process, when the issue becomes reconciling claims more than stabilizing the institution. These are fundamentally different processes from chapter 11.[145]

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141. *See* Edward J. Janger, *Treatment of Financial Contracts in Bankruptcy and Bank Resolution*, 10 BROOK. J. CORP. FIN. & COM. L. 1, 4–5 (2015) (highlighting the disorderly outcome of non-FDIC-administered resolutions in comparison to the predictable and prompt process of bank insolvency proceedings).

142. *See* Robert R. Bliss & George G. Kaufman, *U.S. Corporate and Bank Insolvency Regimes: A Comparison and Evaluation*, 2 VA. L. & BUS. REV. 143, 176–77 (2007) (concluding that "[r]educing uncertainties surrounding the bank-insolvency-resolution process would further reduce the adverse externalities from bank insolvencies" and "may also reduce the incentives for banks to engage in excessive risk taking and moral hazard").

143. Kenneth J. Caputo, *Customer Claims in SIPA Liquidations: Claims Filing and the Impact of Ordinary Bankruptcy Standards on Post-Bar Date Claim Amendments in SIPA Proceedings*, 20 AM. BANKR. INST. L. REV. 235, 243 n.48 (2012).

144. *Cf.* Andrea M. Corcoran, *Markets' Self-Assessment and Improvement of Default Strategies After the Collapse of Barings*, 2 STAN. J.L. BUS. & FIN. 265, 291 (1996) (asserting that flexibility in financial emergencies should not be compromised).

145. Irit Mevorach, *Beyond the Search for Certainty: Addressing the Cross-Border Resolution Gap*, 10 BROOK. J. CORP. FIN. & COM. L. 183, 213 (2015).

OLA tries to hide this reality by providing a thin veneer of judicial oversight at the outset of the case before quickly dispensing with the judge.[146] The CHOICE Act is in many respects even more disingenuous in that it pretends to be a normal bankruptcy process.[147] But the court loses control over the debtor's assets at the outset of the case, and the public agencies—the FDIC and the Fed—are not granted any meaningful participation in the process. Even the regulatory status of the post-transfer trust—which clearly should be considered "a financial holding company" under the Bank Holding Company Act, but might evade even that basic regulation—is left rather vague under the proposed Act.

The CHOICE Act pretends to be a bankruptcy case pretending to be a bank insolvency case, while being neither. Instead, it puts the bulk of the control in the hands of a private trustee who has broad control over the SIFI's assets with limited oversight. That trustee might be subject to only a state attorney general's normal power over trusts.

The entire chapter 14 project is based on this same basic misunderstanding of the goals of bankruptcy, as contrasted with the goals of SIFI resolution.[148] In theory, a SIFI could be resolved in a bankruptcy process, but policymakers have generally believed that the societal costs would be too high. And indeed, if we think back to the pre-FDIC bank receiverships—where depositors were mere unsecured creditors[149]—that supposition is likely correct.

Chapter 14 advocates point to the transparency of chapter 11 as a virtue to be lauded over normal bank insolvency procedures.[150] The latter, in their view, are too apt to become mechanisms of bailout and favoritism, whereas chapter 11 looks like a more virtuous market system. The question is whether realizing due process "up front"—as opposed to after the fact, in the form of

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146. Stephen J. Lubben, *A New Understanding of the Bankruptcy Clause*, 64 CASE W. RES. L. REV. 319, 409 (2013).

147. *See* John Crawford, *Lesson Unlearned?: Regulatory Reform and Financial Stability in the Trump Administration*, 117 COLUM. L. REV. ONLINE 127, 140 (2017) ("The CHOICE Act would repeal Title II of the Dodd-Frank Act and replace it with a new subchapter of the Bankruptcy Code, chapter 11, subchapter V.").

148. *See* Anna Gelpern, *Financial Crisis Containment*, 41 CONN. L. REV. 1051, 1102–06 (2009) (reviewing the policies, procedures, and decisions evaluated in bankruptcy considerations).

149. HIRSCH BRAVER, LIQUIDATION OF FINANCIAL INSTITUTIONS: A TREATISE ON THE LAW OF VOLUNTARY AND INVOLUNTARY LIQUIDATION OF BANKS, TRUST COMPANIES, AND BUILDING AND LOAN ASSOCIATIONS § 501 (1936).

150. *See* Hester Pierce, *Eliminating Dodd-Frank's Overrated Escape Hatch*, REALCLEAR MARKETS (May 25, 2017), https://www.realclearmarkets.com/articles/2017/05/25/eliminatingdodd-franksoverratedescapehatch102707.html [https://perma.cc/BN5V-W4AG] (calling bankruptcy "a predictable, time-tested, transparent mechanism"); *see also* Chadwick Welch, *Dodd-Frank's Title II Authority: A Disorderly Liquidation of Experience, Logic, and Due Process*, 21 WM. & MARY BILL RTS. J. 989, 992 (2013) (arguing that bank insolvency procedures "muddl[e] what should be a framework of transparent rules").

a lawsuit against the FDIC or other regulators—really works in conjunction with the policy goals that motivate bank-resolution mechanisms.

Arguably, the CHOICE Act itself tells us that the answer to this question is "no," since the actual in-court part of the process is so slight under the proposed law. If that is the best that the advocates of "bankruptcy for banks" can do, we might suspect that true bankruptcy will never actually work.

## Conclusion

Bank insolvency uses much of the language of "normal" insolvency. But bank resolution is not the same as chapter 11 or any other business insolvency process. Bank insolvency is about special priorities, whereas corporate bankruptcy is about creditor equality and bargaining. Too often, we let the similar language confound the analysis.

In an idealized world, bank insolvency is a purely technical project with fixed distributional consequences. In reality, particularly when the insolvency has systemic consequences, it takes on a political dimension as well. That is, while certain policy choices are made ex ante, through the choice of resolution mechanism, other policy choices will have to be made ex post, when failure actually happens.

All of the "super chapter 11" or "chapter 11 for banks" proposals—including the actually enacted OLA—attempt to put a judicial gloss on the policy and political process that is bank insolvency. Some, like the CHOICE Act, appear aimed at moving policy choices away from regulators by pretending to give power to judges, while actually moving policy choices to private actors.[151]

It is thought that this judicial veneer will provide a kind of legitimacy to bank insolvency that proponents believe was lacking in the rescue efforts in 2008. But, if taken seriously, the judicial role is entirely incompatible with efforts to contain a systemic crisis. Moreover, the veneer is quite apt to crack in any event: consider the broad role played by the U.S. and Canadian governments in the automotive bankruptcy cases, which involved at best marginally systemic debtors.[152] Somewhat confusingly, many of the critics of those cases nonetheless support some form of chapter 14.

If we do not take the judicial role in bankruptcy for banks seriously and see it as instead a smokescreen, the conclusions are even more disturbing. At best, the CHOICE Act—and proposals like it—are little more than disguised

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151. *See* Arthur E. Wilmarth, Jr., *The Financial Industry's Plan for Resolving Failed Megabanks Will Ensure Future Bailouts for Wall Street*, 50 GA. L. REV. 43, 57–58, 58 n.57 (2015) (discussing the benefits of a Wall Street proposal to private actors).

152. *See* Stephen J. Lubben, *No Big Deal: The GM and Chrysler Cases in Context*, 83 AM. BANKR. L.J. 531, 531, 536 (2009) (discussing governmental involvement in the Chrysler and General Motors chapter 11 bankruptcies).

power grabs by insiders designed to use rule of law concerns as a cover for a deregulatory agenda. When an actual systemic crisis comes, it seems inevitable that the need for governmental assistance will arise yet again, and we will be right back where we were in 2008.[153]

My goal has been to draw attention to the confused thinking involved in many current approaches to bank insolvency. Bank and business insolvency use similar language to describe fundamentally different mechanisms. Only by a return to first principles can we reach sensible policy analysis.

153. *See* Recent Case, State Nat'l Bank of Big Spring v. Lew, *795 F.3d 48 (D.C. Cir. 2015)*, 129 HARV. L. REV. 835, 839 (2016) (describing future OLA litigation concerns).

# Modified Universalism as Customary International Law*

Irit Mevorach**

## Introduction

"Modified universalism" is to date the dominant approach for addressing cross-border insolvency.[1] Heavily influenced by the scholarship and advocacy of Professor Jay Westbrook,[2] it has evolved into a set of norms that can guide parties in actual cases. Adapted to the reality of a world divided into different legal systems and myriad business structures and insolvency scenarios, modified universalism seeks to achieve global collective processes with efficient levels of centralization of insolvency proceedings. It thus requires the identification of a home country where proceedings would be centralized, except where it is efficient to open additional proceedings elsewhere.[3] This outbound aspect of modified universalism is complemented by a choice-of-law norm that, in principle, refers to the *lex fori concursus* (the law of the forum) with limited exceptions.[4] Norms concerning

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1. "Cross-border insolvency" (or international insolvency) means here any form of process or solution, including liquidation, reorganization, or restructuring processes, concerning commercial entities or financial institutions that have cross-border presence (e.g., assets, creditors, branches, or subsidiaries).

2. *See generally* Jay L. Westbrook, *A Global Solution to Multinational Default*, 98 MICH. L. REV. 2276 (2000) (recognizing modified universalism as the best interim solution to addressing multinational insolvencies before movement to a "true universalism" approach).

3. *See, e.g.*, REINHARD BORK, PRINCIPLES OF CROSS-BORDER INSOLVENCY LAW 23 (2017) (discussing the circumstances under which it may be reasonable to permit the commencement of additional proceedings); IAN F. FLETCHER, INSOLVENCY IN PRIVATE INTERNATIONAL LAW 16–17 (2d ed. 2005); ROY GOODE, PRINCIPLES OF CORPORATE INSOLVENCY LAW 786 (4th ed. 2011) ("But some leeway is also given to the concept of territoriality to accommodate the legitimate expectations of local creditors in relation to local assets. Thus the opening of territorial proceedings is permitted in a State where the debtor has an establishment or assets . . . ."); Jay L. Westbrook, *SIFIs and States*, 49 TEX. INT'L L.J. 329, 332 (2014) (advocating for the assignment of one jurisdiction as the *primer inter pares* to most effectively coordinate international financial crises).

4. *See, e.g.*, BORK, *supra* note 3, at 31 ("Second, the proceedings follow the law of the opening state (*lex fori concursus*), which not only boosts efficiency but also constitutes an aspect of universalism.") (citation omitted); Leif M. Clark & Karen Goldstein, *Sacred Cows: How to Care*

recognition, cooperation, and relief ensure that the global collective proceedings are given worldwide effect,[5] subject to specific safeguards where recognition or relief may be denied if universal standards of fairness, nondiscrimination, and due process are not respected.[6] Modified universalism has been quite prevalent in practice, including where key international instruments such as the UNCITRAL Model Law on Cross-Border Insolvency (Model Law)[7] and the EU Insolvency Regulation (EIR)[8] seem to generally follow its approach.[9] There are, however, still gaps in the cross-border insolvency system and in the available frameworks (even where instruments seem to generally embrace modified universalism), including in terms of the entities covered and the participating countries.[10] Generally, the

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*for Secured Creditors' Rights in Cross-Border Bankruptcies*, 46 TEX. INT'L L.J. 513, 515 & n.7 (2011) ("The focus on which country would act as the home court was done in anticipation of that country applying its own laws, including choice of law rules."); Jay L. Westbrook, *Universalism and Choice of Law*, 23 PA. ST. INT'L L. REV. 625, 634 (2005). Professor Westbrook observes:

> The emerging international rule in multinational bankruptcy cases focuses on the center of the debtor's main interests. Up to now, that standard has been adopted primarily as a choice-of-forum rule rather than a choice-of-law rule, but it is necessary to use it for both purposes to achieve the goals of universalism.

*Id.*

5. *See, e.g.*, BORK, *supra* note 3, at 32 (explaining that, for universalism to function, states must cooperate and offer their assistance, especially by recognizing and enforcing foreign proceedings); GOODE, *supra* note 3, at 786 (describing the key universalist elements, including recognition in other countries of the forum state's judgments and assistance by local courts in asset recovery); Westbrook, *supra* note 3, at 345 (noting the necessity of international coordination and cooperation in the management of distressed financial institutions).

6. Such circumstances can be grouped under the notion of "public policy."

7. *See generally* U.N. COMM'N ON INT'L TRADE L., UNCITRAL MODEL LAW ON CROSS-BORDER INSOLVENCY WITH GUIDE TO ENACTMENT AND INTERPRETATION, U.N. Sales No. E.14.V.2 (2014) (identifying as its four main features access to local courts for representatives of foreign proceedings; recognition of foreign proceedings; relief to assist foreign proceedings; and cooperation among courts and other competent authorities of the various states).

8. *See generally* Regulation 2015/848, of the European Parliament and of the Council of 20 May 2015 on Insolvency Proceedings, 2015 O.J. (L 141) 19, 19, 59 (EU) (repealing and recasting Council Regulation 1346/2000); Council Regulation 1346/2000 of May 29, 2000, on Insolvency Proceedings, 2000 O.J. (L 160) 1 (EC). The Council Regulation observes:

> The proper functioning of the internal market requires that cross-border insolvency proceedings should operate efficiently and effectively and this Regulation needs to be adopted in order to achieve this objective . . . . [T]here is a need for a Community act requiring coordination of the measures to be taken regarding an insolvent debtor's assets.

*Id.* The Recast EIR entered into force on June 26, 2017. *Id.* at 56. The regime applies directly to all EU member states except Denmark, which opted out. *Id.* at 29.

9. *See* GOODE, *supra* note 3, at 785–86 ("The current trend, as exemplified by the UNCITRAL Model Law on Cross-Border Insolvency and the EC Insolvency Regulation . . . is clearly in favour of a modified universalist approach . . . .").

10. For example, the Model Law has been adopted by only 45 jurisdictions. U.N. Comm'n on Int'l Trade Law, Status: UNCITRAL Model Law on Cross-Border Insolvency (1997), http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model_status.html [https://perma.cc/N7SN-V8UT]. It does not fully cover the cross-border insolvency and resolution

status of modified universalism is somewhat amorphous, and its norms are often perceived as broad principles or aspects of a general trend.[11]

This Article considers how modified universalism may be elevated from a broad approach to a recognized, international legal source that can be invoked and applied in a more concrete and consistent manner across legal systems in circumstances of international insolvencies alongside the application of written instruments where such instruments exist.[12] It draws from sources of international law, specifically the concept of customary international law (CIL), and shows that CIL is a key legal source that can fill gaps in international instruments, influence existing instruments, and regulate in areas not covered by instruments or regarding countries that are not parties to them. CIL is also useful in taking into account certain biases and territorial inclinations that can influence countries and implementing institutions' decisions and that can, therefore, impede movement towards the universal application of modified universalism.[13] CIL is a "debiasing" measure where its application does not require active action by all participants, such as entry into a treaty or enactment of model laws, as it operates as a default (opt-out) rule. It can thus overcome certain robust biases such as status quo and loss aversion.[14]

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of financial institutions—indeed, the absence of a uniform framework for cross-border insolvency of such institutions is a major gap in the international system for cross-border insolvency and resolution, Irit Mevorach, *Beyond the Search for Certainty: Addressing the Cross-Border Resolution Gap*, 10 BROOK. J. CORP. FIN. & COM. L. 183, 184, 218 n.160 (2015), and it does not fully or expressly cover all aspects of cross-border insolvency (for example, it does not provide specific rules concerning choice of law).

11. See for example the references of the U.K. court in *In re HIH Cas. & Gen. Ins. Ltd.* [2008] UKHL 21, [2008] 1 WLR 852 (appeal taken from Eng.), to a "principle rather than a rule," an "aspiration," and a "thread" or the reference of the U.S. court in *In re Nortel Networks, Inc.*, 532 B.R. 494, 558 (Bankr. D. Del. 2015), to "terms such as 'universalism.'"

12. I address the question of instrument choice, particularly the choice between a treaty regime or a regime based on a model law for cross-border insolvency, in IRIT MEVORACH, THE FUTURE OF CROSS-BORDER INSOLVENCY: OVERCOMING BIASES AND CLOSING GAPS 127–68 (2018).

13. *See generally* Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979) (developing the "prospect theory" in decision-making scholarship); Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCIENCE (n.s.) 1124 (1974) (showing how choices and decisions are strongly biased and often deviate in predictable ways from economically optimal behavior). "Behavioral international law" provides further theoretical grounds and indicative studies regarding the application of recognized biases in international law contexts. *See generally* Anne van Aaken, *Behavioral International Law and Economics*, 55 HARV. INT'L L.J. 421 (2014); Tomer Broude, *Behavioral International Law*, 163 U. PA. L. REV. 1099 (2015) (showing that bounds on decision-making may operate when actors in international law make decisions concerning international law issues).

14. *See generally* Christine Jolls & Cass R. Sunstein, *Debiasing Through Law*, 35 J. LEGAL STUD. 199 (2006) (analyzing how "debiasing" through law could work to address a variety of legal questions). In the context of international law, see generally van Aaken, *supra* note 13, at 449. *See also infra* Part II.

The normative implication is a policy push towards the transformation of modified universalism into CIL so that it can become part of the international insolvency legal order. This Article thus explores to what extent CIL can be utilized in the field of cross-border insolvency and considers possible obstacles in this regard. It proceeds as follows. Part I overviews the notion of CIL, including how it is formed and applied, its limitations and its continued significance. Part II considers the advantages of CIL from a behavioral perspective as a debiasing mechanism. Part III explores the obstacles that might be in the way of formalizing modified universalism as CIL in view of possible narrow perceptions of private international law and cross-border insolvency, as well as the way modified universalism has been conceptualized as an interim approach. Part IV argues that such perceptions are no longer merited. Cross-border insolvency law has a significant international role, and modified universalism has the characteristics of a standalone norm. Part V suggests steps to transition modified universalism from a general trend to CIL and demonstrates the benefits of such development for future international insolvencies.

## I. Customary International Law as a Key International Legal Source

### *A. Establishing CIL*

CIL is one of the key sources of international law,[15] widely acknowledged, and applicable in different legal traditions.[16] It has a privileged position in the international law system and forms the backbone of many areas of international law.[17] CIL arises from the general and consistent practice of states, where that practice is based on a belief in the conformity of the practice with international law.[18] This is the classical

15. Statute of the International Court of Justice, art. 38 (San Francisco, 26 June 1945), 3 Bevans 1179, 59 Stat. 1055, T.S. No. 993, *entered into force* 24 Oct. 1945. CIL is considered one of the three primary sources of international law, the other two being treaties and general principles of law. *See* Brigitte Stern, *Custom at the Heart of International Law*, 11 DUKE J. COMP. & INT'L L. 89, 89 (2011) (noting the centrality to the international order of both custom and treaty). "General principles of law" is a source close to CIL but one that refers to fundamental principles concerning substantive justice and procedural fairness and by which states are bound because of the universal understanding of basic legal concepts by all legal systems. Charles T. Kotuby Jr., *General Principles of Law, International Due Process, and the Modern Role of Private International Law*, 23 DUKE J. COMP. & INT'L L. 411, 412, 422 (2013).

16. ALAN WATSON, THE EVOLUTION OF LAW 43–44 (1985).

17. Andrew T. Guzman, *Saving Customary International Law*, 27 MICH. J. INT'L L. 115, 116 (2005).

18. *See* J.L. BRIERLY, THE LAW OF NATIONS: AN INTRODUCTION TO THE INTERNATIONAL LAW OF PEACE 59–60 (Sir Humphrey Waldock ed., 6th ed. 1963) ("Evidence that a custom in this sense exists in the international sphere can be found only by examining the practice of states . . . whether they recognize an obligation to adopt a certain course . . . [that] shows 'a general practice accepted as law.'"); VAUGHAN LOWE, INTERNATIONAL LAW 38 (2007) (describing the two

understanding of CIL, consistent with its description in the Statute of the International Court of Justice as "evidence of a general practice accepted as law."[19] It encompasses objective and subjective elements, which are complementary and intertwined.[20] The objective element of CIL requires sufficient evidence of state practice that follows the potential CIL.[21] Such evidence should show consistency and practice by various relevant actors, although not necessarily by all countries.[22] Additionally, the required recurrence of the practice may depend on the frequency of circumstances that require action pursuant to the CIL.[23] The subjective (psychological) element is what countries have accepted as law (*opinio juris*). Thus, evidence of state practice should be complemented by evidence that the practice is regarded as an expression of a rule of international law, a conviction that there was an obligation to follow the norm.

The primary and most direct evidence of the existence of CIL would be the actions of countries through the acts of their organs. Thus, when a country acts in a legally significant way or refrains from acting, it contributes to the development of state practice accepted as law. Countries' actions may be discerned, for example, from decisions to adopt certain legislation and from the decisions of national courts.[24] Additionally, treaties and conventions may point to the existence of CIL.[25] Various instruments that may be considered soft law may also provide evidence of an established CIL or contribute to the evolution of new CIL, being determinative of the *opinio juris* or of state practice.[26] Thus, a nonbinding instrument can have a legal effect on customary law. The wording in such an instrument is important because it

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essential components of customary international law: a general practice of states and a belief in the conformity of the practice with international law); HUGH THIRLWAY, THE SOURCES OF INTERNATIONAL LAW 53–91 (2014) ("It is in fact the consistency and repetition rather than the duration of the practice that carries the most weight.").

19. Statute of the International Court of Justice, art. 38(1)(b) (San Francisco, 26 June 1945), 3 Bevans 1179, 59 Stat. 1055, T.S. No. 993, *entered into force* 24 Oct. 1945.

20. THIRLWAY, *supra* note 18, at 62.

21. Hugh Thirlway, *The Sources of International Law*, *in* INTERNATIONAL LAW 91, 100–05 (Malcolm D. Evans ed., 2014).

22. *See* Curtis A. Bradley & Mitu Gulati, *Withdrawing from International Custom*, 120 YALE L.J. 202, 210 (2011) ("It is not clear how much state practice is required in order to generate a rule of CIL, although most commentators agree that [it] must be 'extensive' or 'widespread' . . . .") (citations omitted).

23. THIRLWAY, *supra* note 18, at 65, 67.

24. Jurisdictional Immunities of the State (Ger. v. It.: Greece intervening), Judgment, 2012 I.C.J. Rep. 99, ¶ 55 (Feb. 3).

25. Continental Shelf (Libya/Malta), Judgment, 1985 I.C.J. Rep. 13, ¶ 27 (June 3); *see* THIRLWAY, *supra* note 18, at 58–59 (describing the significance of the International Law Association's Report on the Formation of Customary International Law in studying the relationship between state practice and *opinio juris*).

26. Alan E. Boyle, *Some Reflections on the Relationship of Treaties and Soft Law*, 48 INT'L & COMP. L.Q. 901, 904 (1999).

must be "of a fundamentally norm-creating character such as could be regarded as forming the basis of a general rule of law."[27] It would also be important to consider the level of support given to the instrument by countries and any statements accompanying such instrument that may be relevant to the assessment of countries' beliefs about the conformity of the practice with international law.[28]

### *B. Effect of CIL*

Once CIL has become pervasive enough, countries are bound by it regardless of whether they have codified the laws domestically or through treaties. Unanimity among all countries is not required for it to have a universal effect. Likewise, if an obligation is included in a treaty but also amounts to CIL, it will also bind countries that are not parties to the treaty.[29] Countries in some cases, however, may be exempted from CIL. Under the doctrine of the "persistent objector,"[30] countries can consistently object to CIL (opt out) in its formative stages.[31] The threshold for being regarded a persistent objector is, however, very high, and the objection should be made widely known.[32] Persistent objections should also be made while the rule is still accumulating and before it becomes CIL. Thereafter, in principle, once the CIL is established, it is no longer possible to opt out of the rule except through specific bilateral agreements that establish a different rule.[33]

CIL may be invoked in domestic or international tribunals, yet the application of CIL does not depend on establishing international enforcement mechanisms. Application heavily relies on domestic enforcement structures. Thus, all nations seem to accept that CIL forms an integral part of national law[34] and that courts should take judicial notice of CIL.[35] When ascertaining

27. North Sea Continental Shelf (Ger./Den.; Ger./Neth.), Judgment, 1969 I.C.J. Rep. 3, ¶ 72 (Feb. 20); *see* Alan Boyle, *Soft Law in International Law-Making*, *in* INTERNATIONAL LAW 118, 130–33 (Malcolm D. Evans ed., 2014) (describing the importance of wording in nonbinding instruments that may create customary law).

28. Boyle, *supra* note 27, at 130–31.

29. THIRLWAY, *supra* note 18, at 35–36.

30. *See id.* at 86–88 (providing an overview of the persistent objector doctrine).

31. Bradley & Gulati, *supra* note 22, at 211; Guzman, *supra* note 17, at 164–65.

32. Dino Kritsiotis, *On the Possibilities of and for Persistent Objection*, 21 DUKE J. COMP. & INT'L L. 121, 129 (2010) (noting, for example, the circumstances in *Fisheries* (U.K. v. Nor.), Judgment, 1951 I.C.J. Rep. 116, 131 (Dec. 18), where it was ruled that "the ten-mile rule for the closing lines of bays 'would appear to be inapplicable as against Norway inasmuch as she has always opposed any attempt to apply it to the Norwegian coast'").

33. THIRLWAY, *supra* note 18, at 88.

34. Eileen Denza, *The Relationship Between International and National Law*, *in* INTERNATIONAL LAW 412, 426 (Malcolm D. Evans ed., 2014).

35. *See* MALCOLM N. SHAW, INTERNATIONAL LAW 99–100 (7th ed. 2014) (describing the doctrine of incorporation, which holds that customary international law is automatically part of the local law without any need for constitutional ratification).

the existence and nature of an alleged CIL, domestic courts may have recourse to various types of sources and authoritative material, including "international treaties and conventions, authoritative textbooks, practice and judicial decisions."[36] The actual implementation of CIL in national laws differs, however, to some extent, among jurisdictions.[37] In civil law jurisdictions, the general rule is that CIL takes precedence over inconsistent ordinary national legislation and directly creates rights and duties within the territory.[38] In common law jurisdictions, CIL is recognized as part and parcel of the legal system, and legislation is presumptively construed in a manner that would avoid a conflict with international law.[39]

### *C. Limitations and Critique*

CIL tends to be vague, and the way it emerges is rather unclear.[40] Furthermore, because CIL is based on an evolving experience, it is evidently problematic to ascertain when rules have reached the stage where they can be applied as CIL.[41] There is also a circularity problem. For a rule to qualify as CIL, countries should feel obligated to follow it, but how would countries feel such legal obligation before the rule becomes customary?[42] This uncertainty, as well as CIL's reliance on domestic enforcement mechanisms, also makes CIL prone to nonobservance, especially when it attempts to address difficult cross-border conflicts.[43] There have also been challenges to CIL for lacking a coherent theory and doctrine.[44] It is arguably impossible to observe the universe of countries' practices to be able to ascertain whether references to CIL are made out of obligation.[45] It has also been argued that

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36. The Cristina [1938] AC 485 (HL) 497 (appeal taken from Austl.).

37. *See* SHAW, *supra* note 35, at 99–127 (providing an overview of the implementation of CIL in national laws).

38. *See, e.g.*, Hans-Peter Folz, *Germany*, *in* INTERNATIONAL LAW AND DOMESTIC LEGAL SYSTEMS 240, 245 (Dinah Shelton ed., 2011) (describing CIL's precedence over German statutes and its creation of rights and duties for Germans); Giuseppe Cataldi, *Italy*, *in* INTERNATIONAL LAW AND DOMESTIC LEGAL SYSTEMS 328, 342–44 (Dinah Shelton ed., 2011) (describing Italy's practice of automatically incorporating CIL into its domestic legal system such that CIL assumes the force of constitutional law).

39. For example, CIL is part of the public policy of the UK and part of the domestic law and does not necessitate the interposition of a constitutional ratification procedure. SHAW, *supra* note 35, at 99–100.

40. *Id.* at 102.

41. THIRLWAY, *supra* note 18, at 54–55.

42. ANTHONY D'AMATO, THE CONCEPT OF CUSTOM IN INTERNATIONAL LAW 53, 66 (1971).

43. *See* Barbara C. Matthews, *Emerging Public International Banking Law? Lessons from the Law of the Sea Experience*, 10 CHI. J. INT'L L. 539, 556–57 (2010) (describing the questionable level of domestic enforcement of CIL and detailing the difficulties of codifying the Law of the Sea).

44. *See* THIRLWAY, *supra* note 18, at 231 (noting that CIL is one of international law's "intellectual puzzles"); KAROL WOLFKE, CUSTOM IN PRESENT INTERNATIONAL LAW, at xiii (2d ed. 1993) (describing the ambiguity of the term "custom" with regard to international law).

45. *See* Guzman, *supra* note 17, at 150–53 (highlighting the numerous interpretations of state

CIL does not actually affect country behavior and has little impact in view of the lack of enforcement mechanisms on the international level.[46] Another uncertainty revolves around the question of whose practice and opinion should be considered when attempting to identify the existence of CIL, including the extent to which non-state actors' actions should be taken into account, which countries' actions or omissions should be considered, and whether only the actions of countries that are affected or that are capable of taking action regarding a certain matter are relevant.[47] There is also a risk that CIL is too sticky and fails to allow for developments to meet changing circumstances and new needs of countries and of the international business and financial community.[48]

### *D. CIL's Continued Significance*

Notwithstanding the difficulties that CIL presents, it continues to hold a privileged position in the international legal system.[49] Furthermore, over time there has been some shift from relying only on induction from national practice in identifying CIL to deducing its emergence from broader data sets, including international pronouncements and activities of non-state actors.[50] Some scholars have also theorized CIL in functional terms, suggesting that CIL may be effective when countries interact repeatedly over time, and it may influence country behavior through reputational and direct sanctions.[51] It has also been considered that although the development of CIL might be a slow process, with technological changes, the rise of international institutions, and other developments, CIL may emerge more quickly than in the past.[52] The works of influential international committees of recent times

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practice in discussions of CIL).

46. JACK L. GOLDSMITH & ERIC A. POSNER, THE LIMITS OF INTERNATIONAL LAW 39 (2005); *see also* Guzman, *supra* note 17, at 128 (discussing the argument that because CIL lacks an enforcement mechanism, CIL does not affect state behavior).

47. THIRLWAY, *supra* note 18, at 59–61; *see also* Till Müller, *Customary Transnational Law: Attacking the Last Resort of State Sovereignty*, 15 IND. J. GLOBAL LEGAL STUD. 19, 28–30 (2008) (reviewing scholarship regarding non-state actors' influence on the formation of CIL).

48. THIRLWAY, *supra* note 18, at 68.

49. Niels Petersen, *Customary Law Without Custom? Rules, Principles, and the Role of State Practice in International Norm Creation*, 23 AM. U. INT'L L. REV. 275, 309 (2007) (arguing that such unwritten international law not only counts but "may even gain importance").

50. *See, e.g.*, Roozbeh B. Baker, *Customary International Law: A Reconceptualization*, 41 BROOK. J. INT'L L. 439, 446 (2016) (discussing the debate concerning "modern custom" and "traditional custom" viewpoints on customary international norms); Anthea Elizabeth Roberts, *Traditional and Modern Approaches to Customary International Law: A Reconciliation*, 95 AM. J. INT'L L. 757, 758 (2001) (describing the difference between traditional inductive and modern deductive methods of identifying custom).

51. *See, e.g.*, Guzman, *supra* note 17, at 134, 139 (noting the role that reputational and direct sanctions play in compliance with CIL).

52. *See, e.g.*, Bin Cheng, *Custom: The Future of General State Practice in a Divided World*, *in* THE STRUCTURE AND PROCESS OF INTERNATIONAL LAW 513, 532 (Ronald MacDonald & Douglas

provide further guidance regarding the manner of CIL formation and identification.[53] Importantly, regarding the subjective acceptance of CIL, it is explained that it should be "distinguished from mere usage or habit"[54] and may be negated where it can be shown that participants, when acting in a particular way, were motivated by considerations such as courtesy, convenience, or tradition rather than by a conviction that their acts amounted to CIL.[55]

It is recognized that CIL is binding on all countries whether or not they participated in the relevant practice. Any country in theory can affect CIL, and the position of countries may be considered even where they could not in fact take or refrain from taking an action.[56] Surely, where countries do possess the capacity to engage and interact with other parties, such countries would be more influential and thus privileged regarding the formation and shaping of CIL. However, the reliance of international law on the practice of the more powerful countries can ensure fewer deviations from and violations of CIL where such countries formed the rules. Constraining violations by powerful countries is crucial for the stability of the system, as the impact of breach could be much more pronounced and widespread when committed by such jurisdictions. In addition, because powerful countries are less affected by CIL violations (as they are more resilient to the implications of a breach), they may be less deterred by them. Therefore, it is another advantage if these countries play an important role in shaping the rules.[57]

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M. Johnston eds., 1983) ("[C]ustomary international law, instead of being sluggish and backward as a source of international law, is in fact dynamic, living, and ever-changing . . . .").

53. *See generally* Int'l Law Ass'n, *Statement of Principles Applicable to the Formation of General Customary International Law*, Final Report of the Committee, London Conference (2000) [hereinafter *Statement of Principles*] (attempting to create a practical guide with concise and clear guidelines for the application of customary international law principles); Int'l Law Comm'n, Rep. on the Identification of Customary International Law: Text of the Draft Conclusions Provisionally Adopted by the Drafting Committee, U.N. Doc. A/CN.4/L.872 (May 30, 2016) [hereinafter Draft Conclusions] (describing the way in which the rules of customary international law are determined).

54. Draft Conclusions, *supra* note 53, at 3.

55. *See Statement of Principles*, *supra* note 53, at 35 (describing the practice of sending condolences on the death of a head of state as an example of a practice that, although frequently observed as a matter of comity, does not give rise to a legal obligation); *see also* North Sea Continental Shelf (Ger./Den.; Ger./Neth.), Judgment, 1969 I.C.J. Rep. 3, ¶ 77 (Feb. 20). The court noted:

> The frequency, or even habitual character of the acts is not in itself enough. There are many international acts, e.g., in the field of ceremonial and protocol, which are performed almost invariably, but which are motivated only by considerations of courtesy, convenience or tradition, and not by any sense of legal duty.

*Id.*

56. *See* THIRLWAY, *supra* note 18, at 59–60 (noting, as to the question of whether customary international law existed with respect to the use of nuclear weapons, the fact that a majority of states did not possess nuclear weapons and could therefore neither choose to use them nor refrain from using them).

57. Guzman, *supra* note 17, at 151.

Today, treaty law covers many areas of international law. There are also various other ways for countries to cooperate through soft-law instruments.[58] However, CIL remains binding on countries even outside the treaty framework. The two sources operate in parallel, and the codification of CIL in a treaty does not abrogate the rule as CIL.[59] CIL still plays an important role "regulating both within the gaps of treaties as well as the conduct of non-parties to the treaties"[60] because countries are bound by CIL even if they have not expressed explicit consent. The effect of CIL is also important regarding matters that are not regulated by treaties or by other instruments and for newly emerging issues not yet covered by a treaty.[61] In addition, CIL can serve to influence treaty regimes and may be important and relevant for treaty interpretation where, for example, the treaty refers to rules of CIL.[62] Thus, important areas of international law, including the law of state responsibility, foreign direct investment, diplomatic immunity, human rights, and state immunity,[63] are governed wholly or partially by CIL where treaties are not universal, where a treaty is absent, or where the treaty does not cover all issues. CIL is in use, for example, in international investment law where certain aspects of regulating foreign investment have become settled international law[64] and where CIL remains of fundamental importance despite the proliferation of bilateral investment agreements in this field.[65]

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58. *See* Kal Raustiala, *Form and Substance in International Agreement*, 99 AM. J. INT'L L. 581, 614 (2005) (concluding that there has been a dramatic increase in international cooperation through contracts, unwritten understandings, and pledges).

59. *See* Military and Paramilitary Activities in and Against Nicaragua (Nicar. v. United States), Judgment, 1986 I.C.J. Rep. 14, ¶ 177 (June 27). The Court held:

> [E]ven if the customary norm and the treaty norm were to have exactly the same content, this would not be a reason for the Court to hold that the incorporation of the customary norm into treaty-law must deprive the customary norm of its applicability as distinct from that of the treaty norm.

*Id.*

60. Bradley & Gulati, *supra* note 22, at 209.

61. Where both a treaty and CIL regulate the same situation, normally the treaty is the prevailing *lex specialis*, at least regarding rules that existed at the time of the conclusion of the treaty. *See* Thirlway, *supra* note 21, at 108–09 (observing that even in a situation where customary law exists alongside treaty law, no problem of theory is raised, since the latter is free to modify customary entitlements).

62. Guzman, *supra* note 17, at 120 & n.18 (noting the example of the United States Model Bilateral Investment Treaty art. II (Apr. 1994), which refers to "treatment less favorable than that required by [customary] international law").

63. *Id.* at 116 n.1.

64. *See* Patrick Dumberry, *Are BITs Representing the "New" Customary International Law in International Investments Law?*, 28 PA. ST. INT'L L. REV. 675, 676–78 (2010) (describing the role of custom as a source of international law in the regulation of foreign investment).

65. CIL in this field includes, *inter alia*, the requirement of nondiscrimination, the fair and equitable treatment of foreign investors, the entitlement of foreign investors to national treatment once admitted into the country, and the requirement regarding nondiscriminatory regulatory measures and obligations to respect human rights by multinational companies. For more detail, see

### *E. CIL's Relevance to the Cross-Border Insolvency System*

The nature and characteristics of CIL make it an important legal source for a cross-border insolvency system based on modified universalism and a useful method to shape the international interactions in this subsystem of international law. CIL is responsive to emerging trends in practice. It is based on experience, and it can arise whether written instruments are applicable or not. It applies to all countries, whereby treaties or other instruments apply only to signatories or countries that adopted the instruments. Thus, if modified universalism is recognized as CIL, gaps in the cross-border insolvency system can be filled. Modified universalism is also sufficiently flexible—its emerging norms accommodate different types of business structures and different degrees of global or regional integration, and it can also adapt to changing conditions. Thus, it is akin to CIL, which as a legal source tends to be supple and adaptable. CIL is also not too rigid as a legal source, notwithstanding its universal application through general experience. It can develop gradually over time, and it is possible to change or create new CIL to meet the developing needs of nations.[66] Thus, conduct inconsistent with CIL may in relevant circumstances be a way to create new rules.[67] At the same time, where CIL represents an emerging, widespread, and normatively desirable practice, its tendency to stick is an important advantage.[68]

## II. The Behavioral Force of CIL

### *A. CIL as a Debiasing Mechanism*

CIL can also assist in overcoming territorial inclinations and biases.[69] Decision-makers, including actors making choices regarding issues of international law, may be inclined to avoid changes and cling to the status

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Surya P. Subedi, *International Investment Law*, *in* INTERNATIONAL LAW 727, 740–41 (Malcolm D. Evans ed., 2014). These rules may apply in the absence of a bilateral agreement, where agreements make reference to CIL, or to fill gaps in treaties when treaties are silent on certain issues.

66. THIRLWAY, *supra* note 18, at 69; *cf. id.* at 102 (noting the permanent nature of general principles of law).

67. The ICJ explained in this regard that "[r]eliance by a State on a novel right or an unprecedented exception to the principle might, if shared in principle by other States, tend towards a modification of customary international law." Military and Paramilitary Activities in and Against Nicaragua (Nicar. v. U.S.), Judgment, 1986 I.C.J. Rep. 14, ¶ 207 (June 27).

68. Rachel Brewster, *Withdrawing from Custom: Choosing Between Default Rules*, 21 DUKE J. COMP. & INT'L L. 47, 55 (2010) ("If customary international law already incorporates rules that are net welfare increasing for the international community, then a shift towards the [provision of more opt-out rights, including after formation,] may be welfare decreasing.").

69. For more detail on the possible operation of biases and bounds on decision-making in international law, and specifically in cross-border insolvency, see MEVORACH, *supra* note 12, at 49–79.

quo, especially where choices of certain options are perceived as resulting in a loss (e.g., loss of sovereignty or control over locally situated assets or entities), and more so if the choice requires active action.[70] Additionally, the way options are framed matter to people's choices. Specifically, cognitive psychology studies have shown the effect of legislative framing and the use of default options on choices between alternative options.[71] It has been shown, for example, that people favor agreements that are consistent with legal default rules or terms of trade that are conventional for the type of bargain at issue.[72] This may be due to the stress or sometimes physical effort involved in making changes, but it is also likely because defaults tend to be perceived as representing the existing status quo and the recommended, endorsed option.[73] Furthermore, switching from a default option may be perceived as a risk and a loss; thus, it may be weighed more heavily than the possible gains because of loss aversion.[74] Empirical research in international law concerning adherence to options in treaties has also shown the significant impact of default rules, which were likely perceived as the endorsed status quo position, on countries' (and their implementing institutions') choices.[75] More generally, behavioral international law studies have noted the

70. The existence of loss aversion, whereby losses are exaggerated and given greater weight than gains, and its link to a status quo bias and the endowment effect, has been observed in a wealth of empirical research, including neurobiological experiments, which showed that this pattern of behavior (responding differently to perceived losses as opposed to perceived gains, measured against a perceived status quo position) is tied to the brain's greater sensitivity to potential losses than to gains; experimental studies have also shown that loss aversion has a specific effect when considering *avoiding* an option verses *actively approaching* an option. *See generally* Nicholas D. Wright et al., *Approach-Avoidance Processes Contribute to Dissociable Impacts of Risk and Loss on Choice*, 32 J. NEUROSCIENCE 7009 (2012); Nicholas D. Wright et al., *Manipulating the Contribution of Approach-Avoidance to the Perturbation of Economic Choice by Valence*, 7 FRONTIERS IN NEUROSCIENCE 1 (2013).

71. *See* Daniel Kahneman et al., *Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias*, 5 J. ECON. PERSP. 193, 199 (1991) (pointing to studies showing the effect of such manipulation on a choice between alternative automobile insurance policies).

72. *See, e.g.*, Omri Ben-Shahar & John A.E. Pottow, *On the Stickiness of Default Rules*, 33 FLA. ST. U. L. REV. 651, 662 (2006) (explaining that a deviation from default terms can raise suspicion among parties); Daniel Kahneman et al., *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325, 1343–44 (1990) (concluding that participants' preferences were dependent upon their reference positions); Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608, 646–47 (1998) (stating that participants of the experiment preferred whichever contract term was the default term given).

73. *See, e.g.*, John Beshears et al., *The Importance of Default Options for Retirement Savings Outcomes: Evidence from the United States*, *in* NAT'L BUREAU OF ECON. RES., SOCIAL SECURITY POLICY IN A CHANGING ENVIRONMENT 167, 184–87 (Jeffrey R. Brown et al. eds., 2009) (describing this phenomenon in the context of experiments studying individuals' investment decisions regarding their savings plans).

74. Eric J. Johnson & Daniel Goldstein, *Do Defaults Save Lives?*, 302 SCIENCE 1338, 1338 (2003).

75. Jean Galbraith, *Treaty Options: Towards a Behavioral Understanding of Treaty Design*, 53 VA. J. INT'L L. 309, 352 (2013).

importance of default mechanisms in choice architecture in international law.[76] Thus, a rule can be set up as an opt-out rule or an opt-in rule. An opt-in rule means that the default is nonadherence to the rule. In an opt-out scheme, the default is adherence. If people tend not to deviate from default rules, there is an advantage in setting up opt-out rules, especially where universality of the application of the rule is critical. Thus, if sources of international law that provide an opt-out system are used, higher participation can be expected in comparison to opt-in systems.

CIL can be particularly advantageous as a debiasing mechanism of international law because CIL is an opt-out system where countries are bound by such CIL that has developed through the general practice of nations. Although CIL emerges from the consistent practice of countries, it is not a consensual mechanism. It does not require that countries agree to or enact the rule and as such does not represent a deviation from the status quo. The existence of CIL is based on an understanding that it is a norm of the international community. This does not necessarily mean, though, that a given country consents to the norm. Rather, the acceptance of the binding rule must be felt by countries generally.[77] Critically, to not be bound by the rule, a country needs to actively object to it.[78] As such, CIL is a mechanism of international cooperation that can promote universal application of the norm because opt-out rules are expected to increase participation, particularly on the global level, in the absence of mechanisms to impose regulation directly on countries' legal systems. It might be harder to ensure universal application through, for example, treaties, as treaties require an active opt-in. The fact that CIL requires adherence (or objection) to the rule in its entirety also promotes integrity in its application.[79] Thus, with no room for cherry-picking, it is more likely that the norm will remain uniform and coherent.

### *B. CIL: Shifting the Reference Point*

Outcomes are perceived as gains or losses usually relative to a reference point that people denote during the decision-making process, "rather than as

76. *See* Broude, *supra* note 13, at 1140–41 (noting how individuals have a tendency to adopt default rules even when they are inefficient); van Aaken, *supra* note 13, at 450–52 (explaining how choice architecture, through default rules' opt-in/opt-out mechanisms, provides a framework through which to view international law). Choice architecture is the study of how the ways in which options are presented affect decision-making. *See* RICHARD H. THALER & CASS SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 3 (2009) (defining a choice architect as someone responsible for organizing the context of decision-making).

77. Andrew T. Guzman, *Against Consent*, 52 VA. J. INT'L L. 747, 776 (2012).

78. The emergence of the persistent objector doctrine, see *supra* note 30 and accompanying text, may have been part of an effort to make international law less consensual. Bradley & Gulati, *supra* note 22, at 240.

79. Van Aaken, *supra* note 13, at 452.

final states of wealth or welfare."[80] The reference point usually corresponds to the current asset position (status quo) whereby gains/losses are deviations from the reference point.[81] Thus, a negative perception of modified universalism outcomes is expected particularly where the country's reference point is a regime generally based on territorialism, namely if the country does not have an established internationalist approach in its domestic methods for addressing cross-border insolvency. A modified universalist CIL can, in addition to applying directly in areas not covered by treaties or other instruments, also indirectly promote the adoption of instruments (such as the Model Law) where these instruments reflect modified universalism. A strong leading norm, elevated from a trend to CIL, may gradually affect the reference points of countries and implementing institutions and level the playing field. When recognized as CIL, countries may feel more obliged to follow modified universalism and, over time, assimilate it into the legal system. Thus, adherence to instruments that are premised on modified universalism would less likely be perceived as a change and as a loss.

## III. Conceptual Impediments

### *A. Public and Private International Law as Distinct Disciplines*

Notwithstanding the rather widespread adherence to modified universalism, it has not been invoked or applied as CIL. Modified universalism is not explicitly embraced in the global instruments for cross-border insolvency. Courts in common law jurisdictions often apply common law notions akin to a universalist/cooperative approach, noting that modified universalism is recognized as a broad principle under common law, or they apply the notion of comity. Yet, comity entails different interpretations and is not universal.[82] Modified universalism that could be applied as a universal and uniform norm has usually been considered a broad concept within the constraints of domestic, private international law to the extent that if we were to try identifying it now as CIL, it would be difficult to show consistent practice that is based on belief in the conformity of the practice with international law, and therefore CIL might be disproved. The problem could lie in a narrow perception of cross-border insolvency law as a legal field addressing procedures and technicalities. Because cross-border insolvency law primarily regulates the private international law of insolvency, it can be

80. Kahneman & Tversky, *supra* note 13, at 274. Values are attached to changes rather than to final states, and the perception of changes is also affected by past and present context of experience. *Id.* at 274, 277.

81. *Id.* at 274.

82. It generally refers to the tradition among judges within the common law camp to cooperate and assist foreign jurisdictions. *See* FLETCHER, *supra* note 3, at 17 (contrasting comity with insularity). But its precise meaning is quite elusive.

understood as a field disconnected from public international law and public international law sources. As such, cross-border insolvency law might not be sufficiently influenced by international laws and might not engage in creating CIL.

The relation between private and public international law has been a subject of much debate and considerable theoretical development.[83] In the early nineteenth century, private international law was perceived as a category and an integral part of public international law pursuant to the idea of a unitary international law based on the traditions of *Roman jus gentium*, the *Statutists*, and the natural law; in the latter half of that century, it evolved and crystallized as a separate field with a distinct role.[84] Pursuant to this (modern) traditional separation of roles, public international law governs the relations between nations, provides a legal framework for organized international relations, and addresses the rights and obligations of countries with respect to other countries or individuals. Private international law, on the other hand, deals with the domestic laws of countries that govern conflicts between private persons. Against this backdrop, it has been doubted that rules that are fundamental to private international law (e.g., the rule that rights in rem as applied to immovable and movable property are governed by the *lex situs*, or that form is governed by the *lex loci actus*) could and have generated customary (public) international law.[85]

Generally, the traditional division between private and public international law and the evolution of private international law as a domestic legal order regulating in the domain of private interests contributed to the gradual isolation of private international law from public international law and the general exclusion of a role for international sources.[86] This model has resulted in a private international law system that does not contribute much

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83. *See, e.g.*, K. LIPSTEIN, PRINCIPLES OF THE CONFLICT OF LAWS, NATIONAL AND INTERNATIONAL 63–64 (1981) (examining the influence of public international law on its private counterpart); Kotuby, *supra* note 15, at 411–12, 433 (2013) (noting the increasingly global discourse surrounding private international law); Ralf Michaels, *Public and Private International Law: German Views on Global Issues*, 4 J. PRIV. INT'L L. 121, 121–22 (2008) (describing scholars' different perspectives on public and private international law depending on their geographical and historical context); Ole Spiermann, *Twentieth Century Internationalism in Law*, 18 EUR. J. INT'L L. 785, 788–89, 792 (2007) (providing an historical overview of public and private international law); John R. Stevenson, *The Relationship of Private International Law to Public International Law*, 52 COLUM. L. REV. 561, 564–67 (1952) (analyzing the diverse views of scholars regarding the proper relationship between public and private international law).

84. *See generally* Stevenson, *supra* note 83 (describing the historical relationship between private and public international law).

85. PAVEL KALENSKY, TRENDS OF PRIVATE INTERNATIONAL LAW 17–18 (1971); LIPSTEIN, *supra* note 83, at 64–65.

86. *See* Alex Mills, *The Private History of International Law*, 55 INT'L & COMP. L.Q. 1, 44–45 (2006) ("By defining private international law as part of domestic law, it defines private international lawyers as domestic, not international; it emphasizes their attachment to a sovereign territory.").

to the ordering of international private relations but instead often adds to the complexity of international transactions—as private international laws of different systems often conflict or operate with broad exceptions, creating uncertainty and costs.[87] This division of roles between private and public international law also arguably constrains the ability to regulate the important domain of private international interaction in view of the operation of private power in the global economy.[88]

### *B. Cross-Border Insolvency as a System of Procedural Private International Law*

That cross-border insolvency is a body of specific and narrow rules concerning insolvency procedures has been a common understanding and description of this area of the law.[89] Often, international insolvency does not exist as a "systematically elaborated legal framework" and the domestic private international laws apply.[90] Cross-border insolvency has been generally regarded as "an arcane and rarified area of specialization."[91] Narrow assumptions concerning the role of cross-border insolvency have been notable in the practice and observed in the Eighties and early Nineties. It has been noted that countries have generally presumed that international insolvency is an aspect of private law.[92] Such views resulted in limited interest of countries in the field of cross-border insolvency where countries have confined their role to the regulation of procedure concerning international insolvency. This peripheral interest of governments has also arguably constrained negotiations on insolvency treaties and could explain the general failure in concluding treaties in this field.[93]

The approach to cross-border insolvency has evolved over time, and importantly, there has been growing recognition of the difficulty to control cross-border insolvencies efficiently by relying on the domestic private international laws of national systems. It has been acknowledged that domestic private international laws related to insolvency have preserved the problem of diversity and conflicts between national laws.[94] Consequently,

87. *Id.* at 45–46.

88. A. Claire Cutler, *Artifice, Ideology and Paradox: The Public/Private Distinction in International Law*, 4 REV. INT'L POL. ECON. 261, 279 (1997); Mills, *supra* note 86, at 46.

89. BOB WESSELS, INTERNATIONAL INSOLVENCY LAW 1 (4th ed. 2015).

90. *Id.* at 4.

91. FLETCHER, *supra* note 3, at 6–7.

92. *Id.* at 5.

93. Thomas M. Gaa, *Harmonization of International Bankruptcy Law and Practice: Is It Necessary? Is It Possible?*, 27 INT'L LAW. 881, 897 (1993); John Honsberger, *The Negotiation of a Bankruptcy Treaty* (1985), *reprinted in* MEREDITH MEMORIAL LECTURES: BANKRUPTCY—PRESENT PROBLEMS AND FUTURE PERSPECTIVES 287, 291 (1986).

94. FLETCHER, *supra* note 3, at 6–7.

hugely influential uniform frameworks have emerged, notably the Model Law. Yet, as international instruments that attempt to regulate the specialized field of cross-border insolvency, they, too, can be understood as merely providing certain tools to address private international procedures more efficiently but not as creating general norms that intend to influence substantive results.[95] The important framework for cross-border insolvency applicable in Europe (the EIR) has also evolved as an aspect of the European Community private international law system.[96] It has been observed that the European insolvency framework has not provided a uniform and comprehensive legal framework.[97] In all, the important advance of cross-border insolvency regimes has been tempered by a modest approach concerning the role of cross-border insolvency law and of the frameworks that are being devised to govern cross-border insolvency cases.

### C. *Modified Universalism as a Transitory Approach*

A tendency to underrate the role of cross-border insolvency is exacerbated where modified universalism is perceived as an interim solution, inextricably linked to the aspiration to achieve pure universalism.[98] At least in theory, pure universalism is often considered the ultimate ideal for regulating cross-border insolvency and modified universalism the best solution pending movement to true universalism.[99] Modified universalism is thought to provide a pragmatic transitory approach whilst country laws still differ and could foster the smoothest transition to true universalism.[100]

It is inevitable, however, that whilst modified universalism remains conceptually transitory, its ability to solidify and become CIL is undermined. CIL must represent settled obligatory practice;[101] therefore, a transitory doctrine would be an oxymoron. True, rules or principles of a temporary character may stay in such an interim state for a long time and until a new regime develops. CIL can change, and new CIL can emerge when conduct inconsistent with it may in relevant circumstances show the appearance of new rules. CIL does not have to stay still. Yet, for CIL to emerge in the first place, it should be demonstrated that it is followed consistently based on the belief about the conformity of the practice with international law. It may be difficult to form such a type of law, however, where modified universalism

95. *See, e.g.*, Bank of W. Austl. v. David Stewart Henderson [No. 3] [2011] FMCA 840, ¶ 43 (Austl.) ("[The Model Law] was promoted as having a procedural effect as opposed to a substantive effect that might have included automatic recognition and enforcement or effects.").

96. WESSELS, *supra* note 89, at 6.

97. *Id.* at 7.

98. For discussion of the proposition that cross-border insolvencies should always be unitary and universal, see BORK, *supra* note 3, at 28–29; FLETCHER, *supra* note 3, at 11.

99. Westbrook, *supra* note 2, at 2277.

100. *Id.*

101. *See supra* subpart I(A).

is in this midpoint between an interim solution and a fundamental norm and is conceptually linked to another presumably better approach, thus representing a transitory stage in the development of more ideal rules.

## IV. Reconceptualization: The International Role of Cross-Border Insolvency

### *A. Internationalization of Private International Law*

Gradually since the twentieth century, and more so in recent decades, the division between private and public international law has become uncertain and blurred.[102] The traditional separation of roles of the two fields no longer fits with the current state of globalization or with modern intervention by countries in terms of regulating private market activities, adding a public component or public-interest component to private business law.[103] The conceptualization of the relationship between private and public international law and of the role of private international law is in a state of evolution, too, because of these changes in world realities. It is becoming clear that private international law of a narrow character cannot properly address modern challenges in an increasingly interconnected world.[104] It has been noted that while international disputes in the past were largely limited to regional relations among close legal systems, the discourse has become truly global in recent decades.[105] Therefore, private international law should not be perceived as a mere system of technical rules regarding the proper forum, law, and the facilitation of recognition and enforcement of foreign judgments.[106] Furthermore, private international law should not insulate itself and attempt to regulate private interactions separately from the broader international order, as such isolation obscures the operation of private power in the global political economy.[107]

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102. *See, e.g.*, Michaels, *supra* note 83, at 121–22 (discussing the recent trend toward merging the fields of private and public international law); Spiermann, *supra* note 83, at 793–94 ("The 'internationalist' school according to which private international law was part and parcel of public international law still claimed many followers in early 20th century theory."). *See generally* ALEX MILLS, THE CONFLUENCE OF PUBLIC AND PRIVATE INTERNATIONAL LAW (2009) (challenging the distinction normally drawn between public and private international law by exploring the ways in which the former shapes, and is given effect by, the latter).

103. *See, e.g.*, Michaels, *supra* note 83, at 122–23 (discussing how the distinction between private and public international law has become less clear).

104. Kotuby, *supra* note 15, at 411–12.

105. *Id.*

106. *See id.* at 412 (arguing that private international law should have an interest and a meaningful role to play in identifying and ensuring compliance with general international principles regarding the way transnational disputes are resolved).

107. *See* Cutler, *supra* note 88, at 279 ("[T]he public/private distinction operates ideologically to obscure the operation of private power in the global political economy.").

There are also growing overlaps and intersections of the roles of each field in practice. Thus, public international law shows a rising interest in economic relations, and multinational corporations and individuals are no longer outside its remit.[108] It has also been noted that public international law is becoming domesticated and more technical.[109] Importantly, the result of increasing intersections and overlaps between private and public international law has been a gradual expansion of the role and scope of private international law.[110] Thus, many of the tasks of private international law, for example, its dealing with recent problems of sovereign state insolvency, might have previously been viewed as belonging to public international law.[111]

Movement towards the internationalization of private international law has been apparent for some time with the conclusion of treaties and other international instruments in recent years on matters of jurisdiction, choice of law, and recognition and enforcement of foreign judgments.[112] This trend has coincided with the internationalization of national economies and their increased interdependence. Internationalization can also be seen in the rise of international commercial law and its development from the early stages of the Merchant Law to modern legal orders on a transnational scale.[113] International organizations have been playing a significant part. For example, UNCITRAL has been charged with the task of coordinating global law reform to support international trade.[114] In this gradual reunification of private and public international law, private international law is not

108. *See, e.g.*, Andrew T. Guzman, *A Compliance-Based Theory of International Law*, 90 CALIF. L. REV. 1823, 1826 (2002) (discussing the need for a coherent theory of compliance given international law's increased pertinence to global economic and business relations).

109. Anne-Marie Slaughter & William Burke-White, *The Future of International Law Is Domestic (or, the European Way of Law)*, 47 HARV. INT'L L.J. 327, 327 (2006).

110. Michaels, *supra* note 83, at 123.

111. *Id.* at 137.

112. *See generally* Regulation 2015/848, 2015 O.J. (L 141) 19 (EU) (recognizing that an international agreement is necessary to effectuate cross-border insolvency proceedings); Council Regulation 1215/2012, 2012 O.J. (L 351) 1, 3 (EU) (promulgating rules and principles for jurisdictional issues and for the recognition and enforcement of judgments in international civil and commercial matters); U.N. COMM'N ON INT'L TRADE LAW, UNCITRAL MODEL LAW ON CROSS-BORDER INSOLVENCY WITH GUIDE TO ENACTMENT AND INTERPRETATION, U.N. Sales No. E.14.V.2 (2014) (identifying as its purpose the provision of "effective mechanisms for dealing with cases of cross-border insolvency"); THE HAGUE CONFERENCE ON PRIVATE INTERNATIONAL LAW, https://www.hcch.net/ [https://perma.cc/7RG9-42PS].

113. Harold J. Berman, *The Law of International Commercial Transactions*, 2 EMORY J. INT'L DISP. RESOL. 235, 243 (1988). For a summary of these developments, see Rosalind Mason, *Cross-Border Insolvency and Legal Transnationalisation*, 21 INT'L INSOLV. REV. 105, 108–12 (2012).

114. *See* G.A. Res. 2205 (XXI), at ¶ 8 (Dec. 16, 1966) (directing UNCITRAL to engage in a varicty of tasks to "further the progressive harmonization and unification of the law of international trade").

swallowed by or fully merged with public international law. Rather, its role and scope are augmented.[115]

### *B. Substantive and International Impact of Cross-Border Insolvency*

The increased role of private international law and the relevance of public-international-law sources to the mission of private international law should be highlighted more in the context of cross-border insolvency. A broad internationalist approach assigned to private international law is particularly justified in the field of insolvency where private and public interests intersect: insolvency law is considered "meta-law."[116] Insolvency principles are closely linked to fundamental public policy and social goals, and insolvency outcomes can impact the economy and the wider public.[117] Cross-border insolvency law is not merely procedural but also affects substantive rights, even where it is mainly confined to the harmonization of private international laws pertaining to insolvency.[118] Through a cross-border insolvency framework, it is possible to enforce a collective insolvency process on the global level, including by requiring the transfer of assets to the central proceedings and imposing additional duties and requirements regarding the conduct of such proceedings with the important substantive result of equitable treatment of creditors wherever located. Cross-border insolvency can also do more than connect national legal systems. It can engage in the identification of best practices and in the formulation of international standards, and it can prevent financial collapse.[119]

Cross-border insolvency is of a true international nature, as many cases of general default involve multinational enterprises with branches and subsidiaries spanning multiple countries. The way a court or authority in one country handles international insolvency cases often has significant implications across borders in numerous jurisdictions, affecting a broad range of stakeholders. As aforementioned, the administration of cross-border

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115. Michaels, *supra* note 83, at 137–38; *see also* Robert Wai, *Transnational Liftoff and Juridical Touchdown: The Regulatory Function of Private International Law in an Era of Globalization*, 40 COLUM. J. TRANSNAT'L L. 209, 219–20 (2002) (describing the doctrinal reforms in private international law).

116. Manfred Balz, *The European Union Convention on Insolvency Proceedings*, 70 AM. BANKR. L.J. 485, 486 (1996).

117. The claim that insolvency law's role is merely procedural and should be confined to the respect of pre-acquired rights through orderly distribution of the estate has been strongly rejected by proponents of the "traditionalist" approach. *See generally* Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775 (1987). *Cf.* Thomas H. Jackson, *Translating Assets and Liabilities to the Bankruptcy Forum*, 14 J. LEGAL STUD. 73, 75 (1985) (contending that the traditional approach to bankruptcy distributes assets in a suboptimal way that is different from how a sole owner would have them distributed).

118. *See* BORK, *supra* note 3, at 17–18, 113–14 (setting out the various procedural and substantive aspects of insolvency law).

119. WESSELS, *supra* note 89, at 2–3.

insolvencies can also have an impact on the public and the economy at large.[120] Indeed, international insolvencies and, to an even larger extent, multinational defaults of financial institutions often not only affect the private business community but might influence wider public interests and even threaten the economic and political stability of nation-states.[121] The collapse of Lehman Brothers and other institutions during the global financial crisis are notable examples.[122] The insolvency of Hanjin Shipping in 2016, as well, is an example of how the filing of bankruptcy in one jurisdiction can present paramount global challenges. There, it was a matter of public interest that the South Korean proceedings be swiftly recognized so that cargo worth millions of dollars could resume moving to its various destinations.[123]

The international insolvency regime is a critical component of the international economic framework. The effective resolution of cross-border insolvency contributes to international trade and investment, as the United Nations General Assembly acknowledged when initiating the work in this field.[124] Cross-border insolvency of banks and other financial institutions is also an integral aspect of the global financial system and the architecture of international financial law.[125] Already, and for several decades now, transnational actors have been engaged in the creation of standards in insolvency and the development of frameworks for cross-border insolvency. Against the backdrop of the general evolution of private international law,

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120. *See* Douglass G. Boshkoff, *Some Gloomy Thoughts Concerning Cross-Border Insolvencies*, 72 WASH. U. L.Q. 931, 935 (1994) (commenting that "[b]ankruptcy law has become so important to the national economy that reform no longer can be left to a few academics and insolvency practitioners").

121. Gaa, *supra* note 93, at 909.

122. The collapse of Lehman Brothers nearly brought down the world's financial system in 2008. Mevorach, *supra* note 10, at 194.

123. The former General Counsel for Hanjin Shipping America noted:

> When Hanjin Shipping, once the seventh largest container carrier in the world and the fourth largest container carriers in the transpacific (Asia – U.S. & Canada) trade, filed for bankruptcy, few believed that a 'too big to fail' organization like Hanjin would not be given a government bail-out. So, naturally, no one really appreciated the kind of disruption and losses that would subsequently affect the global supply chain.

Wook Chung, *Hanjin Shipping: From the Eye of the Storm and Back*, MARINE LOG (Mar. 8, 2017), http://www.marinelog.com/index.php?option=com_k2&view=item&id=25323:hanjin-shipping-from-the-eye-of-the-storm-and-back&Itemid=230 [https://perma.cc/5J2F-S46U].

124. *See* G.A. Res. 52/158, ¶ 6 (Dec. 15, 1997) (resolving that the UN is "convinced that fair and internationally harmonized legislation on cross-border insolvency that respects the national procedural and judicial systems and is acceptable to States with different legal, social and economic systems would contribute to the development of international trade and investment").

125. *See* CHRIS BRUMMER, SOFT LAW AND THE GLOBAL FINANCIAL SYSTEM: RULE MAKING IN THE 21ST CENTURY 233–34, 319–24 (2015) ("Cross-Border bankruptcy has been largely operationalized as an outgrowth of domestic (national policy). . . . [and] authorities have begun to coordinate . . . how cooperation would arise between jurisdictions should a multinational bank or firm fail.").

such work on international frameworks for insolvency should continue to develop within their broader international context.

### C. *Separation of Modified Universalism from the Pure Theory of Universalism*

In accordance with its international role, the cross-border insolvency system should strive to transform modified universalism to an established, binding CIL. Conceptually, this requires that modified universalism is no longer regarded as a transitory doctrine linked to pure universalism but rather a standalone norm. Such conceptual separation is also justified where it is *modified* universalism that provides concrete rules fitting with business and legal realities, thus guiding parties in actual cases. Pure universalism offers the most viable theoretical model for cross-border insolvency when it envisages a collective process on the global level encompassing all stakeholders whose interests are implicated and all assets wherever located. Yet modified universalism translates the model to a practical approach.[126]

Would such conceptual separation risk, however, the further spread and application of universalism? Arguably, formalizing modified universalism might make participants more reluctant to follow it. It might be that it is this humility and modesty attached to modified universalism that allowed it to grow through "incrementalism."[127] It may be conceived that rather than making explicit proclamations about the intentions of frameworks and pointing to concrete international laws, it is better to provide tools that achieve the same intentions without "scaring off" countries from participating in the regime.

Yet if modified universalism is eventually transformed to CIL, it can benefit from the additional advantage that it can operate as a debiasing mechanism: namely, it can, at least to some extent, address countries' aversions and reluctance to adhere to modified universalist instruments. Furthermore, by concealing the justificatory basis (the source) of certain solutions and focusing on technical results, there is a risk that both the frameworks' design and the application of the rules they prescribe would be inconsistent. It is also more difficult to fill in gaps in the system in the absence of a general, settled norm. Finally, it was perhaps the case in the earlier stages of development of the cross-border insolvency system that some obscurity regarding its norms was merited so that frameworks could gain the initial traction and expand. Yet the cross-border insolvency system has gone

126. *See* MEVORACH, *supra* note 12, at 1–48, for a discussion of the evolution of modified universalism from the theory of pure universalism.

127. John A.E. Pottow, *Beyond Carve-Outs and Toward Reliance: A Normative Framework for Cross-Border Insolvency Choice of Law*, 9 BROOK. J. CORP. FIN. & COM. L. 197, 198 (2014) (suggesting, however, an *independent* normative theory for choice of law based on modified universalism); John A.E. Pottow, *Procedural Incrementalism: A Model for International Bankruptcy*, 45 VA. J. INT'L L. 935, 939 (2005).

through significant development, and the main cross-border insolvency instrument (the Model Law) has been adopted in a significant number of countries. It is now, therefore, time to stabilize the system further, including through greater clarity about its underlying norms and their legal status.

Such separation and the use of CIL as a source for cross-border insolvency, while requiring that modified universalism is understood and used as a stand-alone norm, should not cause concern to proponents of incremental developments in this field. The use of CIL does not preclude developments. Because it is a source that is flexible and changeable, it can evolve over time, and it is possible to change or create new CIL to meet the developing needs of nations.

## V. Transformation: Modified Universalism Becoming CIL

### *A. Evidence of a General Practice Accepted as Law*

Modified universalist approaches are already widespread in practice. Modified universalism seems to have generally guided the key existing frameworks for cross-border insolvency. These frameworks, in particular the Model Law, have been applied quite successfully by participating countries.[128] This practice is also not confined to a few specific jurisdictions, although it is undoubtedly more paramount in certain countries and regions. It is also not limited to specific entities, though a modified universalist practice is less established with regard to multinational enterprise groups and financial institutions.[129] The usage of cross-border insolvency protocols and the increased cooperation between courts and between insolvency representatives in cross-border insolvencies are also demonstrations of a modified universalist practice.[130]

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128. *See* Irit Mevorach, *On the Road to Universalism: A Comparative and Empirical Study of the UNCITRAL Model Law on Cross-Border Insolvency*, 12 EUR. BUS. ORG. L. REV. 517, 550 (2011) (showing that the Model Law has been implemented and applied by countries in quite a universalist manner); *see also* Jay L. Westbrook, *An Empirical Study of the Implementation in the United States of the Model Law on Cross Border Insolvency*, 87 AM. BANKR. L.J. 247, 268 (2013) (showing the success of the Model Law's application in the United States).

129. *See, e.g.*, Mevorach, *supra* note 10, at 184 (noting that the Model Law does not specifically address international financial institutions); *see also* Barbara C. Matthews, *Prospects for Coordination and Competition in Global Finance*, 104 AM. SOC'Y INT'L L. PROC. 289, 291–92 (2010) (identifying some convergence of key rules pertaining to the resolution of banks that may amount to CIL but also noting the gap in the cross-border resolution system).

130. It was already suggested in the Nineties that cross-border insolvency Concordats and cross-border insolvency agreements, which aim to create close cooperation and the centralization of the process in a lead forum, are likely to become evidence of an international customary norm. David H. Culmer, *The Cross-Border Insolvency Concordat and Customary International Law: Is It Ripe Yet?*, 14 CONN. J. INT'L L. 563, 564 (1999); *see also* Gaa, *supra* note 93, at 882 (asking whether developments in the area should continue by way of the evolving international common law of

Yet for modified universalism to finally transform from an emerging to an established CIL, it is crucial that its application by relevant actors is generally pervasive and consistent. Hesitancy, contradiction, or fluctuation in invoking and applying the norm can undermine and ultimately negate the identification of CIL. Furthermore, the norm should be accepted as law. Thus, CIL might be disproved where it can be shown that participants who followed modified universalism were not motivated by a legal duty and acted in the belief that their acts amount to customary law. It has been argued, for example, regarding the concept of international comity, that "[a]t best, it is only incidental that some civil-law systems arrive at results comparable to the decisions of U.S. courts."[131] Regarding cross-border insolvency, it can be argued that because decisions or actions taken in this field are often either not explicitly based on modified universalism or are based on modified universalism as a broad approach linked to independent domestic common law developments,[132] its usage is in fact a demonstration of a tradition—but not of CIL.

To establish modified universalism as autonomous CIL and make the identification of CIL more plausible, clear pronouncements are needed that can show a consistent acceptance of modified universalism and the application of the norm in accordance with international law. Of primary importance is how countries address cross-border insolvency, especially influential countries (including emerging cross-border insolvency "hubs"[133]) that are more often affected by the norm and have the chance to interact with other state-actors and shape the norm in the process. State-actors' actions matter also when they proclaim intentions and act in international fora, including when deliberating on international instruments or other mechanisms in the form of hard or soft law, as such actions can demonstrate a crystallization of CIL. Existing international frameworks for cross-border

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bankruptcy or whether states should take the initiative to negotiate treaties identifying the applicable law).

131. Joel R. Paul, *Comity in International Law*, 32 HARV. INT'L L.J. 1, 35 (1991). Comity may be described as "the deference of one nation to the legislative, executive, and judicial acts of another—not as an obligation, but as a courtesy serving international duty and convenience." David Farmer, *Chapter 15: Ancillary and Other Cross-Border Cases*, 18 HAW. BAR J., Oct. 2015, at 14, 16.

132. See, for example, the restrictive application of modified universalism by the U.K. Supreme Court in *Rubin v. Eurofinance SA* [2012] UKSC 46 [16], [2013] 1 AC 236 (appeal taken from Eng.) ("[T]here has been a trend, but only a trend, to what is called universalism . . . ."), and the Court's narrow interpretation in *Hooley Ltd. v. Victoria Jute Co.* [2016] CSOH 141 [36] (Scot.) (holding that the Scottish court would refuse to defer to India's insolvency process).

133. Notably, Singapore is "a key hub for cross-border restructuring and insolvency." Kannan Ramesh, Jud. Comm'r, Sup. Ct. of Sing., Speech at the INSOL International Group of 36 Meeting: The Cross-Border Project – A "Dual-Track" Approach 10 (Nov. 30, 2015), http://www.supremecourt.gov.sg/Data/Editor/Documents/In-sol%2036_Speech_khb_upload%20version.pdf [https://perma.cc/ZZL4-KCT9].

insolvency have been somewhat obscure regarding the approach they are following,[134] and thus there is room for clearer pronunciations in instruments of the universal application of modified universalism, intended for general adherence.

How the key players of cross-border insolvency (bankruptcy courts and other implementing institutions, especially in countries most influential in this field) refer to and apply norms of modified universalism is also crucial and could matter beyond the creation of precedent within the jurisdiction, as it can influence and form CIL. Such actors when reaching decisions in line with modified universalism could proclaim the intention of following its prescribed solutions more explicitly and as a matter of obligation. Especially where provisions in instruments are insufficient to address all aspects of a given issue or where the country is not a party to an international framework, modified universalism norms become most relevant. In such cases, instead of, for example, solely relying on inherent discretionary powers in the legal system to assist foreign courts, or grounding decisions on notions such as comity that are often vague and confined to specific countries,[135] courts could explicitly refer to modified universalism as the guiding international law and, in the process, establish the acceptance of modified universalism as CIL.

At various times, American courts have reached universalist decisions based primarily on the Model Law, but also on the principle of international comity enshrined in chapter 15 of the Bankruptcy Code (the American version of the Model Law). In the case of *In re Daebo*,[136] for example, the bankruptcy judge, referring also to *In re Atlas Shipping A/S*,[137] noted that "Chapter 15 'contemplates that the court should be guided by principles of comity and cooperation with foreign courts in deciding whether to grant the foreign representative additional post-recognition relief.'"[138] Relying on the comity principle, the court then granted certain relief to the foreign Korean rehabilitation proceedings and vacated attachments pursuant to the Korean

134. For example, the preamble to the Model Law states that its purpose is to "provide effective mechanisms for dealing with cases of cross-border insolvency," but there is no specific reference to modified universalism, namely to a regime that aims to provide a global approach to multinational default, modified to fit business structures. U.N. COMM'N ON INT'L TRADE LAW, UNCITRAL MODEL LAW ON CROSS-BORDER INSOLVENCY WITH GUIDE TO ENACTMENT AND INTERPRETATION, U.N. Sales No. E.14.V.2 (2014).

135. *See* Kevin J. Beckering, *United States Cross-Border Corporate Insolvency: The Impact of Chapter 15 on Comity and the New Legal Environment*, 14 LAW & BUS. REV. AM. 281, 281 (2008) (describing comity as an "impediment" to attaining unification in the area of cross-border insolvency); John J. Chung, In re Qimonda AG*: The Conflict Between Comity and the Public Policy Exception in Chapter 15 of the Bankruptcy Code*, 32 B.U. INT'L L.J. 89, 96, 104 (2014) (describing comity as an "amorphous concept" that courts have struggled to define).

136. *In re* Daebo Int'l Shipping Co., 543 B.R. 47 (Bankr. S.D.N.Y. 2015).

137. 404 B.R. 726 (Bankr. S.D.N.Y. 2009).

138. *In re Daebo*, 543 B.R. at 53 (quoting *In re* Atlas, 404 B.R. at 738). Chapter 15 of the U.S. Bankruptcy Code refers to the principle of comity in §§ 1507(b) and 1509.

stay of actions concerning the company's assets. This decision was in line with modified universalism norms regarding recognition, cooperation, and relief, yet modified universalism was not mentioned explicitly as the applicable norm.

In future cases of this kind, judges could, in addition to applying domestic concepts of international comity, and especially where technical statutory rules require reinforcement or a separate justificatory force, refer explicitly to modified universalist norms that require uniform adherence, thus contributing to the transformation of them into CIL. The fact that powerful nations such as the United States have adopted international instruments, especially the Model Law, should not be a factor working against modified universalism becoming CIL; rather, this development should be a catalyst for making the norms that such instruments pursue more widespread. The inclination could be to just rely on provisions of instruments as adopted locally and refrain from considering norms beyond the instruments,[139] thus impeding the use of modified universalism as an international norm. Yet by appreciating the role of key actors as creators of international law and the potential of modified universalism to become universal, international law that transcends local differences can help overcome such tendencies.

Decisions of international tribunals could contribute to entrenching modified universalism as CIL as well, if they pronounce modified universalism norms more explicitly. In a case that reached the Court of Justice of the European Union (CJEU), *MG Probud Gdynia*,[140] for example, it was not clear whether the German authorities could order enforcement measures regarding assets of the company situated in Germany (where a Polish company had a branch), in circumstances where the main proceedings were taking place in Poland.[141] The CJEU concluded that the German authorities erred in their attempt to impose such local enforcement measures.[142] The court noted the universality of the main Polish proceedings based on the provisions of the EIR.[143] It further stated, also citing *Eurofood*,[144] that pursuant to the EIR provisions and recitals, proceedings opened in a member state must be recognized and be given effect in all other member states.[145] This rule, the court explained, "is based on the principle of

139. *See, e.g.*, *In re* Bear Stearns High-Grade Structured Credit, 374 B.R. 122, 132 (Bankr. S.D.N.Y. 2007), *aff'd*, 389 B.R. 325 (S.D.N.Y. 2008) (holding that there is no residual common law discretion under chapter 15).

140. Case C-444/07, 2010 E.C.R. I-0417.

141. *Id.* at ¶¶ 16–20.

142. *Id.* at ¶ 44.

143. *Id.* at ¶ 43.

144. Case C-341/04, 2006 E.C.R. I-3813.

145. Case C-444/07, MG Probud Gdynia, 2010 E.C.R. I-0417, ¶ 27 (citing Case C-341/04, Eurofood IFSC Ltd., 2006 E.C.R. I-3813).

mutual trust."[146] Mutual trust is certainly a core notion that facilitated the establishment of the compulsory cross-border insolvency system within the EU.[147] The premise of mutual trust in the administration of justice in the EU requires giving full faith and credit to courts of other member states.[148] Like comity, however, mutual trust is a vague concept,[149] and its justificatory force is limited.[150] It is also confined in the EIR context to relationships between states within the region.[151] Conversely, a reference to modified universalism could both provide concrete justification for the decision to require that full effect be given to the foreign main proceedings and contribute to the transformation of modified universalism to CIL.

The transformation of modified universalism to CIL may not take too long in view of the already existing widespread practice in this direction and the extensive traction that norms of modified universalism have gained in recent years. What is required is not taking a big leap to pure universalism but settling on the norms of modified universalism. Certainly, to develop the norms into CIL requires that countries and implementing institutions have opportunities to interact. Yet cross-border insolvency cases are not a rare phenomenon. Changes in political powers and shifts of economic centers also mean that country interaction is likely to spread more, creating a critical mass and concentration of activity conducive to CIL. It is important to note, however, the evolutionary nature of CIL and hence the fact that the work on its transformation and further development is a process: "The customary process is in fact a continuous one, which does not stop when the rule has emerged . . . . Even after the rule has 'emerged,' every act of compliance will strengthen it, and every violation, if acquiesced in, will help to undermine it."[152] Furthermore, the notion of elevating modified universalism to the status of CIL should not be understood as a replacement of international

146. *Id.*

147. Regulation 2015/848, of the European Parliament and of the Council of 20 May 2015 on Insolvency Proceedings, 2015 O.J. (L 141) 19, 26 (EU) ("The recognition of judgments delivered by the courts of the Member States should be based on the principle of mutual trust."); Case C-444/07, MG Probud Gdynia, 2010 E.C.R. I-0417, ¶ 28; Case C-341/04, Eurofood IFSC Ltd., 2006 E.C.R. I-3813, ¶ 39.

148. *See also* Matthias Weller, *Mutual Trust: In Search of the Future of European Union Private International Law*, 11 J. OF PRIV. INT'L L. 64, 68 (2015) (referring to mutual trust as a "rather opaque, yet almost omnipresent buzzword . . .").

149. WESSELS, *supra* note 89, at 46.

150. Weller, *supra* note 148, at 101 ("The justificatory force of mutual trust is limited. Using mutual trust as legal fiction does not work, at least not beyond the point reached in the system.").

151. *See* Christoph G. Paulus, *The ECJ's Understanding of the Universality Principle*, 27 INSOLVENCY INTELLIGENCE 70, 71 (2014) ("[T]he European legislator's power to regulate issues of insolvency is confined to membership relationships within the EU . . . .").

152. Maurice H. Mendelson, *The Formation of Customary International Law*, *in* 272 RECUEIL DES COURS: COLLECTED COURSES OF THE HAGUE ACADEMY OF INTERNATIONAL LAW 155, 175 (1998).

negotiations and deliberations that attempt to improve the written instruments.[153] To the contrary, creating and guarding modified universalism as an international custom should facilitate such negotiations because of the behavioral force of CIL and its ability to shift the reference point of actors regarding universalism. Vice versa, the development of regional and international frameworks can further define and develop the CIL rules.

### *B. Use of CIL in Future Cross-Border Insolvencies*

Modified universalism established as CIL can promote a wider coverage and a more consistent application of the norms. As noted above, there are still important gaps in the cross-border insolvency system, including participation in the main international framework for cross-border insolvency (the Model Law) and the entities and issues covered by international instruments.[154] Modified universalism, standing on its own two feet, emerging as CIL, can assist in closing such gaps in the complex international system.[155] The pervasiveness of CIL as an international legal source is an important advantage where modified universalism requires universality and full coverage of the market (market symmetry[156]). Once CIL has become prevalent, countries are bound by it regardless of whether they have codified the laws domestically or through treaties unless they have actively objected to it. Thus, while more action through the recognition of the international role of cross-border insolvency is important, it is enough that modified universalism is practiced generally and especially by influential economies and transnational actors. Countries (and their implementing institutions) that are more averse to change will still become party to a system based on modified universalism.

In practical terms, this means, for example, that in future cases involving countries that have not (1) taken action to adopt the Model Law, (2) ensured that the Model Law, where enacted, actually becomes effective in the jurisdiction, (3) become a party to any other international instrument that

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153. For example, see the ongoing deliberations of UNCITRAL Working Group V on the design of model laws on recognition and enforcement of insolvency-related judgments and on the cross-border insolvency of multinational enterprise groups. U.N. Comm'n on Int'l Trade Law, Rep. of Working Group V (Insolvency Law) on the Work of Its Fifty-Second Session, U.N. Doc. A/CN.9/931 (Jan. 15, 2018), http://www.uncitral.org/uncitral/en/commission/working_groups/5Insolvency.html [https://perma.cc/B43H-K2VZ].

154. *See supra* note 10 and accompanying text.

155. *Cf.* Guzman, *supra* note 17, at 119 n.17 (explaining that, even though bilateral treaties dominate the foreign investments legal regime, many investments are not covered by these treaties, yet the legal rules included in the treaties seem to have become CIL and, therefore, are generally more universally binding).

156. *See* Westbrook, *supra* note 2, at 2283 (explaining the importance of market symmetry—the idea that bankruptcy systems in a legal regime cover all transactions and stakeholders within that market—to cross-border insolvency).

follow modified universalism, or (4) enacted rules that otherwise facilitate global collective insolvencies, such countries will still be expected to follow modified universalism. It will also be possible to rely on uniform norms of cross-border insolvency rather than invoke domestic mechanisms when, for example, recognition, relief, or assistance is sought in a foreign jurisdiction. Such norms may be invoked by foreign actors[157] in the court or other body presiding over the process. If the norms are rejected by the relevant institution, the rejection may be regarded as a breach of international law. Provisions in international instruments, too, would apply to countries not party to the framework to the extent that the framework reflects the rules of CIL. Thus, even where a framework does not bind certain countries, its provisions may form part of the global legal order of insolvency.

The use of CIL can overcome outdated notions of comity and reciprocity and equalize the treatment of foreign proceedings and the approach to foreign requests—for example, in a country such as South Africa, which has adopted the Model Law but has not given effect to its provisions.[158] CIL can also assist when taking actions in cross-border insolvencies in countries such as China, which has not adopted the Model Law. Recognition and enforcement in China of foreign insolvency proceedings are conditioned on the existence of a relevant international treaty, in addition to other requirements such as that the insolvency proceeding shall not jeopardize the sovereignty and security of the state or public interests.[159] This specific domestic cross-border insolvency regime that was introduced in China in 2006 was still an obstacle to the smooth administration of cross-border insolvencies. For example, in litigation in the context of the cross-border insolvency of Lehman Brothers, a Chinese court considered that proceedings opened in the UK should not be given effect in China (with regard to property situated in China) because of a lack of reciprocity, as China did not have a relevant arrangement with the UK.[160] Going forward, where modified universalism is applied as CIL,

157. Foreign actors may be state as well as non-state actors. Indeed, both may be subject to the rights and obligations of international law as the scope of international law has been expanded. Specifically, CIL is increasingly invoked by non-state actors. For a discussion of the increasing role of non-state actors in the realm of international law, see Anthea Roberts & Sandesh Sivakumaran, *Lawmaking by Nonstate Actors: Engaging Armed Groups in the Creation of International Humanitarian Law*, 37 YALE J. INT'L L. 107, 112–25 (2012).

158. South Africa included a reciprocity condition requiring it to designate relevant countries that could invoke the Model Law's provisions, yet such designation never took place. Cross-Border Insolvency Act 42 of 2000 § 2 (S. Afr.); *see also* RH Zulman, *Cross-Border Insolvency in South African Law*, 21 S. AFR. MERCANTILE L.J. 804, 816–17 (2009) (noting that comity and reciprocity enshrined in the South African version of the Model Law are outmoded and not in conformity with modern thinking on the subject).

159. Zhong hua ren min gong he guo qi ye po chan fa (中华人民共和国企业破产法) [Enterprise Bankruptcy Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective June 1, 2007), art. 5.

160. Xinyi Gong, *To Recognise or Not To Recognise? Comparative Study of Lehman Brothers*

foreign insolvency representatives should be able to invoke it and attempt recognition and enforcement to promote a collective global approach in the foreign main forum, including in such circumstances where the relevant country is not a party to uniform frameworks and so long as it is not a persistent objector to the CIL regime.

As aforementioned, CIL also plays a role regulating within the gaps of treaties or other instruments. For example, based on modified universalism's norm of cooperation, courts and other authorities would have the authority and the duty to cooperate and communicate, including where the debtor is an entity that is not explicitly covered under existing instruments. The case of *Lehman Brothers*[161] is illustrative. In this case, cooperation was achieved because of the participants' initiative and voluntary will, yet this cooperation was constrained.[162] The enterprise type and structure (i.e., the fact that Lehman Brothers was a multinational financial institution/enterprise group) resulted in aspects of the case falling outside the scope of existing instruments.[163] Where modified universalism is recognized as CIL, cooperation would become a universal legal requirement, including for the purpose of reaching efficient centralized solutions for more complicated enterprise structures.[164]

As modified universalism established as CIL is flexible enough to accommodate changing conditions, it can also be invoked regarding newer types of processes and procedures that may not be covered in written instruments. The shift in the focus of insolvency procedures from formal

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*Cases in Mainland China and Taiwan*, 10 INT'L CORP. RESCUE 240, 241 (2013). The court reached this conclusion even though the UK has adopted the Model Law and therefore would be required to recognize foreign insolvencies pursuant to the terms of the instrument. *See id.* at 242 (asserting that Article 5 of the Enterprise Bankruptcy Law grants outbound universal effect to insolvency proceedings initiated in China and that this might be recognized in the UK pursuant to the Model Law, which does not condition recognition by reciprocity).

161. *In re* Lehman Bros. Int'l (Eur.) [2011] EWHC (Ch) 2022, [2011] All ER 273 (Eng.).

162. *See* Paul L. Davies, *Resolution of Cross-Border Groups*, *in* RESEARCH HANDBOOK ON CRISIS MANAGEMENT IN THE BANKING SECTOR 261, 263–64 (Matthias Haentjens & Bob Wessels eds., 2015) (discussing how both the U.S. and the U.K. took unilateral action in the bailouts of non-national entities, including Lehman Brothers, in order to protect national interests); James M. Peck, *Cross-Border Observations Derived from My Lehman Judicial Experience*, 30 BUTTERWORTHS J. INT'L BANKING & FIN. L. 131, 132 (2015) (explaining that cross-border conflicts and self-interested behaviors in the context of the Lehman insolvencies were unavoidable).

163. Mevorach, *supra* note 10, at 191 (explaining that the general cross-border Model Law for insolvency lacked sufficient measures to address the Lehman insolvency and that no specific cross-border framework exists for international financial institutions).

164. Since the fall of Lehman Brothers, UNCITRAL has been developing model provisions concerning enterprise groups (deliberations were ongoing at the time this Article went to print). U.N. Comm'n on Int'l Trade Law, Working Group V (Insolvency Law), Facilitating the Cross-Border Insolvency of Multinational Enterprise Groups: Draft Legislative Provisions, U.N. Doc. A/CN.9/WG/V/WP.158 (Feb. 26, 2018). Thus, going forward, CIL may address gaps in the new regime including in terms of its universal application pending wide enactment by countries.

liquidations to rescue-oriented and various informal processes, including in the time approaching insolvency where there is likelihood of insolvency or financial difficulties, is an example of such changes in the practice of insolvency that instruments may be slow to capture.[165] However, modified universalism norms can be invoked regarding interim, out-of-court, or pre-insolvency procedures even where they are not covered within the scope of cross-border domestic laws or international instruments. An example of such an approach is the decision of the Singapore court in the *Gulf Pacific Shipping* case.[166] In this case, the court, based on "internationalist concerns," decided to recognize the appointment of liquidators over Hong Kong shipping company Gulf Pacific and grant the requested assistance, despite the debtor being in out-of-court proceedings regarding which the domestic powers of assistance were constrained.[167]

Furthermore, to the extent that CIL does not contradict special treaty law, it can override conflicting laws in civil law countries and will be considered part and parcel of the public policy in common law jurisdictions where legislation is to be construed in a manner that would avoid a conflict with the international norm. Thus, modified universalism understood as CIL can provide the separate, *sui generis* basis and justification for the uniform private international laws based on global collectivity. Any ordinary domestic private international laws could sit alongside the cross-border insolvency CIL regime rather than be considered in conflict with it in the given circumstances. Thus, in future cases with circumstances of the type arising, for example, in *Rubin*—where the existing cross-border insolvency instrument might not provide a clear answer (in that case, regarding the question of enforcement of insolvency-related judgments of the main insolvency forum)[168]—the foreign insolvency representative would be able to rely on modified universalism as an international norm.[169] Such an

165. *See, e.g.*, *Proposal for a Directive of the European Parliament and of the Council on Preventive Restructuring Frameworks, Second Chance and Measures to Increase the Efficiency of Restructuring, Insolvency and Discharge Procedures and Amending Directive 2012/30/EU*, at 28, COM (2016) 723 final (Nov. 22, 2016) (attempting to harmonize aspects related to preventive restructuring proceedings in EU member states).

166. [2016] SGHC 287 at [6] [(HC, S'pore)] (unreported) (recognizing the foreign proceedings and allowing the liquidators to obtain information regarding a closed bank account of the company).

167. *Id.* at [10].

168. Rubin v. Eurofinance SA [2012] UKSC 46 [91], [2013] 1 AC 236 (appeal taken from Eng.).

169. Since *Rubin*, UNCITRAL has been developing a model law on the enforcement of insolvency-related judgments (deliberations were ongoing at the time this Article went to print). U.N. Comm'n on Int'l Trade Law, Rep. on the Work of Working Group V (Insolvency Law) on its Fifty-Second Session, U.N. Doc. A/CN.9/931, Annex, Draft Model Law on Cross-Border Recognition and Enforcement of Insolvency-Related Judgments at 16 (Jan. 15, 2018); U.N. Comm'n on Int'l Trade Law, Working Group V (Insolvency Law), Recognition and Enforcement of Insolvency-Related Judgments: Draft Model Law, U.N. Doc. A/CN.9/WG/V/WP.156

outcome was unattainable in the *Rubin* case, and the request to enforce the judgment of the central foreign court was denied because modified universalism was applied as a general principle of common law subject to the domestic private international law regime.[170] In other circumstances, courts may be asked, for example, to give full effect to a foreign stay on actions concerning the assets of the enterprise, instead of (as happened in *Pan Ocean*[171]) apply domestic *ipso facto* rules that allow them to terminate contracts, thus undermining the collectivity of the cross-border insolvency process.[172] Similarly, courts could be asked to recognize transactions already approved by foreign main reorganization proceedings, instead of (as happened, e.g., in *Elpida*[173]) applying the domestic rules concerning asset sales.[174] The application of the domestic rule can undeniably delay the process, as well as provide local creditors an unjustified chance to challenge the sale, undermining the norm of a global, nondiscriminatory approach prescribed by modified universalism.

Modified universalism based on CIL could also serve to influence international instruments. It could reinforce technical rules where the instrument refers to the rules of CIL. Currently, requirements in cross-border insolvency frameworks, for example, cooperation "to the maximum extent possible,"[175] could be understood in different ways. They could be interpreted in a universalist manner, suggesting obligatory cooperation to achieve universality within the parameters of modified universalism. Yet they could also be understood as suggesting cooperative territorialism, namely self-serving cooperation, that promotes local interests in the case at hand while still allowing, for example, ring-fencing of assets if that appears to be in the interests of national stakeholders. The lack of clear statements concerning the level of universalism that should be followed also renders proclamations of objectives—such as effectiveness, efficiency, or fairness, stated as the aims of cross-border insolvency systems[176]—open to interpretation and variation

(Feb. 19, 2018). Thus, going forward, CIL may assist in closing gaps in the new regime, including in terms of its universal application pending wide enactment by countries.

170. Rubin v. Eurofinance SA [2012] UKSC 46 [177], [2013] 1 AC 236 (appeal taken from Eng.).

171. Pan Ocean Co. v. Fibria Celulose S/A [2014] EWHC (Civ) 2124, [2014] All ER 03 (Eng.).

172. *Id.*

173. *In re* Elpida Memory, Inc., No. 12-10947, 2012 WL 6090194 (Bankr. D. Del. Nov. 16, 2012).

174. *Id.* at *8–9.

175. U.N. COMM'N ON INT'L TRADE L., UNCITRAL MODEL LAW ON CROSS-BORDER INSOLVENCY WITH GUIDE TO ENACTMENT AND INTERPRETATION 13, U.N. Sales No. E.14.V.2 (2014).

176. *Id.* at 3. The Model Law on Cross-Border Insolvency promotes several objectives:

> Cooperation between the courts and other competent authorities of this State and foreign States involved in cases of cross-border insolvency; [g]reater legal certainty for trade and investment; [f]air and efficient administration of cross-border

in the cross-border context. Thus, fairness and efficiency may be viewed from a vested-rights, territorial perspective or from a global, universalist perspective. Going forward, CIL can be used to ensure a consistent application of objectives and requirements enshrined in frameworks in line with modified universalism. Modified universalism based on CIL can also provide specific substance to requirements to interpret instruments by having regard to their "international origin."[177]

## Conclusion

Lessons from international law, as well as insights from cognitive psychology of decision-making, highlight the advantages that can be gained from modified universalism conceptualized and formed as CIL. Modified universalism recognized as CIL could fill gaps and promote consistency in the application of regional and international frameworks. Furthermore, a modified universalist CIL can assist in the areas where biases impede movement to more optimal solutions. If the rules of modified universalism are generally conceived as CIL, modified universalism will be the default universal rule, embraced as an opt-out regime, and adherence to it would not require positive action from all participants. Such use of legislative framing can affect the consequences of inaction and can result in higher participation, with greater universality and integrity, in the application of modified universalism. In this respect, it is important that the role of cross-border insolvency is reinforced. Indeed, as a private international law system, it has international objectives to pursue. Private international law generally is increasingly being reunited with the international law system, and its role is augmenting. The international nature of cross-border insolvency and the fact that insolvency addresses both private and public interests further justify the solidification of its international role. Thus, cross-border insolvency law should engage in international norm creation and, in that regard, could rely on modified universalism where it provides concrete and practical rules that can be followed consistently. Key actors, importantly courts and other authorities presiding over cross-border insolvency cases—as well as regulators, policy makers, and international organizations engaged in international insolvency law making—should be less context-dependent and

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> insolvencies that protects the interests of all creditors and other interested persons, including the debtor; [p]rotection and maximization of the value of the debtor's assets; and [f]acilitation of the rescue of financially troubled businesses, thereby protecting investment and preserving employment.

*Id.*

177. *See, e.g.*, *id.* at 5 ("[R]egard is to be had to [this law's] international origin and to the need to promote uniformity in its application and the observance of good faith."); *see also* Jay L. Westbrook, *Interpretation Internationale*, 87 TEMP. L. REV. 739, 750–51 (2015) (arguing that "system" texts that establish an international framework require an international rather than an insular interpretation).

should perceive their roles more broadly, considering public international law sources and mechanisms for creating and enhancing international obligations.

# A New Approach to Executory Contracts

John A.E. Pottow*

## I. Introduction and Summary

Few topics have bedeviled the bankruptcy community as much as the proper treatment of executory contracts under § 365 of the Bankruptcy Code.[1] The case law is "hopelessly convoluted" and a "bramble-filled thicket."[2] While many have struggled in the bootless task of providing coherence to the unwieldy corpus of case law and commentary, all would agree Jay Westbrook has been at the modern vanguard of this Sisyphean task.[3] (I assign Westbrook to the "modern" forefront, thereby relegating Vern Countryman, whose legacy in this domain rightly persists, to the annals of history, choosing as my perhaps arbitrary dividing line the adoption of the 1978 Bankruptcy Code.)[4]

Why have executory contracts proved so nettlesome? Under the Code, a large part of the damage is self-inflicted, resulting from unfortunate drafting that begat an ever-accumulating snowball of confused jurisprudence.[5] But there is also a salience bias (vividness bias, really) at work of disproportionate focus on the striking plight of the contractual counterparty who is aggrieved when a debtor deploys executory-contract rights under § 365—rights that accord the debtor certain powers in dealing with executory contracts otherwise unavailable at state law. (This bias underestimates the baseline unhappiness that bankruptcy inflicts upon all creditors equally and fairly.) Westbrook has relatedly noted that courts in their struggle to do equity under the Code sometimes resist these executory-contract powers.[6] In doing

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1. 11 U.S.C. § 365 (2012).

2. Cohen v. Drexel Burnham Lambert Grp., Inc. (*In re* Drexel Burnham Lambert Grp., Inc.), 138 B.R. 687, 690 (Bankr. S.D.N.Y. 1992) (citations omitted).

3. *See, e.g.*, Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 239 (1989).

4. 11 U.S.C. § 101 (2012). *See generally* Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 442–44 (1973) [hereinafter Countryman I] (propounding a seminal test).

5. *See infra* note 21 and accompanying text.

6. Jay Lawrence Westbrook & Kelsi Stayart White, *The Demystification of Contracts in Bankruptcy*, 91 AM. BANKR. L.J. 481, 510–11 (2017) ("The problem with wild cards is that chance—sometimes found under the mask of equity—can favor either player.").

so, they gravitate to the textual restriction of § 365 to "executory" contracts.[7] Skeptical courts frequently conclude that a contract is not "executory"—and therefore cannot fall under § 365—to deny relief that strikes these courts as unseemly. Indeed, a judicial cottage industry in bankruptcy has developed on the definition of "executoriness" and concomitant scope of access to § 365.[8]

Countryman gets first credit for tackling the definitional challenge of what it means for a contract to be "executory" under the prior Bankruptcy Act. His eponymous test for executoriness is well cited in many opinions and is otherwise known as the "material breach" test.[9] Westbrook, albeit with characteristic gentility, upended that doctrinal framework by advocating an abolition of the concept of executoriness from the Code altogether and replacing it by (or subsuming it within) a "functional" analysis focused on debtor economic benefit.[10] His executoriness discussion, started three decades ago, and especially his back-and-forth on the topic with Michael Andrew, is canonical bankruptcy scholarship.[11]

The challenges of defining executoriness persist through today. The recent American Bankruptcy Institute's Commission on the Reform of Chapter 11 tasked a specific Expert Group to examine the Code's treatment of executory contracts.[12] The Group's first recommendation was to abolish the requirement of executoriness as a restriction on § 365.[13] (Yes, Westbrook was front and center on the group.) The Commission, however, stunned the insolvency community by not only rejecting the Group's recommendation, albeit in an apparently divided decision, but doubling down on executoriness:

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7. 11 U.S.C. § 365(a) (2012) (referencing "executory" contracts).

8. *See, e.g.*, AM. BANKR. INST., COMMISSION TO STUDY THE REFORM OF CHAPTER 11, 112 (2014) [hereinafter ABI REPORT] ("[C]ourt[s] on a case-by-case basis determine[] whether a particular contract is executory."); Westbrook & White, *supra* note 6, at 494–95 (noting that "courts continued to expand the application" of multiple executoriness tests "to more and more kinds of contracts").

9. Countryman I, *supra* note 4, at 460.

10. Westbrook, *supra* note 3, at 230.

11. *See generally* Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection"*, 59 U. COLO. L. REV. 845, 849 (1988) [hereinafter Andrew, *Rejection*] (characterizing "the election to 'assume or reject' [as] the election to assume or not assume"); Michael T. Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U. COLO. L. REV. 1, 3 (1991) [hereinafter Andrew, *Reply to Westbrook*] (noting "contrary views on specific elements of Westbrook's analysis").

12. *See generally* ABI REPORT, *supra* note 8 (outlining "Recommended Principles" for the treatment of executory contracts in bankruptcy).

13. ADVISORY COMM. ON EXECUTORY CONTRACTS AND LEASES, ABI COMMISSION TO STUDY THE REFORM OF CHAPTER 11: EXECUTIVE SUMMARY REGARDING SECTION 365 ISSUES 1 (2013) [hereinafter ABI ADVISORY COMMITTEE] ("The Advisory Committee recommends eliminating the term 'executory' in favor of adopting the Functional Test which allows the trustee or debtor in possession . . . to keep beneficial contracts and reject burdensome ones based solely upon benefit/harm to the estate."), http://commission.abi.org/sites/default/files/ABI-365-Comm-Overview-Summary_(WEST_34307609_3).DOCX [https://perma.cc/2PH7-GCHJ].

it advocated its *retention* in the Code and the *codification* of the Countryman material breach test for definition.[14] In doing so, the Commission noted—without an apparent whiff of irony—that this decision would allow reliance on "well developed" case law.[15] To describe the executory-contracts precedents in bankruptcy as "well developed" (or even "vaguely helpful") skirts credulity.[16] Were the Commission's recommendations in any danger of attracting congressional attention, this linguistic legerdemain might be worrisome, but thankfully the dysfunction of our modern Congress has ridden to the rescue. Thus, the debate over the role (and very definition) of "executoriness" in bankruptcy law has not only been rekindled, but appears to be here to stay.

Acknowledging that the thrust of commentary heeds Westbrook's call to abolish executoriness as a gatekeeper to the § 365 powers,[17] I want to offer a novel approach and argue against that grain. Specifically, in this Article I will suggest not only that the fight should be called off, but that defeat should be conceded. Executoriness, for better or worse (mostly worse), is here to stay in the Code. My resignation may seem like Westbrook heresy, but there is a method to my madness. Here is my key contention: the impulse behind the resistance to the abolition of executoriness, reflected most recently by the ABI Commission's intransigence, is at root a reluctance (perhaps conscious, perhaps not) by elite lawyers to relinquish what they feel is a legal arbitrage opportunity to combat debtor power.[18] Namely, counterparties believe that the doctrinal fluidity of the concept of executoriness allows them wide latitude to argue a contract is executory when such a classification will accord them legal advantage over the debtor but in the next case argue that a similar contract is not executory when that contrary label will accord the leg up.[19] As such, executoriness's confusion and uncertainty is a feature rather than a bug.

Principled commentators like Westbrook decry this sneakiness, bemoaning the deadweight litigation loss. A clear, sensible rule defining executoriness should be established with a defensible normative foundation.

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14. ABI REPORT, *supra* note 8, at 112.

15. *Id.* at 112, 115 (describing case law as a "valuable resource").

16. *See* Westbrook & White, *supra* note 6, at 497 ("[T]here was no thorough explanation of the majority recommendation or how it addresses the courts' frustration with executoriness analysis and their divergent conclusions.").

17. As far back as 1997, The National Bankruptcy Review Commission recommended deleting "executory" from § 365 to end the executoriness debates. NAT'L BANKR. REVIEW COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS 454 (1997).

18. Economically, the ambiguity creates more of an option value than an arbitrage because there are not, of course, two separate markets, but I use arbitrage because I think it better captures the two-facedness of the evil presented.

19. Beyond the scope of this Article is a formal model of the role of risk aversion addressing why lawyers do not equally foresee enjoying the benefits of being the debtor's counsel with the offsetting § 365 power they so fear. Loss aversion is likely interacting with the vividness bias.

Countryman offered one; Westbrook had another.[20] My approach sidesteps this skirmish. Rather than fight on what the definition of executoriness should be in an effort to wipe out the grey zone, my tack is to blunt the arbitrage impulse *ab initio*. The way to do so is by taking seriously how the Code should treat a *non-executory contract*, the presumable residual category of a contract flunking the executoriness test (whatever test is selected). The treatment of non-executory contracts is woefully undertheorized in bankruptcy literature, and so I try to fill this unwelcome void.[21] Indeed, cases where executoriness is litigated simply end after a declaration of non-executoriness without any rigorous working-through of the consequences.[22] This is regrettable. Treating the structure and policies of the Bankruptcy Code holistically, I will try to show what should happen to a non-executory contract in bankruptcy, entirely outside the domain of § 365. My conclusion is that while non-executory contracts may be treated as formally distinct from executory contracts, *their functional outcomes will mimic those of executory contracts by synthetic replication through other Code provisions*. If my analysis holds and non-executory contracts, while different, garner largely similar treatment to executory contracts, then the pernicious opportunity for arbitrage from the executoriness game will collapse.

This Article will proceed as follows. First, it will offer an abbreviated explanation of the treatment of executory contracts under the Code, chronicling the development of the concept of executoriness and the subsequent challenges of its effects. Second, it will explain a new approach that embraces and makes its peace with executoriness by focusing on the proper treatment of non-executory contracts. Third, it will address some of the anticipated counterarguments to the new approach. Finally, it will offer a quick road test to demonstrate how the new approach would have more easily resolved a major litigated precedent in this field.

## II. The Problem of Executoriness and the Traditional Approach(es)

### *A. The Genesis of Executoriness and § 365*

*1. The Historical Problem of Provability.*—Insolvency systems have been wrestling with executory-contract rights for quite some time. For

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20. *Compare infra* note 63 and accompanying text (Countryman), *with infra* note 73 and accompanying text (Westbrook).

21. "[O]ne rule that could be considered 'well-settled' is that once a contract has been determined to be 'non-executory,' there are no rules." Westbrook & White, *supra* note 6, at 498. Even Countryman, whose treatment of executory contracts is encyclopedic, at most indirectly intimated at the proper treatment of non-executory contracts. *See id.* at 519 (characterizing charitably Countryman's treatment of the issue as "implicit").

22. *See, e.g.*, *In re* Drake, 136 B.R. 325, 328 (Bankr. D. Mass. 1992) ("[T]he [a]greement cannot be deemed executory."); *see also* Westbrook & White, *supra* note 6, at 499 (collecting cases).

example, the 1898 Bankruptcy Act sometimes respected so-called *ipso facto* clauses that terminate contracts automatically (*ipso facto*) upon the insolvency of a party,[23] an outcome now banned under § 365.[24] But the origin of the problems of modern executory contracts has to do with statutory drafting that addressed a different issue—the now-abolished concept of *provability*. Under the Act, only some financial grievances against an insolvent debtor were "provable,"[25] which functioned as a sort of bankruptcy version of ripeness. Consider, for example, a debtor who ran over someone's foot. The victim might claim money is owing; the debtor–driver might deny liability. If no lawsuit had yet been commenced, let alone concluded with a monetary judgment of a debt owing, then the claim was not *provable* in the debtor's bankruptcy proceeding.[26] This could be a mixed blessing. It was initially bad for the creditors, because they could not participate in the division of the debtor's assets, but it was sometimes good as well, because if the debtor survived after bankruptcy (e.g., the debtor was an individual or a reorganized corporation), then the unprovable claim survived as well, continuing to haunt the debtor post-discharge.[27] But if the debtor were a corporation in liquidation, the provability bar was all bad news for the creditor.

What about contracts? To understand the impact of provability, we first need to understand what trustees did with contracts, and to understand that, we need to understand what they did with leases. As remains the case today, trustees were entitled to all the debtor's property (some would say, "vest in title," some would say, "control as a mere custodian"),[28] but they were also

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23. *See, e.g.*, Irving Tr. Co. v. A.W. Perry, Inc., 293 U.S. 307, 311 (1934) (holding enforceable a provision that provided the "filing of the petition in bankruptcy was . . . a breach of the lease"). Even the old cases bristled at this doctrine and so cabined its reach at every turn. *See, e.g.*, Gazlay v. Williams, 210 U.S. 41, 48–49 (1908) (holding the *ipso facto* provision ineffective); *see also* Vern Countryman, *Executory Contracts in Bankruptcy: Part II*, 58 MINN. L. REV. 479, 522 (1974) [hereinafter Countryman II] (noting the old Act's "forfeiture provisions . . . are by their terms confined to leases"). I am leaving aside in this historical discussion the bizarre, now largely buried doctrine of "anticipatory breach" by bankruptcy. *See* Cent. Tr. Co. v. Chi. Auditorium Ass'n, 240 U.S. 581, 592 (1916) ("We conclude that proceedings, whether voluntary or involuntary, resulting in an adjudication of bankruptcy, are the equivalent of an anticipatory breach of an executory agreement.").

24. 11 U.S.C. § 365(e) (2012).

25. *See, e.g.*, Zavelo v. Reeves, 227 U.S. 625, 632 (1913) ("[O]nly provable debts are discharged.").

26. *See, e.g.*, Brown & Adams v. United Button Co., 149 F. 48, 53 (3d Cir. 1906) (holding that a claim for unliquidated damages that results from the injured property of another is not provable in bankruptcy).

27. *See* Countryman I, *supra* note 4, at 443 ("[U]nder § 17a of the Bankruptcy Act only provable debts are discharged.").

28. 11 U.S.C. § 541(a) (2012). While assignees under the Acts vested in the debtor's property outright, equity receivers (who preceded modern reorganizations) merely controlled debtor property as custodians. Quincy, Mo. & Pac. R.R. Co. v. Humphreys, 145 U.S. 82, 97 (1892) ("[The equity

free to abandon uneconomical assets.[29] The abandonment doctrine applied to leases of real property as well.[30] If the debtor had an ongoing ("unexpired") lease that was financially burdensome, the trustee could abandon it. Now, that raised a provability problem, especially when traditional real-property remedies are considered.[31] Under many states' property law, the rent covenant stemmed from the realty itself, and so dispossession terminated the prospective obligation to pay rent.[32] (The separate contractual promise to pay the rent prospectively, which the trustee might have breached by rejecting the lease, was a separate problem.)[33] In other words, while the bankruptcy system could get its head around a claim for unpaid back rent quite well (a debt owing to the creditor/landlord), it struggled with whether a claim for unpaid future rent triggered by the trustee's abandonment of an uneconomical long-term lease was provable, especially when the landlord had possession of the land returned by the debtor's vacating the premises.

Related uncertainty befell contracts. If the debtor were current on any invoices, would abandonment ("rejection") of the contract trigger a provable claim for breach of future expectation loss?[34] Case law initially struggled, much wanting to find that it should.[35] Congress tried to clarify the matter, beginning in 1933, to allow for more widespread provability. Starting with railroad receivership cases in § 77 of the Act (amended two years later), it allowed for a rejection counterparty to be "deemed . . . a creditor . . . to the extent of the actual damage or injury."[36] Section 77 begat 77B (extending the application beyond railroad reorganizations to corporations), which in turn begat Chapter X in 1938's Chandler Act's more general corporate reorganization "chapter" provisions.[37]

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receivers] were ministerial officers, . . . mere custodians.").

29. *See* Am. File Co. v. Garrett, 110 U.S. 288, 295 (1884) (recognizing the principle based on historical English practice).

30. *See, e.g.*, *Quincy, Mo.*, 145 U.S. at 102 (applying the abandonment doctrine to a long-term lease).

31. The provability problem extended to leases of personalty as well. *See* Countryman I, *supra* note 4, at 449–50 n.50 (collecting cases).

32. *E.g.*, William Filene's Sons Co. v. Weed, 245 U.S. 597, 601 (1918) ("Rent issues from the land.").

33. *See* Miller v. Irving Tr. Co., 296 U.S. 256, 258 (1935) ("Under the clause in question, it was, at the time the petition in bankruptcy was filed, uncertain, a mere matter of speculation, whether any liability ever would arise under it.").

34. The older Acts were more forgiving of contract provability than "pure tort." For example., § 63a(8) allowed for provability of "contingent contractual liabilities," but not tort claims, Schall v. Comers, 251 U.S. 239, 248–49, 253 (1920), absent reduction to judgment (or implied assumpsit), Davis v. Aetna Acceptance Co., 293 U.S. 328, 331 (1934).

35. *See, e.g.*, Irving Tr. Co. v. A.W. Perry, Inc., 293 U.S. 307, 310–11 (1934) (holding an *ipso facto* clause effective to terminate a lease and trigger a provable claim).

36. Bankruptcy Act, ch. 774, § 77, 49 Stat. 911, 914 (1935); *see also* Bankruptcy Act, ch. 204, § 77, 47 Stat. 1467, 1474 (1933) (allowing creditors of a railroad to file a petition).

37. Bankruptcy Act, ch. 424, § 77B, 48 Stat. 911, 915 (1934) (including "claims under

Similarly, in the liquidation context, 1934 amendments to the Act's § 63a(7) allowed for "claims for damages respecting *executory contracts* including future rents," which was rewritten in the Chandler Act for "claims for anticipatory breach of contracts, *executory in whole or in part*, including unexpired leases of real or personal property."[38] These amendments also resolved what was implicit from the abandonment doctrine: that the trustee could never be forced to take unwanted property; it was the trustee's election whether to assume or reject an unexpired lease,[39] and so Congress provided that *affirmative acknowledgment* was required to assume a lease, with the default in liquidation being deemed rejection after a period of time. Specifically, "[w]ithin sixty days after the adjudication, the trustee shall assume or reject any executory contract, including unexpired leases of real property. . . . Any such contract or lease not assumed or rejected within such time . . . shall be deemed to be rejected."[40] This explicit treatment of lease claims under § 63a(7) and contract claims under § 63a(9), albeit with slightly different language, solved the provability conundrum of postpetition repudiation ("rejection") damages for these unfinished transactions; they were henceforth all provable claims. This statutory introduction of the term "executory" made sense, of course, because only if a contract is *executory* (i.e., not completely "executed") can there be a claim for anticipatory repudiation upon the trustee's disclamation.[41] If the contract is fully performed, by contrast, there are no future obligations over which to fight about provability, only unpaid matured debts to be filed as claims.[42] Similarly, a lease needs to be *unexpired* for there to be a potential breach claim for unpaid future rents. An expired lease may have some back rent owing but again raises no provability issues; fully concluded transactions are unremarkable for provability. Thus, "executory" entered the U.S. bankruptcy

executory contracts, whether or not such claims would otherwise constitute provable claims under this Act").

38. Bankruptcy Act, ch. 424, § 63a(7), 48 Stat. 911, 924 (1934) (emphasis added); Bankruptcy Act, ch. 575, § 63a(9), 52 Stat. 840, 873 (1938) (emphasis added).

39. *See* United States Tr. Co. v. Wabash W. Ry. Co., 150 U.S. 287, 299–300 (1893) ("The general rule . . . is undisputed that an assignee or receiver is not bound to adopt the contracts, accept the leases, or otherwise step into the shoes of his assignor, if in his opinion it would be unprofitable or undesirable to do so; and he is entitled to a reasonable time to elect whether to adopt or repudiate such contracts.").

40. Bankruptcy Act, ch. 575, § 70b, 52 Stat. 840, 880–81 (1938). Countryman chronicles how the judicially created doctrine of abandonment carried forth the English practice that "[i]t has long been a recognized principle of the bankrupt [sic] laws that the assignees were not bound to accept property of an onerous or unprofitable character." Countryman I, *supra* note 4, at 440 (quoting Am. File Co. v. Garrett, 110 U.S. 288, 295 (1884)).

41. *See* Andrew, *Reply to Westbrook*, *supra* note 11, at 34 n.155 (noting that under the equivalent U.K. Insolvency Act, a trustee may "disclaim" "any unprofitable contract," which has the effect of its exclusion from the estate) (citations omitted).

42. 11 U.S.C. § 502 (2012).

statutory lexicon through these Depression-era provisions that were designed to clarify the provability status of claims for unfulfilled future obligations triggered by a bankruptcy trustee's abandonment of financial detritus.

*2. Provability's Solution and the Introduction of Executoriness (and § 365).*—As part of Congress's bankruptcy overhaul resulting in the 1978 Code, the concept of provability was finally abolished with a wide definition of "claim" that covered all conceivable monetary obligations, such as contingent, unmatured, and unliquidated claims, like the tort cause of action above.[43] Everything was now a "claim" and hence both provable and dischargeable in a bankruptcy proceeding (no more haunting the discharged debtor with the financial sins of the past). With everything becoming provable, the very need for that term was eliminated.[44] Congress's intent in so doing was to corral every possible financial beef with a debtor into one forum and compel resolution with comprehensive finality.[45] This neater solution was widely praised and, had Congress just thought of it back in 1938, would have obviated the requirement for § 63a and the language of "executory" contracts.[46] Congress also consolidated the prior Chandler Act provisions into § 365, which now covers the estate's treatment of executory contracts and unexpired leases.[47] Section 365(a) provides: "[T]he trustee, subject to the court's approval, may assume or reject any *executory contract* or unexpired lease of the debtor."[48]

Note that § 365(a) codified the court's oversight role in the assumption

43. *Id.* § 101(5); H.R. REP. NO. 95-595, at 180 (1977) ("H.R. 8200[, the Bankruptcy Code,] abolishes the concept of provability in bankruptcy cases."). (Source text is entirely capitalized.).

44. Well, nearly everything. A painful strand of cases has emerged finding that executory contracts (usually leases) neither assumed nor rejected in a chapter 11 simply "ride through," saddling the debtor with an ongoing lease and the counterparty with an unprovable claim. *E.g.*, *In re* Bos. Post Rd. Ltd. P'ship, 21 F.3d 477, 484 (2d Cir. 1994) ("A debtor in Chapter 11 must either assume or reject its leases with third parties . . . . If the debtor does neither, the leases continue in effect and the lessees have no provable claim against the bankruptcy estate.").

45. *See* H.R. REP. NO. 95-595, at 309 ("By this broadest possible definition [of claim] . . . the Bill contemplates that all legal obligations of the debtor, no matter how remote or contingent, will be able to be dealt with in the bankruptcy case.") (Source text is entirely capitalized.); S. REP. NO. 95-989, at 21–22 (1978) (using the same language); H.R. DOC. NO. 93-137, pt. 2, at 154–55 nn.1–5 (1973) (containing the proposed text).

46. *See, e.g.*, Westbrook & White, *supra* note 6, at 494 (describing the "Code['s] eliminat[ion of] the concept of 'provability'" as an "important change"); *see also In re* M.A.S. Realty Corp., 318 B.R. 234, 237 (Bankr. D. Mass. 2004) (describing the revision that eliminated provability as "a distinction of critical importance"); Cohen v. Drexel Burnham Lambert Grp., Inc. (*In re* Drexel Burnham Lambert Grp., Inc.), 138 B.R. 687, 706–07 (Bankr. S.D.N.Y. 1992) (describing the Code's abolishment of provability as a "structural innovation[]").

47. *See* Westbrook & White, *supra* note 6, at 492 ("These [statutory] origins are important because they reveal that Congress intended the statutory predecessor to section 365 to ensure that counterparties holding rejected contracts, including leases, would be paid and discharged.").

48. 11 U.S.C. § 365(a) (2012) (emphasis added).

or rejection of contracts, too, which in turn spawned jurisprudence over the standard by which the court ought to assess the debtor's decision (with a majority approach settling on a business judgment rule level of deference).[49] But even more important than § 365(a) was the power conferred on trustees and debtors under § 365(b). Unhelpfully phrased as a *restriction* on assumption, § 365(b)'s true import is to confer a *power* upon the debtor to cure contractual defaults.

> If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee—(A) cures, or provides adequate assurance that the trustee will promptly cure, such default.[50]

This flex of preemptive federal law trumps general state contract law, because a material breach of contract ordinarily allows the aggrieved counterparty the self-help remedy of termination.[51] Section 365(b) overrides this and says notwithstanding the (material) breach of an executory contract, if the breach is cured pursuant to § 365(b), the debtor in federal bankruptcy may assume the contract and carry on under its benefits. The counterparty's self-help remedy of termination is scuttled.[52] This cure-and-assume power irritates contractual counterparties tremendously, of course, because the contracts those parties most want to terminate are bad deals that they made, which are by zero-sum game reasoning precisely the sorts of good deals that the debtor/trustee is anxious to assume. But for § 365(b), the debtor would be unable to do this in the face of a material breach at common law. Counterparties equally hate a debtor's rejection of an executory contract containing a good deal for the counterparty by the same logic.

Section 365's power is even worse for the counterparty, because it cannot even be "contracted around." For example, the parties' decision to say that a filing for bankruptcy *ipso facto* terminates the contract is explicitly invalidated.[53] And even seemingly *impossible-to-cure* breaches are, in some contexts, excused under § 365.[54] In sum, § 365 provides a powerful arrow in the debtor's quiver, according the debtor the option to "reshape" the

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49. Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (*In re* Richmond Metal Finishers, Inc.), 756 F.2d 1043, 1046 (4th Cir. 1985) ("[The] question [of acceptance or rejection] must start with . . . deference mandated by the sound business judgment rule . . . .").

50. 11 U.S.C. § 365(b)(1) (2012).

51. 1 RESTATEMENT (SECOND) OF CONTRACTS § 237 (AM. LAW INST. 1981).

52. *See, e.g.*, *In re* Circle K Corp., 190 B.R. 370, 376 (B.A.P. 9th Cir. 1995) (noting how § 365(b) overruled such pre-Code cases as *In re Schokbeton Indus., Inc.*, 466 F.2d 171 (5th Cir. 1972), which held that breach precludes assumption and bankruptcy accords no power to cure).

53. 11 U.S.C. § 365(e)(1) (2012).

54. *Id.* § 365(b)(1)(A) (rescuing certain lease defaults).

bankruptcy estate with an option to assume valuable contractual rights,[55] either for performance by the debtor itself or for assignment to a third party for a price, notwithstanding the existence of a breach.[56]

### *B. Executoriness as a Restraint on § 365: The Creation of New Problems*

Counterparty hostility to § 365 drives the annals of case law of litigants seeking to avoid its reach. And the key to their stratagem is textual seizure upon the statutory qualifier that only "executory" contracts are subject to § 365 and all her debtor powers. Aggrieved counterparties often insist that the debtor's contract is not an executory contract and hence cannot "enter" § 365. Important for explaining the chaotic case law in this area, the litigious counterparties are what might be called "equal opportunity executoriness critics." When the debtor had a good contract (and hence a bad one for the counterparty) it sought to assume, the counterparty would claim the contract was not executory and, therefore, could not avail itself of the cure and assumption powers of § 365.[57] But in cases in which the contract was burdensome for the debtor (and hence good for the counterparty), the counterparty would then argue that the contract was not executory and, therefore, could not be rejected.[58] Note the bizarre logic under this reasoning, as some courts blithely pronounced: if "the contract is not executory, . . . [it is] neither assumable nor capable of rejection."[59] A contract that neither can be assumed nor rejected creates an existential legal crisis, which some have described as "zombie" contracts that leave the debtor in a "legal limbo."[60] Many a court caught in the middle of an executoriness fight would make the initial decision, whether the contract was indeed executory or not, and then

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55. ELIZABETH WARREN, JAY LAWRENCE WESTBROOK, KATHERINE PORTER & JOHN A.E. POTTOW, THE LAW OF DEBTORS AND CREDITORS 453–54 (7th ed. 2014).

56. Lest the uninitiated reader worry Congress went wild with § 365, she should be assuaged by the provisions that incorporate common law bars on assignment, such as an inability to assign "personal" contracts. *See* 11 U.S.C. § 365(c)(1) (2012).

57. Post v. Sigel & Co., Ltd. (*In re* Sigel & Co., Ltd.), 923 F.2d 142, 145–46 (9th Cir. 1991) (rejecting counterparty's argument that contract's non-executoriness precluded debtor assumption under § 365).

58. *E.g.*, Lycoming Engines v. Superior Air Parts, Inc. (*In re* Superior Air Parts), 486 B.R. 728, 738 (Bankr. N.D. Tex. 2012) ("[W]hen a contract is non-executory, the debtor remains bound to its obligations."); *In re* Spectrum Info. Techs., Inc., 193 B.R. 400, 403 (Bankr. E.D.N.Y. 1996) (noting creditor's objection that the "[a]greement is not an 'executory contract' . . . and, therefore, not subject to rejection").

59. *In re* Hawker Beechcraft, Inc., 486 B.R. 264, 276 (Bankr. S.D.N.Y. 2013). These cases are legion: "This Court has already ruled that the Settlement Agreement is not executory, and therefore the Debtor could not reject it. Likewise, since it is not an executory contract, the Debtor cannot assume it." *In re* Airwest Int'l, Inc., No. 86–00145, 1988 WL 113101, at *3 (Bankr. D. Haw. Oct. 12, 1988).

60. *See* Westbrook & White, *supra* note 6, at 482 ("We propose an end to zombie contracts and the obsolete notions that keep them upright by abolishing the 'material breach' rule."); Westbrook, *supra* note 3, at 239.

simply hide from the consequence of a finding of non-executoriness, presumably hoping the parties would just sort out amongst themselves what to do next in this limbo.[61] Court after court, right up to the circuit level, has continued to struggle.[62] And debtors, too, flounder over just what they can do in a world of uncertain executoriness.[63]

"Executoriness," a little textual throwaway from the Chandler Act era's amendments clarifying archaic provability issues, has now become the hook of one of bankruptcy law's most intractable (and pointless) sources of jurisprudential confusion—What is an "executory" contract in bankruptcy that the debtor can subject to § 365?[64]

### *C. Traditional Responses to Executoriness's Problems*

*1. Defining Executoriness: Countryman and the Material Breach Test.*—This brings us back to Vern Countryman. Neither the Act nor the Code defined "executory," perhaps thinking it too obvious.[65] An important academic figure in the development of the 1978 Bankruptcy Code, Countryman propounded a widespread test that now bears his name for whether a contract is executory. Under Countryman's definition, a contract is executory if both parties have sufficient unperformed obligations so that either's discontinuance would constitute a material breach, hence the label "material breach" test.[66] Courts loved the test's seeming simplicity, although only a few openly recognized that it just pushed litigation onto the "materiality" prong.[67]

The material breach test does indeed work well for many simple

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61. *E.g.*, *In re* Interstate Bakeries Corp., 751 F.3d 955, 964 (8th Cir. 2014) (limiting itself to declaration of non-executoriness); *In re* S.A. Holding Co., LLC, 357 B.R. 51, 59 (Bankr. D.N.J. 2006) (same).

62. "Because § 365 applies only to executory contracts, a debtor-in-possession does not have the option of rejecting or assuming non-executory contracts and remains bound by the debtor's obligations under those contracts after the bankruptcy filing." Stewart Foods, Inc. v. Broecker (*In re* Stewart Foods, Inc.), 64 F.3d 141, 145 (4th Cir. 1995) (noting elsewhere in its opinion that the consequence of deemed continuation is the same as assumption).

63. *E.g.*, *In re* Sudbury, Inc., 153 B.R. 776, 776 (Bankr. N.D. Ohio 1993) (seeking to avoid unwelcome contract by arguing in the alternative *either* it was executory and would be rejected *or* it was non-executory and therefore incapable of assumption).

64. An interesting, but ultimately unhelpful, Supreme Court foray into this riddle is *Central Tablet Mfg. Co. v. United States*, 417 U.S. 673 (1974), which attempted to distinguish "executory" from "executed." *Id.* at 684–85, n.7.

65. In the adoption of the Code in 1978, Congress candidly admitted it had no definition of "executory." H.R. REP. NO. 95-595, at 347 (1977) ("Though there is no precise definition of what contracts are executory, it generally includes contracts on which performance remains due to some extent on both sides.") (Source text is entirely capitalized.).

66. Countryman I, *supra* note 4, at 460.

67. *See* Chattanooga Mem'l Park v. Still (*In re* Jolly), 547 F.2d 349, 350–51 (6th Cir. 1978) (noting that material breach test does "not resolve this [executoriness] problem"). The zenith of

contracts, but problems arise with more nuanced arrangements. Take, for example, option contracts, where the debtor merely holds a valuable option to purchase Blackacre for a favorable price. Lacking an obligation ever to exercise the option, the debtor could scarcely be said to commit a "material breach" (or any breach) should she decline to exercise it. Under the Countryman test, this option contract would not be executory and hence could not fall under § 365 with its power to assume.[68] Counterparty-optioners who made bad deals were quick to make this argument in their debtor's bankruptcy cases, convincing courts accepting the Countryman test that the debtor simply *could not assume the option* as it could not fall under § 365(a).[69] Other problematic examples abound, including the chimerical rights hanging over a departed employee with a noncompete clause in her (erstwhile) employment contract. Clearly the employer had no remaining obligations that could be materially breached, even though the employee clearly did. The Countryman test said the noncompete was no longer an executory contract, and thus the debtor *could not reject it* under § 365, meaning the debtor–employee remained somehow permanently saddled with a de facto nondischargeable obligation.[70] And so on. Indeed, courts often resorted to "analytical gymnast[ics]" to find contracts executory (or not) in order to bring them under (or outside) § 365's scope to achieve just results.[71]

*2. Backlash: Westbrook's Call for Abolition.*—The seminal scholar to confront the problems of the executoriness doctrine and the Countryman test was Westbrook, who advocated the simplest solution: abolishing the

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confusion over "materiality" of remaining obligations—and hence the make-or-break point on executoriness—likely arises in the intellectual property cases with licensing agreements. Westbrook and White assemble a considerable footnote showing the demoralizing conflict in case law over materiality in this domain. *See* Westbrook & White, *supra* note 6, at 508 n.141, 504 n.125.

68. *E.g.*, Travelodge Int'l, Inc. v. Cont'l Props., Inc. (*In re* Cont'l Props., Inc.), 15 B.R. 732, 736 (Bankr. D. Haw. 1981) ("Since the Agreement is an option contract and not an executory contract, it cannot be assumed.").

69. *E.g.*, Intermet Realty P'ship v. First Pa. Bank (*In re* Intermet Realty P'ship), 26 B.R. 383, 388 (Bankr. E.D. Pa. 1983) ("There is no interest which could be termed an executory contract and assumed by the debtor.").

70. *See, e.g.*, *In re* Spooner, No. 11-31525, 2012 WL 909515, at *3 (Bankr. N.D. Ohio Mar. 16, 2012) (finding a noncompete contract not executory and hence un-rejectable).

71. Bronner v. Chenoweth-Massie P'ship (*In re* Nat'l Fin. Realty Tr.), 226 B.R. 586, 589 (Bankr. W.D. Ky. 1998). *Compare In re* Ichiban, Case No. 06-10316-RGM, 2014 WL 2937088, at *1–2 (Bankr. E.D. Va. June 30, 2014) (finding that seemingly trivial notice and appraisal provisions, while contingent, are sufficiently material for remaining ongoing obligations to render LLC agreement executory), *with In re* Knowles, No. 6:11-bk-11717-KSJ, 2013 WL 152434, at *4 (Bankr. M.D. Fla. Jan. 15, 2013) (contending that similar provisions are too remote to be material remaining obligations and so contract is non-executory). In *In re Drake*, 136 B.R. 325, 325 (Bankr. D. Mass. 1992), the trustee argued in the alternative that the employee–debtor's noncompete agreement was *either* non-executory and, therefore, could not be rejected *or* executory and, therefore, could be assumed and assigned!

executoriness requirement altogether and refocusing attention on the § 365(a) question whether the debtor's business decision to assume or reject a contract should survive judicial scrutiny.[72] For what one assumes was branding purposes, Westbrook felt compelled to style his abolitionist argument a "functionalist" approach to defining executoriness, even going so far as suggesting courts could fit his approach into existing case law.[73] More specifically, Westbrook initially said the test of whether a contract is executory is whether there is an economic benefit to assuming or rejecting it for the estate.[74] He then clarified in subsequent writing that the assumed precondition of the definition of executory is the historical common law definition—i.e., whether there was literally any performance, by any party, anywhere, left under the contract that still had to be done.[75] Stripped bare, Westbrook's position was not really an *interpretation* of executoriness at all; it was a compelling normative argument to purge the executoriness requirement.[76] Some courts bit,[77] but for many, it was a bridge too far.[78]

*3. Doubling Down: The ABI Commission's Retrenchment.*—Despite some enthusiastic takers, Westbrook's alternative never gained the traction of the Countryman test. True, the recent ABI Commission's Expert Group right out of the gates took Westbrook's abolitionist argument as its first recommendation for improvements to the Code on the topic of executory contracts.[79] The Commission, however, rejected this suggestion, preferring instead the "well developed" case law on executoriness, because it provides guidance to parties and courts.[80] In fact, the Commission recommended codifying the Countryman test into law, cheerfully burying the vexing questions of options, noncompetes, and other difficult contract cases into an

72. Westbrook, *supra* note 3, at 230 (advocating "abolishing the requirement of executoriness altogether").

73. *See id.* at 327 ("[T]he functional approach fits neatly within the existing structure and the detailed provisions of the Code.").

74. *Id.* at 253 (delineating "Net Value" calculus in bankruptcy).

75. 1 SAMUEL WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 1:19 (4th ed. 2007) (observing that courts identify an executory contract as "a contract, the obligation of which relates to the future, or a contract under which the parties have bound themselves to future activity that is not yet completed or performed.").

76. He eventually came clean. Westbrook & White, *supra* note 6, at 484 n.16 ("Functional Analysis was not an approach to determining executoriness, but a proposal to abandon executoriness all together as a threshold test.").

77. *See, e.g.*, *In re* Bayou Shores SNF, LLC, 525 B.R. 160, 168 (Bankr. M.D. Fla. 2014) (finding the contract executory under the functional approach and Countryman test).

78. *See, e.g.*, Butler v. Resident Care Innovation Corp., 241 B.R. 37, 44 (D.R.I. 1999) (criticizing functional analysis as "ignor[ing] the statutory mandate that the contract be executory").

79. *See* ABI ADVISORY COMMITTEE, *supra* note 13.

80. *See* ABI REPORT, *supra* note 8.

encyclopedic footnote to its report,[81] vying for the 2014 Understatement of the Year Award in admitting that courts "struggled" and the test produced inconsistencies.[82] But the decision was not just motivated by pedigree. Lying just beneath, or even at the surface, was a naked distributive concern: that § 365 accords too much power to the debtor, and so the executoriness wrinkle serves a "gating feature" function that allows some counterparties to win arguments on executoriness grounds that prevent a debtor from gaining access to § 365 and taking action that the counterparty dreads.[83]

Even leaving aside the vividness bias of the Commission's concern—focusing on the highly visible plight of the counterparty succumbing to the debtor's power under § 365 to the ignorance of the more diffuse benefit to all other stakeholders of the estate aided by that debtor's adroit treatment of a contract—the primary objection to the retention of executoriness as a "gating" valve is that the concept lacks normative coherence or principle. (Westbrook himself witheringly agrees.)[84] Similar gatekeeping could arise by saying the judge gets to flip a coin and each time it's heads the debtor can't use § 365. That, too, would reduce the power of the debtor, but not in a way that any well-designed legal system would consider tolerable. A principled way to reduce debtor leverage would be to accord greater discretion to the judge under § 365(a), perhaps tacking on an ability to deny rejection or assumption if it would be inequitable under the circumstances, but that's a topic for another day.[85] Nonetheless, the Commission has doubled down on executoriness, suggesting it should stay in the Code as a beacon for litigious contractual counterparties.[86]

## III. A Better Approach to Executoriness: Taking Non-Executoriness Seriously

### *A. Sharpening the Debate*

To find a way out of this mess, we need a new approach. Let us consider the two archetypal contracts for which the debtor is likely to face an executoriness challenge. As mnemonic, we can use aviary labels: first, the unwanted "albatross" that the debtor wants to drop like a hot potato but the counterparty seeks to cast as non-executory, hoping that doing so will stymie

81. *Id.* at 113 n.416.

82. *Id.*

83. *Id.* at 115 (bemoaning the "unfair[ness]" abolition of executoriness would visit on counterparties).

84. The Commission retained executoriness as a safety valve on debtor abuse "at the sacrifice of logic and, more importantly, predictable commercial results." Westbrook & White, *supra* note 6, at 486–87.

85. Westbrook and White would seem to agree. *Id.* at 486.

86. ABI REPORT, *supra* note 8, at 114 (noting litigation experience of some ABI Commissioners).

the debtor's rejection efforts by barring access to § 365 (and its rejection powers); and second, the coveted "golden goose" that the debtor is desperate to keep but the counterparty also seeks to cast as non-executory to similarly stymie the debtor's assumption by foreclosing § 365 (and its assumption powers). Think of a hot realty option to scoop up Blackacre for a song: it's a golden goose for the option holder; it's an albatross for the option granter.

*1. The Easy Case: The Non-Executory Golden Goose (Without Default).*—Let's start with the golden goose contract that the debtor wishes to keep, which, for even further simplicity, we'll assume is not in default. Suppose the counterparty challenges executoriness. If the debtor wins on the executoriness argument, the contract is assumed under § 365. If the debtor loses, the contract cannot be assumed under § 365. But what does that mean? The non-executory contract is still property—best thought of as a chose in action to sue for the debtor's rights under the contract.[87] More accurately, it is hybrid property conjoining the debtor's right to enforce the contract benefits with the deleterious obligations to perform that the counterparty can translate into a claim if breached under § 502.[88] Thus, formally, the contract-qua-hybrid property passes to the estate under § 541's capacious reach to "all legal or equitable interests of the debtor in property."[89] This allows the debtor to enjoy its economic benefit as property of the estate.[90] All this is done irrespective of § 365. Thus, at least in the absence of default, whether the contract is executory or not has no effect on the debtor's exploitation of the economic rights; § 365, and *a fortiori* "executoriness," is irrelevant.[91]

*2. The Harder Case: The Non-Executory Albatross.*—The albatross is where things start to get complicated. If the debtor wants to reject an unwanted contract, but the counterparty launches an executoriness challenge, the debtor faces more of a hurdle. Again, if the debtor wins, no problem and the contract is rejected under § 365(a). But if the counterparty succeeds in arguing the contract is non-executory and hence cannot be rejected under § 365, what happens? In a thoughtful historical discussion, Michael Andrew noted that under prior American and English practice, the undesirable

87. The Act provided for "rights of action arising upon contracts," 30 Stat. 565 (1898), *amended by* 66 Stat. 429 (1952), 11 U.S.C. § 110(a)(5) (1958), and "property, including rights of action," *id.*, as property of the estate.

88. Technically, the acceleration of all claims, 11 U.S.C. § 101(5) (2012), means that the liabilities crystallize as well so as to permit comprehensive discharge. But that is of no moment when the debtor wishes to assume.

89. *Id.* § 541(a)(1).

90. Countryman indirectly accepted this reasoning. Countryman I, *supra* note 4, at 458–59.

91. *See, e.g.*, Warner v. Warner (*In re* Warner), 480 B.R. 641, 652, 655 (Bankr. N.D.W. Va. 2012) (LLC agreement that was not executory still entered the bankruptcy estate under § 541); Ehmann v. Fiesta Inv., LLC (*In re* Ehmann), 319 B.R. 200, 206 (Bankr. D. Ariz. 2005) (same).

contract never entered into the bankruptcy estate in the first place—it was "excluded," because unless and until a receiver or an assignee accepted debtor property under the Act, the historical abandonment doctrine left the estate unscathed.[92] Whatever the historical accuracy of his argument (and it does appear accurate),[93] Andrew's "exclusionary" approach now seems outdated given the 1978 Code's intentional inclusivity through the expanded definition of claim, where *everything* is included in the estate to enable comprehensive resolution of financial distress.

Many courts struggle with the non-executory albatross, assuming that it nevertheless persists if it is unable to be rejected under § 365(a).[94] Yet a contract is still a contract, and even if it cannot be rejected under § 365, it can still be repudiated. Moreover, bankruptcy courts do not generally order specific performance against the trustee (due to the innocence of the other creditors from the debtor's prior acts).[95] Thus, for most contracts, the only real remedy for the counterparty from debtor repudiation is a breach claim for damages.[96]

Now, under formal rejection of an executory contract via § 365, the Code specifies that the counterparty has a provable unsecured damages claim relating back to the petition date.[97] But if the contract is non-executory and the debtor wants to repudiate, courts become flummoxed, most apparently implying (hoping?) that the debtor has to perform.[98] Andrew, of course, solves this problem by having the albatross never enter the estate in the first

92. *See* Andrew, *Rejection*, *supra* note 11, at 881 (noting that courts "excluded 'executory' contract and lease assets from the bankruptcy estate . . . absent an election by the trustee to accept them").

93. *E.g.*, Copeland v. Stephens (1818), 106 Eng. Rep. 218, 222 (KB) (holding title to leases and contracts does not pass to estate unless "accepted").

94. *E.g.*, *In re* Capital Acquisitions & Mgmt. Corp., 341 B.R. 632, 637 (Bankr. N.D. Ill. 2006) (finding LLC operating agreement non-executory and thus "enforceable" in bankruptcy).

95. *See, e.g.*, *In re* Pina, 363 B.R. 314, 333–35 (Bankr. D. Mass. 2007) (refusing to enforce prepetition injunctive judgment where it would harm unsecured creditors by diminishing size of bankruptcy estate); ABI REPORT, *supra* note 8, at 119 ("[R]ejection of an executory contract or unexpired lease should not . . . entitle the nonbreaching, nondebtor party to a right of specific performance.").

96. For simplicity, this Article will assume all breach claims are reducible to damages to avoid the sidebar of can-be-compelled-to-accept-monetary-judgment issues. 11 U.S.C. § 101(5)(B) (2012). Critically for bankruptcy, these damages will never be compensatory for the counterparty if paid with the general unsecured dividend. Thus, in an idealized contract world of frictionless damages awards, a counterparty would be economically indifferent to performance or breach-remedied-by-full-expectation damages. Not so in bankruptcy, where any damage award (absent priority) will be paid out for pennies on the dollar. Westbrook, *supra* note 3, at 253 (labeling, one feels gleefully, the discounted bankruptcy dividend as "little tiny Bankruptcy Dollars").

97. 11 U.S.C. § 365(g)(1) (2012).

98. *E.g.*, *In re* KBAR, Inc., 96 B.R. 158, 159–60 (Bankr. C.D. Ill. 1988) (holding Hardee's franchise agreement to be no longer executory and hence its covenants could not be rejected in bankruptcy but rather remained in full force).

place and so not be a problem for the trustee (but then presumably also being not provable, taking us back to the unhappy, old days). Yet, there is a plausible argument that cannot be ignored: if the debtor demurs performance of such a contract, the breach claim becomes an administrative charge against the estate *entitled to priority repayment*.[99]

The argument for priority status of a non-executory contract's abandonment damages goes something like this. Everyone agrees that if the debtor assumes an executory contract under § 365 and then subsequently breaches, the breach damages are administrative expenses of running the estate; that's in the Code.[100] Just as the trustee has to pay utility bills postpetition, if the trustee enters into a contract postpetition, so too does that business expense become a cost of running the estate that is entitled to administrative priority.[101] An assumed executory contract is no different from a new contract entered into postpetition: it's a cost of running the show that the trustee willingly incurs on the calculus that the benefits outweigh the burdens (the same way most trustees find paying the electric bill worth it to keep the lights on).

Following my formalism on the golden goose above, however, if the contract is somehow non-executory, it still has to go somewhere, under the doctrine of Conservation of Contractual Mass. It must, therefore, enter the estate under § 541 automatically. Thus, the trustee must dispose of it as *estate property* to get rid of it (in this case, repudiate the contract and give rise to a concomitant breach claim). Since this abandonment occurs postpetition, it must be another cost of running the estate (think of it as paying the garbage collector to haul off unwanted debris). Ergo, the breach damages are also an administrative expense, just as with an executory contract the trustee assumes but later breaches.[102] The only difference here from § 365 is that this de facto assumption prior to rejection is purely involuntary and never approved by the bankruptcy court.[103] This prospect of favored priority helps explain why a counterparty to an albatross seeks a declaration of non-executoriness. The first best position, of course, is to trick the court into thinking that exclusion from § 365 simply ends the discussion and the debtor is just out of luck and must go on performing forever; but the nearly as attractive fallback position

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99. *See* 11 U.S.C. § 507(a)(2) (2012) (priority repayment status for administrative claims); *id.* § 365(g)(2) (conferring administrative status on post-assumption breach claims).

100. *Id.* § 365(g)(2).

101. *Id.* § 503(b)(1).

102. The counterparty tried this tack in *In re Airwest Int'l, Inc.*, No. 86–00145, 1988 WL 113101 (Bankr. D. Haw. Oct. 12, 1988), but the court held it was "premature" to adjudicate the priority claim pending assessment whether postpetition conduct by the debtor was tortious. *Id.* at *3.

103. *Compare* 11 U.S.C. § 541(a)(1) (no approval required for automatic vesting of the estate with all the debtor's property), *with id.* § 365(a) (requiring court approval for assumption).

is to say that if such a non-executory contract is rejected, the breach damages must be treated as administrative claims entitled to first priority payout.[104]

*3. The Hardest Case: Non-Executory Golden Goose (with Default).*— Finally, let us return to the golden goose, which we discovered is easy for the debtor to retain when we assume the absence of default. But if we relax that assumption and put the debtor in default, then we see the incentive to fight over executoriness. The power to cure defaults effectively neutralizes the state law contract rights of the counterparty to respond to a material breach with the self-help remedy of termination by forcing the counterparty to accept the debtor's cure and keep the contract alive.[105] This allows, by federal preemptive power of the Code, a debtor to resurrect a slain golden goose (or more precisely, resuscitate a mortally wounded one). If the contract is non-executory, however, and simply sitting in the debtor's lap under § 541, then unless we find a power elsewhere in the Code, there is *no cure power of § 365(b)* to preserve that contract's innate value to the debtor. Thus, we can encapsulate the golden goose problem as one of no express power to cure. And indeed, we can fret further by noting an *ipso facto* clause—providing for the contract to terminate automatically upon filing for bankruptcy—would also escape § 365(e)'s invalidation provision if the contract falls outside that subsection's scope as non-executory.

To summarize, there seemto be both primary and secondary counterparty advantages incentivizing executoriness challenges. For albatrosses, which the counterparty says are non-rejectable, the primary advantage is to trick a debtor or court into requiring performance, period, while the secondary advantage is priority status payment for breach damages in the event of non-performance/rejection/abandonment/repudiation—whatever we want to call it. The primary advantage to the counterparty for golden geese in arguing they are non-assumable is tricking the debtor into just giving up on the contract, while the secondary advantage is to block the cure power of § 365(b). I now seek to demonstrate through a proper understanding of the Code's text and structure that these claimed advantages are not just theoretically repugnant to the Code but *doctrinally unsupportable* (or at the very least, are not doctrinally preordained).

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104. Note that absent recognized property rights, they will not prevail in an action against the debtor for specific performance in a bankruptcy court. For a good property rights analysis case, see *In re Walter Energy, Inc.*, No. 15–02741–TOM11, 2015 WL 9487718, at *6 (Bankr. N.D. Ala. Dec. 28, 2015). *See also In re* Plascencia, 354 B.R. 774, 780 (Bankr. E.D. Va. 2006) (holding that a recorded realty option created a non-rejectable property interest).

105. The muscular cure power of § 365(b) can be contrasted with the limited cases where cure is allowed at state law. *See, e.g.*, U.C.C. § 2-508 cmt. 2 (AM. LAW INST. & UNIF. LAW COMM'N 2014) (explaining the limited power to cure in sale-of-goods contracts if "circumstances" justify).

### B. *Entering the Debate: Working Through the Code on Non-Executoriness*

We have above identified the three paradigmatic cases of non-executory contracts in ascending order of legal complexity and now turn to what I contend is their proper treatment under the Code if we take the concept of a non-executory contract seriously (i.e., not as a show-stopper whose declaration magically truncates further discussion).

As previously discussed, the first scenario is easy: a golden goose not in default. Consider, for example, a valuable unexpired option held by the debtor that the optioner wishes to evade. The optioner argues that the option cannot possibly be an "executory" contract due to its flunking the Countryman test (as there would be no material breach if the debtor did nothing until the end of time). The optioner then drops the second shoe and argues that because it is not executory, the option cannot fall under § 365 and, therefore, cannot be assumed under § 365(a). Poof! It disappears as a debtor asset. Commentators have struggled to shoehorn the option into the Countryman test,[106] but the simpler solution, *contra* Westbrook, is to concede that it is not an executory contract. As discussed above, however, it cannot just vanish. The unexpired option still exists as inchoate "property of the estate" under § 541,[107] just as a lien is an inchoate twig in the bundle of rights. As such, the debtor need do nothing with regards to this property. If the optioner ever asks the debtor whether the option is "assumed," the debtor can just respond she no more needs to assume the option than she needs to assume the drill press in the factory: it's all valuable property of the estate to be deployed in due course.[108]

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106. Andrew, *Reply to Westbrook*, *supra* note 11, at 32–34. This is a frequent problem with insurance cases, in which the prepaid premium seems to discharge the insured's obligations, and so when the unexpired policy needs to be assumed, the debtor–insured will point to all the purportedly executory remaining duties to cooperate, i.e., to assure executoriness. *See, e.g.*, Pester Ref. Co. v. Ins. Co. N. Am. (*In re* Pester Ref. Co.), 58 B.R. 189, 191 (Bankr. S.D. Iowa 1985) (finding the contract to be executory).

107. *See, e.g.*, BNY, Capital Funding LLC v. U.S. Airways, Inc., 345 B.R. 549, 556 (Bankr. E.D. Va. 2006) ("As an unexercised option, the LOI was property of U.S. Airways's bankruptcy estate.").

108. Unlike § 365(a), § 541's automatic vesting of the non-executory golden goose will not give the counterparty definitive notice of its legal obligations—a policy some argue is an important bankruptcy one. *See, e.g.*, Westbrook & White, *supra* note 6, at 518 (asserting that notice to counterparties is necessary to promote fairness). But so what? What notice is needed for a happy counterparty whose contract is not in default—that the contract is continuing to be performed uneventfully as it has been all along? Let that tree fall in the forest! Accordingly, I am unsympathetic to the optioner in *Bronner v. Chenoweth–Massie P'ship* (*In re Nat'l Fin. Realty Tr.*), 226 B.R. 586 (Bankr. W.D. Ky. 1998). That optioner was left uncertain whether an option had been assumed or rejected after broken-off negotiations, mistakenly assuming/hoping it was rejected only to be surprised two years later when a third party exercised the option. *Id.* at 588–90. If the clear default rule is that contracts pass to the estate and remain there unless and until rejected under § 365 or abandoned under § 554, then the counterparty has legal certainty and knows it has a duty to pester.

*1. Abandoning the Albatross.*

*a. The Power.*—What about the converse situation of a burdensome contract that the debtor wants to run screaming from? Here, we might flip the debtor to be the optioner in the prior example, or consider an erstwhile employee–debtor laboring under a noncompete clause. The counterparty/option holder now argues that the contract flunks Countryman, so it cannot be rejected pursuant to § 365(a), because of course it doesn't fall under § 365's purview. Noncompete cases are notorious for accepting this view (probably because the court thinks the debtor is trying to pull a fast one by weaseling out of a noncompete clause), and so these cases simply say that the clause somehow "remains valid."[109] But the proper answer, doctrinally, lies again in remembering that, formally, the wart-laden contract is the property of the estate under § 541—but that the trustee can *abandon* the property under § 554, which provides that "[a]fter notice and a hearing, the trustee may abandon any property of the estate that is burdensome to the estate."[110] To be sure, a contract is a curious hybrid form of property conjoining an asset (the chose in action to compel the benefit of the bargain) with a liability (a claim for the consideration the debtor owes). Abandonment of the property on the asset side of the ledger does not "vaporize[]" the counterparty's claim on the liability side,[111] of course, but that truism does not undermine the debtor's absolute power under § 554 to abandon the albatross. Once again, § 365 is never needed.[112] Courts seem to underappreciate the role of § 554 in this

109. Jenson v. Cont'l Fin. Corp., 591 F.2d 477, 482 (8th Cir. 1979) (holding that "the security agreement is not executory," and thus it "remains valid"); *see also, e.g.*, Meiburger v. Endeka Enters. (*In re* Tsiaoushis), 383 B.R. 616, 621 (Bankr. E.D. Va. 2007) (concluding that an operating agreement was not executory and thus its sections remained "valid and fully enforceable"); Ready Prod., Inc. v. Jarvis (*In re* Jarvis), No. 04-10806-JMD, 2005 WL 758805, at *5 (Bankr. D.N.H. Mar. 28, 2005) (finding the noncompete agreement non-executory and non-rejectable in granting employer–plaintiff injunctive relief against employee–debtor).

110. 11 U.S.C. § 554(a) (2012).

111. Sunbeam Prods. v. Chi. Am. Mfg., LLC, 686 F.3d 372, 377 (7th Cir. 2012).

112. I leave to one side the concern of seasoned practitioners of "inadvertent" assumption. True, automatic vesting under § 541 does not require an overt act, as does § 365, to check mistaken albatross acquisition, but neither does deemed rejection under § 365(d) protect against inadvertent rejection. In other words, there is no intrinsically "safe" default rule. The choice is between a default rule, with the attendant risks of carelessness, *see* Ebert v. DeVries Family Farm, LLC (*In re* DeVries), No. 12-04015-DML, 2014 WL 4294540, at *14 (Bankr. N.D. Tex. Aug. 27, 2014) (finding that because trustee never assumed, § 365(d) deemed executory contract rejected), or the ambiguous quagmire of no default specification, *see* Phx. Mut. Life Ins. Co. v. Greystone III Joint Venture (*In re* Greystone III Joint Venture), 995 F.2d 1274, 1281 (5th Cir. 1991) (holding that the chapter 11 debtor's leases continue—and the lessees have no provable claim against the bankruptcy estate—when the debtor neither assumes nor rejects its leases with third parties).

context.[113] Even courts that get to the right result do not seem to understand how they are getting there.[114]

*b. The Claim.*—Thus, the debtor can happily abandon a non-executory contract under § 554, without need to address § 365 and its executoriness gate at all. This, of course, is a breach (formally an anticipatory repudiation, but the result is the same). But that conclusion avoids the harder question of what befalls the counterparty's claim that is engendered by such a breach.[115] There are three possibilities: the counterparty has no claim; the counterparty has a general unsecured claim; or the counterparty has an administrative priority claim. The first possibility arises from the Swiftian reasoning that if § 365 does not apply, then presumably § 365(g)(1)'s conferral of the unsecured claim upon the aggrieved counterparty cannot kick in. One doubts the executoriness-denying counterparties intend this to be the logical consequence of their executoriness victory. Nor is it a plausible outcome because it would require de-coupling the contract's liabilities from its assets, a result unseemly to bankruptcy jurisprudence and common sense.[116]

Therefore, there must be some form of damages claim filable by the aggrieved counterparty for the rejection breach. But what sort of claim? Recall that if this were an *executory contract* breach claim, the Code's clear text of § 365(g)(1) designates it as a general unsecured one.[117] Why a

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113. For example, *In re FBI Distribution Corp.* simply declares that the postpetition breach of a non-executory contract gives rise to an unsecured prepetition claim, a result I find congenial, but with no reference to § 554. Mason v. Official Comm. of Unsecured Creditors (*In re* FBI Distrib. Corp.), 330 F.3d 36, 48 (1st Cir. 2003).

114. Discussion of § 554 is frequently lacking in these cases. *See, e.g.*, *In re* Majestic Capital, Ltd., 463 B.R. 289, 301–02 (Bankr. S.D.N.Y. 2012) (using non-executoriness to prevent priority treatment of burdensome severance package, yet nonetheless "grant[ing] the motion to reject"); *In re* Exide Techs., 378 B.R. 762, 766 (Bankr. D. Del. 2007) (using non-executoriness to prevent debtor from having inadvertently assumed expensive retirement agreement). Andrew, in defending his exclusionary approach, embraces the abandonment power. *See* Andrew, *Rejection*, *supra* note 11, at 863 (noting that rejection and abandonment both result in "exclusion of an asset from the estate"). And in a footnote, he seems to agree with the core of my analysis. *Id.* at 890 n.165.

115. Andrew's "exclusionary" approach led to the cumbersome conclusion that such contracts would revert to the debtor (not estate) and plausibly give a claim against the debtor for breach that might not be discharged by the debtor's bankruptcy. Andrew, *Rejection*, *supra* note 11, at 863.

116. *See* Century Indem. Co. v. Nat'l Gypsum Co. Settlement Tr. (*In re* Nat'l Gypsum), 208 F.3d 498, 506 (5th Cir. 2000) ("Where the debtor assumes an executory contract, it must assume the entire contract, *cum onere*—the debtor accepts both the obligations and the benefits of the executory contract.").

117. 11 U.S.C. § 365(g)(1) (2012). What's interesting about § 365(g)(1) is that its retroactive designation of the claim as occurring prepetition, *id.* § 502(g), appears to be textually necessary to render the counterparty an estate "creditor." *Id.* § 101(10)(A). Would the non-executory breach counterparty, unable to rely on these relation-back provisions, not be able to be a "creditor"? Although little seems to ride on it for the debtor (as the counterparty still holds a dischargeable "claim," *id.* §§ 524(a)(2), 1141(d)(1)(A)), the counterparty may face some grief under § 726. But it

different result for a *non-executory* contract? Recall further the reasoning above that deems the breach as if the contract had been *assumed and then rejected by the estate*. Everyone agrees that that is a priority claim (a stance codified in § 365(g)(2)).[118] If, however, we accept the logic from the golden goose scenario above that a non-executory contract vests in the estate automatically by § 541 without need to resort to § 365 at all, then we are faced with the necessary sauce for the gander that to abandon it the debtor must abandon property *of the estate*—hybrid property that carries an appurtenant claim for damages. Thus, since the estate is doing the abandoning that gives rise to the breach claim, the breach claim should be a cost of the estate's doing business, and hence entitled to administrative priority.[119] Viewed this way, § 365(g)(1) is not so much the conferral of provability (that it historically was) but a dispensation withdrawing the presumptive administrative priority of an estate breach claim. Closing the textual circle on this reasoning, because § 365(g)(1) demotes the breach claim to "mere" unsecured status for executory contracts, the lack of a similar demotion clause elsewhere in the Code for non-executory contracts means, just as Andrew feared, that the breach claim against the estate could be deemed to trigger administrative expense priority.[120]

Textual checkmate? Hardly. The solution lies in fighting text with text. And here I have the advantage of the Code's actual language, which Countryman did not have in 1973. The incursion of expenses postpetition is a necessary condition for administrative expenses under § 503(b) of the Code.[121] But postpetition timing, while necessary, is not sufficient. Rather, we must take cognizance of the Code's insistence of administrative expenses being "actual" and "necessary,"[122] and as textually inclined courts inform us:

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appears to be of little moment: courts routinely consider the non-executory breach counterparty to have a claim under § 502 and seem to muddle through just fine. *See, e.g.*, *In re* FBI Distrib. Corp., *supra* note 113, at 48 (holding the postpetition breach of non-executory contract triggered the prepetition claim as a "contingent claim . . . [even though] the right to payment arises during the reorganization when the contingency occurs"); Stewart Foods, Inc. v. Broecker (*In re* Stewart Foods, Inc.), 64 F.3d 141, 143, 145 (4th Cir. 1995) (holding counterparty had prepetition claim for postpetition breach of stipulated non-executory contract).

118. Congress either caps this intrinsically beneficial claim or deems it administrative notwithstanding its lack of benefit (depending on one's perspective) for certain leases. 11 U.S.C. § 503(b)(7) (2012).

119. Andrew noted that the historic *Copeland* case may have been animated (wrongly, in his view) by this very concern. Andrew, *Rejection*, *supra* note 11, at 859–63 ("[The *Copeland* concept's] premise, that the estate would become liable merely by succeeding to a contract or lease, was not clearly correct.").

120. *Id.* at 860 ("The courts in these pre-statutory cases thus identified contracts and leases as assets having the perceived potential of imposing administrative liabilities *upon the estate* by virtue of its succession to the debtor's ownership.").

121. Section 503(b) deals with expenses of the estate, which are given priority under § 507(a)(2). 11 U.S.C. §§ 503(b), 507(a)(2) (2012).

122. *Id.* § (b)(1)(A). *See* Ford Motor Credit Co. v. Dobbins, 35 F.3d 860, 866–68 (4th Cir. 1994)

> The modifiers "actual" and "necessary" must be observed with scrupulous care[,] because [o]ne of the goals of Chapter 11 is to keep administrative costs to a minimum in order to preserve the debtor's scarce resources and thus encourage rehabilitation. In keeping with this goal, § 503(b)(1)(A) was not intended to saddle debtors with special postpetition obligations lightly or give preferential treatment to certain select creditors by creating a broad category of administrative expenses.[123]

Here, the trustee/DIP as fiduciary of the estate has no desire for the counterparty's services. They are not an insurance premium that preserves valuable property the estate wishes to realize. Nor are they taxes, that necessary evil levied on that valuable property, which are also explicitly provided for in § 503.[124] Rather, they are the dead hand of the past, clamoring for a leg up on other creditors, offending bankruptcy's policy of equality.[125] But what is even more important is that the estate *never* receives any benefit from the rejected contract and its related breach claim. This observation is critical to contrast the situation from that where the debtor affirmatively assumes an executory contract (thus enjoying some benefit from it) and then subsequently breaches it. There, the estate has, however fleetingly, enjoyed some "actual" and "necessary" usage of the contract and must pay the piper for its attendant costs in the event of breach.[126] With this non-executory

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(holding that "actual and necessary" costs must stem from affirmative use, as opposed to mere passive possession, of estate property by the debtor *and* such use must provide concrete, as opposed to merely potential, benefit to the estate).

123. *Dobbins*, 35 F.3d at 866 (alterations in original) (internal citations and quotations omitted) (quoting General Amer. Transp. Corp. v. Martin (*In re* Mid Region Petroleum, Inc.), 1 F.3d 1130, 1134 (10th Cir. 1993)).

124. 11 U.S.C. § 503(b)(1)(B) (2012).

125. *See Dobbins*, 35 F.3d at 865 (quoting *In re* James B. Downing & Co., 94 B.R. 515, 519 (Bankr. N.D. Ill. 1988) ("The presumption in bankruptcy cases is that the debtor's limited resources will be equally distributed among the creditors. Thus, statutory priorities must be narrowly construed.")). A strand of jurisprudence has evolved involving environmental liabilities for burdensome property the debtor abandons postpetition under § 554. Some courts have not allowed administrative priority precisely because of the lack of benefit to the estate. *See, e.g.*, *In re* H.F. Radandt, Inc., 160 B.R. 323, 327 (Bankr. W.D. Wis. 1993) (Section 503 "mandate[s] that [administrative priority] be granted where necessary to 'preserve' the estate," and "preservation [would not] be accomplished by granting [administrative priority to environmental cleanup]"). But many have tagged the debtor with cleanup costs as an administrative priority. *See, e.g.*, United States v. LTV Corp. (*In re* Chateaugay Corp.), 944 F.2d 997, 1009–10 (2d Cir. 1991) ("If property on which toxic substances pose a significant hazard to public health cannot be abandoned, it must follow . . . that expenses to remove the threat posed by such substances are necessary to preserve the estate."). The complex issues of federal environmental policy and the interaction between CERCLA and the Code require caution with generalization from these cases.

126. *Dobbins*, 35 F.3d at 867 (collecting authority), focuses on the mere possession of creditor property versus affirmative use or conscious exploitation of resources. *Id.* (citations omitted) (noting that "a benefit to the estate results only from use of the . . . property" and "[t]hat which is actually utilized by a Trustee in the operation of a debtor's business is a necessary cost"). *Dobbins* and its ancestors/progeny have enjoyed more citations vigor than the Supreme Court's odd tort case of

contract, by contrast, the unwanted property automatically vested into the estate over the debtor's howling, and the debtor abandoned it at the first possible moment.[127] Accordingly, the seeming analogy between the assumed-and-subsequently-rejected (executory) contract and the automatically-vested-but-never-wanted-and-quickly-abandoned (non-executory) contract falls apart.[128] The simple conclusion is that because unwanted non-executory contracts never confer any benefit, ever, upon the estate, their breach damages upon rejection cannot find the textual anchor to avail themselves of § 503(b).[129] They are neither an "actual" nor "necessary" cost of "preserving" the estate. As such, the concern of presumed priority status collapses, permitting the debtor to abandon property of a contractual albatross under § 554.[130] Ample case law supports this proposition.[131]

*2. Assuming the Golden Goose.*—Previously, I have contended that a debtor need do nothing to "assume" an advantageous non-executory contract; it automatically vests its way into the estate through § 541. But for simplicity, that prior discussion assumed the contract was not in default. If we relax that assumption, the debtor faces a harder task. Recall both that (1) general state contract law permits a contract party facing material breach to walk away

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*Reading Co. v. Brown*, 391 U.S. 471 (1968), which established the proposition, largely on policy grounds, that a postpetition tort damages claim should enjoy administrative priority. *Id.* at 485. Nearly all subsequent cases have cabined *Brown* to torts. *See, e.g.*, *In re* Lazar, 207 B.R. 668, 681 (Bankr. C.D. Cal. 1997) ("From *Reading* arose the general rule that the postpetition tort liabilities of a business that continues to operate in bankruptcy qualify for administrative expense priority as actual and necessary expenses for preservation of the estate.").

127. I have no problem with the debtor paying administrative priority expenses for intra-bankruptcy usage under the contract.

128. We might also draw indirect support from the Supreme Court's recent musings in *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973, 985 (2017) that priority provisions can be treated more flexibly in the context of reorganization when value is created for all creditors but less so in the context of final liquidation where claimed priority must be scrutinized especially rigorously.

129. The court in *Mason v. Official Comm. of Unsecured Creditors (In re FBI Distribution Corp.)*, 330 F.3d 36, 48–49 (1st Cir. 2003) embraced this logic. It disagreed that the breach claim on a non-executory contract should get administrative claim priority, because even though the contract was breached postpetition, and even though as a non-executory contract, it apparently was unrejectable and saddled the estate in perpetuity, it nonetheless did not confer any benefit on the debtor postpetition. *Id.* Accordingly, the breach claim was held to be a general unsecured claim (mimicking the outcome of § 365(g)(1) as if the contract had been executory and rejected), following my proposed analysis.

130. At least one court has adopted my approach of treating the "rejected" non-executory contract the same as if rejected under § 365. *See In re* Hawker Beechcraft, Inc., 486 B.R. 264, 277 (Bankr. S.D.N.Y. 2013) (awarding prepetition breach claim for damages for non-executory contract rejected by debtor); *see also In re* Majestic Capital, Ltd., 463 B.R. 289, 299 (Bankr. S.D.N.Y. 2012) (allowing the debtor to reject COO's employment contract even though "the contract was not executory" and denying administrative priority).

131. *See, e.g.*, *Dobbins*, 35 F.3d at 868 ("[I]t . . . strikes us as inequitable to tax unsecured creditors for a decline in the value of collateral when the decline does not result from a use that actually benefits the estate.").

from the contract in self-help and (2) bankruptcy law tries, absent a countervailing federal bankruptcy policy interest, to respect state law entitlements (such as contract remedies) to the maximum extent possible.[132] Thus, we start from an orientation that a contract in material default should be cancelable by the counterparty and not subject to any resuscitation in bankruptcy absent some special Code power.

Section 365, however, accords just such special power. Section 365(b)'s condition on assumption that requires cure necessarily implies a power to cure. The precise scope of the § 365 cure power is not free from textual doubt and warrants its own painful statutory exegesis,[133] but it would be absurd to suggest there is no power to cure implicit in § 365(b). Case closed for executory contracts. For non-executory contracts, which by definition cannot avail themselves of § 365(b) and its cure power, the power to cure must come from elsewhere.

*a. Reorganization.*—Fortunately for reorganization cases, the Code expressly confers a power to cure defaults in a plan of reorganization.[134] Thus, statutorily, there is no important difference between the power to cure executory contracts and non-executory contracts in reorganization cases.[135]

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132. Butner v. United States, 440 U.S. 48, 55, 57 (1979) (holding that state law should presumptively determine rights and obligations of debtors and creditors absent a countervailing federal bankruptcy policy evidenced by structure, text, and history of the Code).

133. *Compare In re* Claremont Acquisition Corp., Inc., 113 F.3d 1029, 1035 (9th Cir. 1997) (holding debtors may not assume or reject a contract that is impossible to cure), *with In re* Vitanza, No. 98-19611DWS, 1998 WL 808629, at *20, *24 (Bankr. E.D. Pa. Nov. 13, 1998) (allowing assumption despite impossible-to-cure default). *See also In re* Bankvest Capital Corp., 270 B.R. 541, 543 (Bankr. D. Mass. 2001) ("[P]enalty rate obligation and a nonmonetary default are two separate types of breaches which a debtor is not required to cure prior to assumption of a contract."). Congress tried to fix these provisions with BAPCPA, but it's unclear if it did. Risa Lynn Wolf-Smith, *Bankruptcy Reform and Nonmonetary Defaults—What Have They Done Now?*, AM. BANKR. INST. J., Aug. 2005, at 6, 35. ("[C]hanges made in the Bankruptcy Reform Act of 1994 left practitioners unsure about whether debtors' obligations to cure non-monetary defaults had been eliminated. The Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) has finally answered some of the questions, though the language is murky.").

134. 11 U.S.C. §§ 1123(a)(5)(G), 1322(c)(1) (2012).

135. There are discrepancies at the margin. For example, the general power to cure in § 1123(a)(1)(G) does not excuse penalties of the sort expressly excused from cure for executory contracts under § 365(b)(2)(D), but it is hard to imagine this wrinkle ever becoming a driver of future executoriness litigation. (A strand of case law unnecessary to resolve here struggles to reconcile §§ 365(b)(2) and 1123(d). *See, e.g., In re* Sagamore Partners, Ltd., Bankr. Appeals, 512 B.R. 296, 306–313 (S.D. Fla. 2014) (attempting to harmonize § 365(b)(2) with § 1123(d)), *aff'd in part, rev'd in part and remanded sub nom. In re* Sagamore Partners, Ltd., Fed. Appx. 864 (11th Cir. 2015); *In re* Phx. Bus. Park Ltd. P'ship, 257 B.R. 517, 520–21 (Bankr. D. Ariz. 2001) (relying on § 365(b)(2) in addressing § 1123(d) and the 1994 amendments).) Of course, not everyone wants to cure in reorganization. In one unusual case, *Meilburger v. Endeka Enterprises LLC (In re Tsiaoushis)*, the reorganizing debtor *wanted* to *ipso facto* dissolve an LLC agreement and so argued that the LLC agreement was non-executory to avoid § 365(e)'s invalidation clause. 383 B.R. 616, 616–17 (Bankr. E.D. Va. 2007) (noting chapter 11 trustee's opposition to the LLC property

The harder problem, then, is in liquidation cases under chapter 7, where the non-executory contract finds no succor analogous to §§ 365, 1123, or 1322. And, indeed, there might be an inverse textual implication that the absence of these explicit textual cure provisions should be read to forbid it "interstitially" for chapter 7 debtors.

*b. Liquidation.*—The question of the chapter 7 debtor seeking to assume a defaulted non-executory golden goose is admittedly the thorniest for this analysis. I flag at the outset that this subset is a rare one. Most executoriness fights Westbrook and White unearthed in their comprehensive empirical study were in reorganization cases, and of the subset of liquidation cases, not one involved an assumption battle.[136] Nonetheless, abundant caution counsels that we press on to see if such a power can be found. And to tackle this question, we can initially divide the liquidation universe of contractual defaults into "*Ipso Facto*" Breaches and "Everything Else" Breaches.

*i. Ipso Facto.*—Consider first *ipso facto* defaults, where the sole breach of the contract is the very occurrence of bankruptcy. Does the Code permit the debtor to cure?[137] I think the answer is probably "yes" given § 541(c)(1).[138] That provision of the Code invalidates *ipso facto* clauses that would terminate a contract and thus prevent it from becoming property of the estate. So the federal hostility to *ipso facto* clauses is clearly established.[139]

The Code also invalidates *ipso facto* clauses and excuses them from the cure requirements of § 365(b).[140] Should this be taken as a textual signal that § 541 cannot be relied upon to do all the work of rescue from *ipso facto*

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manager's motion contending that the operating agreement was executory). This case's odd posture makes it of limited helpfulness, alas, but still fun.

136. *See* Westbrook & White, *supra* note 6, at 536–61 app. (analyzing thirty-three cases in an appendix—only two of which involved liquidations, and none involved a debtor attempting to assume an executory contract where the counterparty objected on non-executoriness grounds).

137. Perhaps "ignore" is better than "cure," because what would "cure" even mean in this context—voluntarily dismissing the petition?

138. *See* 11 U.S.C. § 541(c)(1) (2012) ("[A]n interest of the debtor in property becomes property of the estate . . . notwithstanding any provision in an agreement . . . or applicable nonbankruptcy law— . . . (B) that is conditioned on the insolvency or financial condition of the debtor.").

139. Note the historical contrast from earlier bankruptcy laws where *ipso facto* clauses were honored; perhaps Congress over time bristled at the destruction of value. Countryman has an excellent historical discussion on courts' reluctance to give effect to *ipso facto* clauses, with fundamental disagreement over (a) whether the Act's respect of them with regard to unexpired leases should be cabined to leases or extended to all executory contracts, and (b) whether they could be respected only in straight bankruptcy (versus chapter reorganization) cases under the Act. Countryman II, *supra* note 23, at 521–27.

140. 11 U.S.C. § 365(b)(2) (2012) (excusing *ipso facto* default cure); § 365(e)(1) (invalidating *ipso facto* default clauses).

clauses? I don't think so. Even leaving aside the permissibility of Congress using some belt and suspenders to avoid negative implications (perhaps having some overlap between §§ 541(c)(2) and 365(b)(2)), if we really wanted to get down into the textual weeds, we could point to § 365(b)(2)'s nominally broader scope than § 541(c)(1)'s. For example, § 365(b)(2) expands the denigration of *ipso facto* terms to those triggered by postpetition finances.[141]

More importantly, if we step back from the text to consider the structure and purpose of the Code, it makes little sense to invalidate an *ipso facto* clause in an executory contract for purposes of getting the contract into the bankruptcy estate only to find that, but for § 365(b)(2), the same contract would be unassumable. What would the purpose of its entry into the estate have even been—to await inevitable rejection? But of course, if we take seriously the concept of a non-executory contract, then we immediately recall § 365 is of no moment because such a contract vests into the estate automatically by virtue of § 541, and it is quite clear that § 541(c)(1) invalidates the *ipso facto* clause at the vesting stage.[142] Accordingly, even for the chapter 7 debtor, who is accorded no textually explicit power to cure defaults, it seems uncontentious to claim that defaults on account of *ipso facto* clauses may be ignored and the federal bankruptcy policy of hostility toward them may comfortably preempt the state law contract right of automatic termination.[143]

*ii. Everything Else.*—The harder question, then, is the Everything Else world of defaults. Can they be cured for the chapter 7 debtor? After all, if a non-executory contract is a discrete "thing" that enters the estate irrespective of § 365, then that "thing" is a contract already in default. Assuming no stay violation,[144] presumably the counterparty has the right to

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141. *Id.* § 365(b)(2).

142. This is the approach taken by *In re Denman*, 513 B.R. 720, 725, 727 (Bankr. W.D. Tenn. 2014) and *Movitz v. Fiesta Inv., LLC* (*In re Ehmann*), 319 B.R. 200, 206 (Bankr. D. Ariz. 2005).

143. A strand of LLC cases has tried to revivify state laws providing for *ipso facto* termination of contracts through the back door of § 365(c)(1), which bars assumption of contracts if assignment is prohibited by applicable non-bankruptcy law. 11 U.S.C. § 365(c)(1). These cases sneakily say that while the contract is not *ipso facto* terminated (per § 365(e)), it can never be assumed (per § 365(c)(1)), leading to the same result: killing the contract for the debtor. This proposition is contentious. *Compare, e.g.*, Nw. Wholesale, Inc. v. PAC Organic Fruit, LLC, 357 P.3d 650, 662–63 (Wash. 2015) (holding § 365(e)(1)'s prohibition against *ipso facto* clauses to be inapplicable), *with, e.g.*, Horizons A Far, LLC v. Webber (*In re* Soderstrom), 484 B.R. 874, 880 (Bankr. M.D. Fla. 2013) (holding § 365 applies if the contract is executory).

144. It is readily possible that a declaration of breach could be shown as an attempt to punish the debtor for stiffing the counterparty. *See, e.g.*, Pester Ref. Co. v. Ins. Co. of N. Am. (*In re* Pester Ref. Co.), 58 B.R. 189, 191 (Bankr. S.D. Iowa 1985) ("Even if the insurance contract was not treated as an executory contract, the unilateral act of INA to cancel the policy would be barred by the automatic stay of 11 U.S.C. § 362(a).").

exercise the termination right for self-help. Can the bankruptcy debtor, nonetheless, ram cure down the counterparty's throat? Here, I concede a need to resort to weaker textual footing, but I take solace in the Code's Last Refuge of the Textually Damned, § 105.[145]

Let's consider the situation in which it may arise. A debtor in liquidation is in default on a valuable contract the trustee wishes to assume, say, an LLC operating agreement, but the counterparty has successfully argued the contract is non-executory because remaining performance is only due on one side. The trustee promptly offers to cure, noting that the counterparty has incurred no financial harm on account of the default. Nonetheless, the counterparty recalcitrantly insists on its rights to terminate the contract, seizing upon the technical right of the default as an escape route from the unfavorable bargain. Just to close the loop, state law has no equitable doctrines of excuse that the hapless debtor can point out to stave off this churlish termination.[146] At wit's end, the trustee comes to the bankruptcy court and says, "Look, this contract has value for the creditors, it's no skin off the counterparty's nose because all defaults have been cured, and so I would like an injunction under § 105 preventing him from exercising his self-help remedy of termination." Could the bankruptcy court issue such relief?

This hypothetical presents sympathetic facts for just such a countervailing federal policy—the preservation of value for creditors with no offsetting harm to the counterparty (other than being made to live with the bad deal it made)—that warrants preempting the counterparty's state law self-termination rights.[147] Well before *Timbers*,[148] the Supreme Court accorded great latitude to bankruptcy courts to enjoin difficult creditors whose actions would imperil a bankruptcy proceeding's success.[149] And, of course, since the contract is being ratified by the estate, any subsequent breach damages would be entitled to administrative priority as a backstop,

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145. 11 U.S.C. § 105(a) (2012) ("The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.").

146. *Cf.*, *e.g.*, 1 RESTATEMENT (SECOND) OF CONTRACTS § 229 (AM. LAW INST. 1981) (establishing that a non-occurrence of a condition can be excused if the non-occurrence would result in disproportionate forfeiture).

147. Westbrook offers some initial insights into what fundamental bankruptcy policies might be (at least with respect to contracts), listing four basic policies. Westbrook & White, *supra* note 6, at 515–17. I accept these at face value and note that maximization of creditor value appears front and center on this policy list.

148. *See* United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365, 372, 377–78 (1988) (upholding the restriction of secured creditors' compensation for lost time value of their collateral).

149. The canonical case for this proposition is *Cont'l Ill. Nat'l Bank & Tr. Co. v. Chi. R.I. & P. Ry. Co.*, 294 U.S. 648, 678–79 (1935), although there was some debate over that holding's application to straight bankruptcy liquidation cases. *Id.* at 671–72. *See also* Countryman II, *supra* note 23, at 517 (discussing case law).

according the counterparty even more comfort.[150] As a final kicker, the debtor would note that under chapter 11, this surly creditor would be deemed to have supported the plan as unimpaired.[151] Indeed, on these facts, I would think the case for injunctive relief would be presumptively attractive; albeit requiring some hoops to jump through, cure would be allowed, by hook or by § 105 crook. If that is so, then even the hardest case of a non-executory contract—the non-*ipso facto* default of a chapter 7 debtor's contract—still can be cured under a properly purposive reading of the Code. It's not as textually straightforward as § 365(b), but the cure power is still there.

*3. Summary.*—Note what a thorough working through of the Code's application to a non-executory contract reveals: far from relying on § 365, the debtor or trustee has ample opportunity under the Code, perhaps with some creativity but surely on solid textual footing, to cure an attractive contract's default and thereby retain a golden goose. This means, crucially, that the power to cure actually requires no recourse to § 365(b) and thus no concomitant need to demonstrate executoriness: executory and non-executory contracts alike can be cured. And if that is correct, then I have succeeded in my underlying mission of eliminating the main functional difference in the treatment of executory versus non-executory contracts under the Code. Indeed, I am too modest. Not only have I collapsed the difference between executory and non-executory contracts under the Code regarding the ability to assume a golden goose, but I have also similarly collapsed the distinction regarding the rejection of an albatross, by dispatching the concern of priority repayment of § 554 abandonment damages. My mission accomplished, the counterparty has lost the primary foundation for the arbitrage opportunity, which means the *ex ante* incentives to litigate executoriness will dry up. Executoriness remains but it has lost all its sting.[152] As such, I no longer care about the definition of executoriness, and, more importantly, nor will anyone else.[153] This is perhaps a radical approach to

150. 11 U.S.C. § 365(g)(2) (2012).

151. *Id.* § 1124(2).

152. At worst, I have created a new boilerplate duty to tack on a footnote to every § 365 motion that says, "in the event this contract is found to be non-executory, the debtor retains its rights under § 541 and moves to abandon under § 554." (This is a trivial evil compared to *Stern v. Marshall*, 564 U.S. 462 (2011), this generation's fount of bankruptcy litigation.)

153. If pushed for my own definitional preference, I would revert to Williston's: "[A] contract, the obligation of which relates to the future, or a contract under which the parties have bound themselves to future activity that is not yet completed or performed." 1 SAMUEL WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 1:19 (4th ed. 2007). *See also* 3A WILLIAM COLLIER, COLLIER ON BANKRUPTCY ¶ 63.33, at 1935 (14th ed. 1940) ("All contracts to a greater or less extent are executory. When they cease to be so, they cease to be contracts.") (citing Williston). This approach has a pedigree in the legislative history to the Code, see *In re Norquist*, 43 B.R. 224, 225, 228 (Bankr. E.D. Wash. 1984) (citing Williston and stating "the Supreme Court in citing the legislative history appears to have agreed with the expression of Congress that a precise definition

executory contracts, but its elimination of senseless litigation should make it normatively attractive.

## IV. Counterarguments

I anticipate several respectable counterarguments to this new approach, and so I offer this preemptive rebuttal.

### *A. Reading "Executory" Out of the Code?*

This is a trick objection, because many, like Westbrook, *want* to read it out of the Code, so would see this as praise rather than criticism to my approach of taking the idea of a non-executory contract seriously. But I can see a deeply committed textualist bemoaning that I have rendered "executory" redundant, effectively redrafting § 365 as if the word had been deleted.[154]

This critique misses the mark. My treatment of non-executory contracts merely mimics the treatment of executory contracts under § 365, but does so through a distinct doctrinal route that respects the formal categorical difference. Now, whether this synthetic replication upsets the "structure" of the Code's "implicit policies" by creating near-redundancy is a separate attack, but as soon as we move into the structure and policies of the Code, I gain the theoretical high ground by pointing to the absolute absence of justification found anywhere in the Code (or anywhere else) to treat non-executory contracts differently from executory contracts.[155]

### *B. Evading § 365's Burdens?*

My response to the prior criticism unfortunately runs right into the snare of this correlative complaint: if non-executory contracts merely mimic § 365 treatment, but don't exactly run through the § 365 gauntlet, then that means the burdensome provisions of § 365 (e.g., the adequate assurances of future performance as a precondition to assumption under § 365(b)(1)(C)), are simply excused for non-executory contracts. If so, I've turned executoriness

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of an executory contract is inadvisable"), and Westbrook, too, finds it congenial. Westbrook & White, *supra* note 6, at 520 (explaining that "executory" should be understood in light of common law). Thus, I do not care about "truly" non-executory contracts in the sense of discussing sunsets after dark, Westbrook, *supra* note 3, at 243, just those contracts that flunk the Countryman test but still have unperformed aspects.

154. Similar angst enraged the district court in *Stewart*, which objected to the treatment of a non-executory contract's breach as a claim under § 502, because to do so would treat the contract as rejected under § 365(b), which was not allowed in its view—a holding that was promptly reversed on appeal. *See* Stewart Foods, Inc. v. Broecker (*In re* Stewart Foods, Inc.), 64 F.3d 141, 144–45 (4th Cir. 1995).

155. *See In re* ZRM-Oklahoma P'ship, 156 B.R. 67, 70–71 (Bankr. W.D. Okla. 1993) (emphasizing the importance of interpreting the Code in a "coherent and consistent" manner).

on its head by creating a reverse arbitrage where the *debtors* will now try to argue their contracts aren't executory to evade such requirements![156]

This concern, while logically articulable, is overstated for two interrelated reasons. First, to a considerable extent, the requirements of § 365(b)(1)(C) (and (b)(1)(B) for that matter) are largely redundant to contract rights under state law.[157] Consider by way of example the ubiquitous Uniform Commercial Code's sales provisions in Article 2. There, the insolvency of the buyer is listed as a categorical example of objective grounds for insecurity, and insecurity gives rise to the right to demand adequate assurance of future performance.[158] Second, recall that the foundation of the statutory power to allow nonconsensual cure (outside the reorganization context) is likely injunctive relief through § 105, and so, in fashioning that relief, a bankruptcy court would be loath to give the debtor a "freebie" of not having to provide assurances that her executory-contract-holding peer would, especially when such assurances are likely the required baseline at state law. (There certainly are no countervailing federal policies requiring *Butner*

156. This appears to have happened in the cryptic *Bronner v. Chenoweth-Massie P'ship* (*In re Nat'l Fin. Realty Tr.*), 226 B.R. 586, 587–88 (Bankr. W.D. Ky. 1998), in which the receiver wrote a sloppy plan forgetting to assume a valuable option in chapter 11. *Id.* When the counterparty caught him and demanded evidence of assumption, he pivoted to say the contract was non-executory and so had not been presumptively rejected (as all executory contracts had been) under the plan. *Id.* The court agreed and the option, deemed non-executory, survived the plan, saving the receiver's bacon. *Id.* The counterparty's unsuccessful argument had sounded in notice, implying that absent such evidence of assumption the counterparty was right to infer deemed rejection and enjoy repose accordingly. *Id.* The counterparty's problem, however, is really in the Code's lack of default rules for executory contracts in non-chapter 7 cases. Westbrook and White imply that the option should have been deemed rejected under § 365(d), but I don't see how that's the case, unless this was a chapter 7 case, which it did not appear to be. *See* Westbrook & White, *supra* note 6, at 524. Section 365(d)(2) merely sets a deadline for the assumption/rejection decision, but, unlike § 365(d)(1), it does not specify the consequences of the failure to act. This results in a case law quagmire. *See, e.g.*, Phx. Mut. Life Ins. Co. v. Greystone III Joint Venture (*In re* Greystone III Joint Venture), 995 F.2d 1274, 1281 (5th Cir. 1991) (noting that a lease neither assumed nor rejected before a chapter 11 plan confirmation just rides through with the debtor still bound and with the creditor without a provable claim). Note § 365(p), which does provide a default rule in the case of inaction, interestingly does not textually restrict its application to unexpired leases. 11 U.S.C. § 365(p) (2012). Indeed, this is not the only provision of § 365 that does not apply on its face to executory contracts: § 365(o) would appear to apply only to *non-executory* contracts—and this is a subsection of § 365! *See id.* § 365(o):

> [T]he trustee shall be deemed to have assumed . . . and shall immediately cure any deficit under, any commitment by the debtor to a Federal depository institutions regulatory agency . . . to maintain the capital of an insured depository institution, and any claim for a subsequent breach of the obligations thereunder shall be entitled to priority under section 507.

157. *See* 11 U.S.C. § 365(b)(1)(B) (2012) (requiring compensation for breach damages before assumption); *id.* § 365(b)(1)(C) (requiring adequate assurance of future performance before assumption).

158. U.C.C. § 2-609 cmt. 3 (AM. LAW INST. & UNIF. LAW COMM'N 2002) ("[A] buyer who falls behind in 'his account' with the seller . . . impairs the seller's expectation of due performance.").

divergence from state law that spring to mind.) In short, I am not denying the risk,[159] but I think it likely the concern of seeking a declaration of non-executoriness as a bypass around § 365's conditions on assumptions will arise infrequently.

Finally, I should mention the cognate idea of "evading" judicial review under § 365(a).[160] Recall that the assumption—or rejection—of an executory contract requires court approval.[161] If non-executory contracts do not run through § 365, are non-debtor stakeholders stripped of their judicial oversight protection? Again, I think this concern is overstated, even leaving aside the implicitly heroic assumptions about the judicial role in a corporate decision largely governed by the business judgment rule. First, a non-executory contract that is rejected is abandoned under § 554, and that does require a court hearing even if it does not explicitly require "approval."[162] Few debtors will abandon a valuable contract for nefarious reasons, fess up to it in open court, and then sit back and stare a judge in the eyes and coolly sneer, "Nothing you can do about it because it isn't even your decision to approve!" No litigant has that much political capital to squander, and every judge has heard of § 105 and can trot out decisions intoning that bankruptcy courts are courts of equity.[163] Second, a non-executory contract in default that is assumed will require court blessing as well, either through the discretionary

159. One case where this has popped up is *BNY, Capital Funding LLC v. U.S. Airways, Inc.*, 345 B.R. 549 (Bankr. E.D. Va. 2006). There, the debtor was able to retain a contract to make a financial accommodation, despite the bar of § 365(c)(2), by successfully persuading the court that the contract was non-executory and hence fell outside § 365 and § 365(c)(2). *Id.* at 553, 555. Westbrook and White see this as an outrage, where U.S. Airways got out of § 365(c)(2) jail free, Westbrook & White, *supra* note 6, at 525, but I'm more ambivalent. Even leaving aside the court's point that the debtor had onerous financial conditions precedent to meet before exercise (not least of which was keeping current on the aircraft leases to the optioner), 345 B.R. at 555, I am not sure how much divergence from state law evasion of § 365(c)(2) would entail. If, as the *U.S. Airways* court conceded, the option was a contract (albeit a non-executory one), then the traditional contract defenses and excuses spring into action. Certainly it is an open question whether insolvency of the counterparty would discharge performance, either on grounds of material mistake, 1 RESTATEMENT (SECOND) OF CONTRACTS § 152 (AM. LAW INST. 1981), or frustration of purpose, *id.* §§ 265–68, especially if the subject matter of the contract was to make a loan. At a minimum, adequate assurances would be demandable as a condition to continuation. For a good background discussion of Congress' intent behind § 365(c)(2), see *In re Teligent*, 268 B.R. 723, 737 (Bankr. S.D.N.Y. 2001).

160. Section 365(a)'s requirement of court approval stems from a long history of courts inserting themselves into an oversight role under the Act. *See* Countryman II, *supra* note 23, at 556.

161. *See* Allegheny Ctr. Assocs. v. Appliance Store, Inc. (*In re* Appliance Store, Inc.), 148 B.R. 226, 232 (Bankr. W.D. Pa. 1992) (holding that § 365(a) superseded prior case law allowing assumption without court approval).

162. The § 554 hearing will also give notice to the counterparty definitively clarifying its contractual rights.

163. Adam J. Levitin, *Toward a Federal Common Law of Bankruptcy: Judicial Lawmaking in a Statutory Regime*, 80 AM. BANKR. L.J. 1, 1 (2006) ("A basic tenet of bankruptcy practice is that 'the bankruptcy court is a court of equity.'") (citations omitted).

power to confirm the plan of reorganization or the discretionary power to order the cure injunctively in liquidation. So all roads lead to court involvement; no wool will be pulled over judicial eyes.

### C. *Forfeiting § 365's Benefits?*

Conversely, there is the reverse concern: that, other than the power to cure, there are other benefits to the debtor in § 365 that the non-executory-contract-holding debtor will not be able to access. Does my synthetic replication of § 365 through other provisions of the Code cover these benefits as well? Here, I think I have met my Waterloo and have to concede not. But it is a trivial Waterloo. The principal benefit in § 365, beyond the general power to cure addressed previously, is the excuse of an impossible-to-cure default for some forms of unexpired leases.[164]

Section 365(b)(1)(A)'s text is a mess, but it appears to excuse impossible-to-cure defaults of real property leases (and add on some extra requirements for what to do if that lease is non-residential).[165] The implication of the most likely reading of the drafting is that a debtor with an impossible-to-cure default on a personal property lease is just out of luck: the impossibility precludes cure, and non-cure precludes assumption. Here, I am forced to concede an apparent benefit unique to § 365; the debtor outside § 365 has no similar salvation. That said, the problem appears trivial when we, for the first time, confront § 365's application both to unexpired leases and to executory contracts. While "executoriness" has generated a litigation minefield, "unexpired" has not. Parties (and courts) are less likely to disagree whether a lease is over or not; one anticipates an empty set of litigants fighting over whether and how the debtor can cure the defaults of an *expired* lease.[166]

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164. There is the boondoggle damage claim under §§ 507(a)(2) and 502(b)(7) for certain nonresidential real property leases, 11 U.S.C. §§ 507(a)(2), 502(b)(7) (2012), but leases interest me less than contracts for the reasons given in the text. If pressed, I could parse the debtor's power to sidestep "cure[]" with "provid[ing] adequate assurance" of "prompt[]" cure as a possible benefit accorded by the Code unavailable at state contract law, but that's too fine a pinhead upon which to dance. *Id.* § 365(b)(1)(A).

165. A plausible reading is that § 365(b) does the opposite and declares that impossible-to-cure defaults on real property leases are just lethal, period, for the debtor seeking assumption, but that nonresidential leases are saved from the fire if the specified conditions are met. This interpretation requires ascribing to Congress an intent to render residential leases harder for debtors to assume than nonresidential ones, a reading of § 365(b) that skirts absurdity.

166. Although, they do fight the *timing* of when the defibrillators have to come off. *See* 11 U.S.C. § 541(b)(2) (2012) (excluding from estate nonresidential real property leases that expire under their own timing provisions).

### *D. Inapplicability of Other § 365 Provisions?*

There are surely other differences that would arise from whether or not a contract falls under § 365, but it is difficult to say *ex ante* which way they cut, let alone predict whether they will birth a new fount of arbitrage. For example, the sixty-day deemed rejection rule is clearly one that would only apply to executory contracts under § 365,[167] but it's hard to say with any confidence whether this will cause many executoriness fights. It surely does sometimes,[168] but it seems likely that whatever incentive effect it has is dwarfed by the status quo's preoccupation with the make-or-break excutoriness question of power to assume/reject *vel non*.[169]

The two most significant wild cards are the special rules within § 365 for real estate contracts and intellectual property agreements.[170] The real estate rules are easier: the special property-like remedy accorded by § 365(i)(2) likely maps many states' real property rules for vendees in possession.[171] (Somewhat ironically, a vendee who has moved into full possession is likely to have tendered full payment and may not be in an executory contract at all.) And because it is such a rarely litigated provision of the Code, it is unclear whether § 365(j)'s rules for vendees not-yet-in-possession intend to strip property rights if state law grants an equitable property remedy under a conversion doctrine. Accordingly, it is difficult to assess whether there is a material (or any) inside-versus-outside § 365 difference here, let alone whether executoriness fights will be prevalent as a consequence.[172]

The hardest prediction pertains to the intellectual property rules of § 365(n). It is difficult to score § 365(n)'s ancillary provisions.[173] Even Westbrook throws up his hands and concedes they largely (if not identically)

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167. *Id.* § 365(d)(1).

168. It came up in *Ebert v. DeVries Family Farm, LLC* (*In re Devries*), No. 11-43165-DML-7, 2014 WL 4294540, at *4 (Bankr. N.D. Tex. Aug. 27, 2014) (trustee who missed sixty-day deadline to assume tried to argue that the LLC operating agreement was non-executory so it would not be deemed rejected).

169. *See, e.g.*, Foothills Tex., Inc. v. MTGLQ Inv'rs, L.P. (*In re* Foothills Tex., Inc.), 476 B.R. 143, 155 (Bankr. D. Del. 2012) (conceiving the debtor's entire adversary proceeding to turn on whether the contract was executory).

170. 11 U.S.C. § 365(i)(2) (2012) (special counterparty remedies for vendees in possession); *id.* § 365(j) (vendees out of possession); *id.* § 365(n)(1) (intellectual property licensees).

171. *See, e.g.*, Nickels Midway Pier, LLC v. Wild Waves, LLC (*In re* Nickels Midway Pier, LLC), 341 B.R. 486, 496–97 (D. N.J. 2006) (relying on state law to determine that § 365(i) was inapplicable).

172. The closest case I could find to mentioning this issue was *In re Nickels Midway Pier, LLC*, which mused in dicta on the preemptive scope of § 365 and its interaction with state law specific performance remedies (and more specifically, the separate provision of the Code defining "claim"). *Id.* at 498–99.

173. 11 U.S.C. § 365(n)(1)(B) (2012) (allowing some licensees to retain rights to licensed IP or supplementary agreements in return for continued royalty payments).

track preexisting non-bankruptcy contract rights.[174] Review of the case law involving § 365(n) where executoriness is disputed shows an unsurprising focus on the rejection *vel non* question (i.e., can the license be rejected or not).[175] There do not appear to be many secondary disputes over attempts to avoid perceived burdens of these ancillary provisions.[176] Moreover, there are a host of other intellectual property disputes (e.g., trademarks) that do not even fall under this subsection's scope.[177] In sum, loath as I am to end on an equivocal note, in all honesty I cannot say whether these residual issues will drive ongoing executoriness disputes; I can just share empirical skepticism that they are likely to be meaningful.[178]

## V. A (Very Quick) Road Test Case Study

In closing, let us take a brief road test to see how the new approach would have better served a famous bankruptcy case, *Exide*.[179] In *Exide*, the bankruptcy court (affirmed by the district court) held the debtor's burdensome trademark assignment contract to be executory and allowed its rejection as a key step of the reorganization plan.[180] The counterparty appealed all the way up to the Third Circuit, which reversed and said the debtor's contract was not executory under the Countryman test and hence could not be rejected.[181] The poor bankruptcy court was left with a reorganized debtor that was now saddled with a trademark license that it thought had been cancelled but was now apparently binding.[182] Under the

174. Westbrook & White, *supra* note 6, at 532, 533 n.246. Westbrook indeed brands any divergence from state law in § 365(n) (and cognate subsections) "congressional mistakes." Westbrook, *supra* note 3, at 331 n.434.

175. *See, e.g.*, Lewis Bros. Bakeries Inc. v. Interstate Brands Corp. (*In re* Interstate Bakeries Corp.), 751 F.3d 955, 961–64 (8th Cir. 2014) (applying the Countryman test to uphold the objection that the license could not be rejected as it was non-executory). This case presents the wonderful surreality of the debtor's attempt first to reject the contract, and then subsequent withdrawal of that motion and substitution of a motion to assume it. *Id.* at 959. Nonetheless, the counterparty's resistance persisted in both postures! *Id.* at 964.

176. One example is *Szilagyi v. Chi. Am. Mfg., LLC* (*In re Lakewood Eng'g & Mfg. Co.*), 459 B.R. 306 (Bankr. N.D. Ill. 2011), in which the parties fought over the scope of the waiver provisions of § 365(n)(2)(C). *Id.* at 341. But there was no challenge to executoriness in that case, which was conceded. *Id.* at 342.

177. 11 U.S.C. § 101(35A) (2012).

178. *Cf.* Westbrook & White, *supra* note 6, at 511 (noting that the focus of executoriness fights is whether debtors can assume/reject the contract).

179. *In re* Exide Techs., 607 F.3d 957 (3d Cir. 2010).

180. *Id.* at 961.

181. *Id.* at 964 ("Because the Agreement is not an executory contract, Exide cannot reject it.").

182. The debtor's backup argument that the contract had nonetheless been dealt with under the plan as a claim was rejected by an angry remand court that invoked judicial estoppel, finding the debtor's conduct end-runny. Exide Techs. v. Enersys Del., Inc. (*In re* Exide Techs.), Bankr. No. 02-11125 (KJC), Adv. No. 10-52766 (KJC), 2013 WL 85193, at *1, *7–8 (Bankr. D. Del. Jan. 8, 2013) (noting that the complaint was filed "in an attempt to circumvent" the Third Circuit ruling).

functional approach, of course, it could have been rejected. Executoriness's definition was not just fatal, but unclear in its application to the various courts that faced the issue. Under my approach, the debtor would not have cared. What the debtor could have done as soon as it realized it was in dodgy executoriness terrain, which it did,[183] was simply tack a footnote onto its § 365 rejection motion saying that in the alternative, the motion was to abandon burdensome property of the estate under § 554 to which it would not accord any damages priority status. As such, either by § 365(g)(1) or by § 502, the debtor would have paid off a monetary claim to the licensee and moved on, as it hoped, with its reorganized life. All this would have been independent of whether the Third Circuit adhered to Countryman, decided to overrule it in favor of Westbrook, or took some new path (of which there is no shortage of options).[184]

## VI. Conclusion

The ABI Commission has made clear that executoriness is here to stay. Since it is, we should stifle its arbitrage-inducing tendencies by demonstrating how § 365's key functional outcomes can be replicated by carefully applying other provisions of the Bankruptcy Code to non-executory contracts, the residual category of agreements that flunk whatever test of executoriness is governing circuit law. This new approach will redirect the executoriness litigation energy to more productive fields. This path does not follow Westbrook directly. It does better: it honors him for having shown us the right way.

183. *Id.* at *4.

184. *See, e.g.*, *In re* Riodizio, Inc., 204 B.R. 417, 424 (Bankr. S.D.N.Y. 1997) (following neither Countryman nor Westbrook).

# Global Insolvency Proceedings for a Global Market: The Universalist System and the Choice of a Central Court

Jay L. Westbrook*

In this time of relative prosperity, large multinational companies are filing insolvency proceedings all over the world.[1] Restructuring is now part of the daily routine of global business—back then a bit more, at the moment a bit less, but always a stream of needed repairs. The overall challenge is to manage damaged enterprises across borders in a world governed by nation-states. In this Article, I suggest that we should enlarge our perspective to embrace not only the Model Law on Cross-Border Insolvency (Model Law),[2] but also the larger system of modified universalism that it both presupposes and anticipates.

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1. At the time of writing, recent filings have included *In re* Premium Point Master Mortg. Credit Fund, Ltd., No. 1:18-BK-10586 (Bankr. S.D.N.Y. filed Mar. 1, 2018); *In re* PT Bakrie Telecom Tbk, No. 1:18-BK-10200 (Bankr. S.D.N.Y. filed Jan. 29, 2018); *In re* RCR Int'l Inc. and RCR Int'l Inc., No. 1:18-BK-10112 (Bankr. D. Del. filed Jan. 18, 2018); *In re* Bibby Offshore Servs. Plc, No. 1:17-BK-13588 (Bankr. S.D.N.Y. filed Dec. 20, 2017); *In re* CGG Holding (U.S.) Inc., No. 1:17-BK-11637 (Bankr. S.D.N.Y. filed June 14, 2017); *In re* Toys "R" Us, Inc., No. 3:17-BK-34665 (Bankr. E.D. Va. filed Sept. 19, 2017); *In re* Zetta Jet USA, Inc., No. 2:17-BK-21386-SK (Bankr. C.D. Cal. filed Sept. 15, 2017); *In re* Seadrill Ltd., No. 6:17-BK-60079 (Bankr. S.D. Tex. filed Sept. 12, 2017); *In re* Takata Americas, No. 1:17-BK-11372 (Bankr. D. Del. filed June 25, 2017) (seeking chapter 15 relief in aid of a Japanese proceeding); *In re* Ultra Petroleum Corp., 575 B.R. 361 (Bankr. S.D. Tex. 2017); *see also* Michael O'Boyle & Michael Perry, *Mexico's ICA Says Filed Pre-packaged Bankruptcy Plan*, REUTERS (Aug. 26, 2017), https://www.reuters.com/article/us-mexico-ica/mexicos-ica-says-filed-pre-packaged-bankruptcy-plan-idUSKCN1B604S [https://perma.cc/8NDV-VLLU].

2. U.N. COMM'N ON INT'L TRADE LAW (UNCITRAL), UNCITRAL MODEL LAW ON CROSS-BORDER INSOLVENCY WITH GUIDE TO ENACTMENT AND INTERPRETATION, U.N. Sales No. E.14.V.2 (2014) [hereinafter UNCITRAL MODEL LAW].

## I. Background

As explained just below, I have argued that the text of the Model Law should be interpreted as a "systems" text consistent with its intended purpose as a major part of that international system. I expand the argument here to say that the needs of the system of modified universalism embodied in the Model Law should govern judicial action over an expanding pool of issues touching international insolvency. Those jurisdictions that have adopted texts or judicial principles similar to the Model Law should embrace a similar understanding, even if they do not adopt the Model Law itself.[3]

This Article discusses these key elements of the Model Law system:

1. At the heart of the system of modified universalism is the choice of a central court to coordinate a multinational case, so the discussion includes an analysis of the general rule for choosing the central court and important exceptions to that rule;
2. The "center of the debtor's main interests" (COMI) test best identifies the central court because the court's relationship to the debtor legitimates its actions as the jurisdiction with the strongest interest in the case;
3. Certain situations create exceptions to the COMI test or require supplementation of that test; and
4. Every multinational case requires real-time coordination and cooperation among jurisdictions, which in turn require an active judicial role in guiding professionals toward international communication and cooperation.

### *A. "Systems" Texts*

When a binding legal text is adopted that has a purpose or rationale only if applied as part of a system, the courts should be active to resolve issues it does not squarely cover in a way that facilitates that system. To retain old doctrines or refuse to consider new issues may amount to obstruction of the system that the lawgiver meant to adopt.[4] In this Article, my central objective

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3. A number of countries that have not adopted the Model Law nonetheless follow similar principles under the doctrine of "comity" or international cooperation. *See, e.g.*, Jay Lawrence Westbrook, *Chapter 15 at Last*, 79 AM. BANKR. L.J. 713, 721 & nn.50–53 (2005) (discussing German and Spanish bankruptcy law).

4. This Article is not the place to launch an extensive discussion of textualism, so I will merely note my disagreement with any doctrine that permits the courts to announce they will not move an inch beyond what a legal text requires even to further the policy that is reflected in the text. I must observe, however, that allegiance to such doctrines seems often to turn on judicial views about the underlying policy. For a juxtaposition of the ever-narrowing scope of "extraterritorial" effects of Congressional enactments with the constantly expanding boundaries of the Federal Arbitration Act in the United States, compare *In re* Ampal-Am. Isr. Corp., 562 B.R. 601 (Bankr. S.D.N.Y. 2017) (refusing to apply provisions of the Bankruptcy Code extraterritorially absent clear statutory intent), *with* Am. Express Co. v. Italian Colors Rest., 570 U.S. 228 (2013) (holding that the FAA does not

is to describe the needs of the global insolvency system as represented by the Model Law. As one consequence, I hope to advance our understanding of the Model Law as a systems law that should be interpreted in ways that advance the needs of the system. In a recent article, I outlined the systems analysis:

> One useful distinction that I have not found in the literature is the difference between a standards text and a system text. It seems plausible to divide international instruments into two broad categories: those that seek to establish international (or universal) standards and those that seek to establish an international system. . . .
>
> As a general proposition, it would seem that the international rule for the standards texts would usually be focused almost entirely on uniformity, so that states and individual actors could conform their conduct . . . to those international norms, and nations could be consistent in applying those norms. By contrast, uniformity would be an important but subsidiary goal for a system text. There the overriding need is for decisions that enable the international system to function as designed. Uniformity would certainly contribute to that goal, but would hardly be enough by itself.[5]

I concluded by proposing that "courts should determine if an international text establishes a system rather than standards; if so, it should adopt whatever [rule] best enables that system to achieve its intended ends."[6] In that analysis, the Model Law is a systems (institutional) text, while a text devoted to international rules (for example, about priority in insolvency distributions) would be a "standards" text. While any legal text must be applied as written, most texts require interpretation and occasionally the filling of an unintended gap that impedes the text's intended function. Understanding the needs of the global insolvency system helps both in applying the Model Law and in achieving the demands of modified universalism where the Model Law does not apply.[7] This Article starts with that understanding and proceeds from there.

### *B. Goals of Global Insolvency Law*

In that context, we begin with the fundamental goals of insolvency law that are common to all of us: maximizing value for all stakeholders and

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permit courts to invalidate a contractual waiver of class arbitration on the ground that the plaintiff's cost of individually arbitrating a federal statutory claim exceeds the potential recovery), and AT&T Mobility v. Concepcion, 563 U.S. 333 (2011) (invalidating a law that conditioned the enforcement of arbitration on the availability of class procedures because that law interfered with fundamental attributes of arbitration).

5. Jay Lawrence Westbrook, *Interpretation Internationale*, 87 TEMP. L. REV. 739, 750–53 (2015).

6. *Id.* at 750–51.

7. *See supra* notes 2–3 and accompanying text.

satisfying public policy in a fair allocation of that value.[8] Nations still differ substantially in defining the classes of stakeholders in an insolvency proceeding and in the allocation of value to each class,[9] but we are united in seeking to obtain as much value as possible and to achieve socially desirable ends in a fair and orderly process.

Neither of these goals can be fully realized unless a single collective insolvency proceeding extends over an entire market. Only in a single proceeding can all assets be assembled to be sold or recapitalized free of prior claims and value allocated fairly to all stakeholders.[10] Only a unified approach can produce predictable results that enhance the efficiency of market transactions based on a common understanding of the effects of insolvency.[11] For that very reason, the founders of the United States, in

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8. *See* Jay Lawrence Westbrook, *Systemic Corporate Distress: A Legal Perspective*, *in* RESOLUTION OF FINANCIAL DISTRESS: AN INTERNATIONAL PERSPECTIVE ON THE DESIGN OF BANKRUPTCY LAWS 47, 55 (Stijn Claessens et al. eds., 2001) ("General agreement exists on the central purposes of insolvency law: maximizing asset values, providing equality of treatment for creditors and other parties with similar legal rights, preventing and undoing fraud, and providing commercially predictable results and transparent legal procedures.").

9. *See, e.g.*, JANIS P. SARRA, EMPLOYEE AND PENSION CLAIMS DURING COMPANY INSOLVENCY: A COMPARATIVE STUDY OF SIXTY-TWO JURISDICTIONS 9, 13 (2008) (finding that some nations use a priority system for employees, who are viewed as "particularly vulnerable claimants," and that many of those countries institute caps on the amounts of claims that are given priority).

10. *See* Jay Lawrence Westbrook, *A Global Solution to Multinational Default*, 98 MICH. L. REV. 2276, 2292–93 (2000) (explaining that a single bankruptcy proceeding can provide a unified approach to assembly and sales of assets, increase the possibility of reorganization, and ensure equality for stakeholders with similar legal rights around the world).

11. *Id.* at 2293 ("A single court would maximize asset values . . . by providing a unified approach to assembly and sale of assets as a whole. If it commanded a worldwide stay, it could most effectively protect those assets prior to sale."). *See also* Cambridge Gas Transp. Co. v. Official Comm. of Unsecured Creditors [2006] UKPC 26, [2007] 1 AC 508 (appeal taken from the Isle of Man) (reaffirming the universalist tradition of the English common law and recognizing pragmatism and realism that are integral features of the notion of "modified universalism"); McGrath v. Riddell (*in re* HIH Cas. & Gen. Ins. Ltd.) [2008] UKHL 21, [2008] 1WLR 852, [6]–[7], [30], [36] (appeal taken from Eng.) (advocating for the principle of universalism); World Bank Group [WBG], *Principles for Effective Insolvency and Creditor/Debtor Regimes*, at 20 (2016), http://documents.worldbank.org/curated/en/518861467086038847/pdf/106399-WP-REVISED-PUBLIC-ICR-Principle-Final-Hyperlinks-revised-Latest.pdf [https://perma.cc/4WWQ-GDZW] (discussing the objectives of effective insolvency systems); TRANSNATIONAL INSOLVENCY: GLOBAL PRINCIPLES FOR COOPERATION IN INTERNATIONAL INSOLVENCY CASES princ. 1–2 (AM. LAW INST. & INT'L INSOLVENCY INST. 2012) (outlining the objectives and aim of the Global Principles) [https://perma.cc/T7MS-CJV7] [hereinafter ALI–III GLOBAL PRINCIPLES]; Todd Kraft & Allison Aranson, *Transnational Bankruptcies: Section 304 and Beyond*, 1993 COLUM. BUS. L. REV. 329, 364 (1993) ("A system that brings together all the creditors, and all the debtors' property, for a single distribution is the most efficient and equitable system possible."); John Lowell, *Conflict of Laws as Applied to Assignments for Creditors*, 1 HARV. L. REV. 259, 264 (1888) ("[I]t would be better in nine cases out of ten that all settlements of insolvent debtors with their creditors should be made in a single proceeding, and generally at a single place[.]"); Jay Lawrence Westbrook, *Multinational Financial Distress: The Last Hurrah of Territorialism*, 41 TEX. INT'L L.J. 321, 324–25 (2006) ("To function effectively, bankruptcy law must have a reach co-extensive with the market

seeking to create a single national market, realized that one of the few specific powers that must be given to the new national government was the authority to make uniform national laws on the subject of bankruptcy.[12] Similarly, older writers asserted the "universalism" of insolvency law.[13]

It follows that the globalized marketplace of the twenty-first century requires a global insolvency proceeding. That should be our goal. However, because insolvency laws differ considerably around the world, and it is a technical and difficult area of law, that ideal will not be achieved for some time.[14] In light of that, an increasing number of courts and academics have come to accept a standard that I have suggested—"modified universalism"—which is universalism adapted to the political realities of differing laws in a world in which law is administered by nation-states.[15] The objective is to

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in which it operates. It is for that reason that most bankruptcy laws are national in scope, even in countries like the United States where much commercial and property law is regional.").

12. U.S. CONST. art. I, § 8. *See* Dan J. Schulman, *The Constitution, Interest Groups, and the Requirements of Uniformity: The United States Trustee and the Bankruptcy Administrator Programs*, 74 NEB. L. REV. 91, 99–105 (1995) (discussing the original intent behind the bankruptcy power); Westbrook, *supra* note 10, at 2286–87 (noting that the Founders gave the national government the power to govern general defaults while reserving the commercial law-making power to states).

13. *See, e.g.*, J.H. DALHUISEN, 1 DALHUISEN ON INTERNATIONAL INSOLVENCY AND BANKRUPTCY 3-3, 3-11 (7th ed. 1986) (indicating that the need for coordination was becoming more widely recognized among nations and asserting that "full faith and credit" treaties have forwarded coordination in bankruptcy); JOSEPH STORY, COMMENTARIES ON THE CONFLICT OF LAWS 7–8 (Morton J. Horwitz et al., eds., Arno Press Inc. 1972) (1834) (proposing that the public welfare may necessitate exceptions to the general rule that the laws of one country are limited to that country); Lowell, *supra* note 11, at 264; Kurt Nadelmann, *Legal Treatment of Foreign and Domestic Creditors*, 11 LAW & CONTEMP. PROBS. 696, 709–10 (1946); Jay Lawrence Westbrook, *Theory and Pragmatism in Global Insolvencies: Choice of Law and Choice of Forum*, 65 AM. BANKR. L.J. 457, 458 (1991); *see also* FRIEDRICH CARL VON SAVIGNY, PRIVATE INTERNATIONAL LAW AND THE RETROSPECTIVE OPERATION OF STATUTES: A TREATISE ON THE CONFLICTS OF LAWS 257–64 (William Guthrie trans., 2d ed. 1880) (discussing the peculiar nature of bankruptcy and its implications on the conflict of laws); John D. Honsberger, *Conflict of Laws and the Bankruptcy Reform Act of 1978*, 30 CASE W. RES. L. REV. 631, 675 (1980) (discussing the trend toward harmonization between the bankruptcy systems of the United States and Canada); Stefan A. Riesenfeld, *The Evolution of Modern Bankruptcy Law*, 31 MINN. L. REV. 401, 415 & nn.95–97 (1947) (surveying classic leading scholarships in international insolvency law and theory of universality); Barbara K. Unger, *United States Recognition of Foreign Bankruptcies*, 19 INT'L L. 1153, 1183 (1985) (observing the U.S. courts' increasing recognition of foreign proceedings, which demonstrates a more cooperative universality view).

14. *See* JAY LAWRENCE WESTBROOK, CHARLES D. BOOTH, CHRISTOPH G. PAULUS & HARRY RAJAK, A GLOBAL VIEW OF BUSINESS INSOLVENCY SYSTEMS 232 & n.19 (2010) (discussing the practical obstacles faced by a unitary approach as a result of the disparities in the laws of various countries) [hereinafter WESTBROOK ET AL., A GLOBAL VIEW]; Westbrook, *supra* note 10, at 2299 (recognizing that to realize a universalist approach requires international consensus and would take a long time).

15. *See* Cambridge Gas [2006] UKPC 26 [16]–[20] (appeal taken from Isle of Man) (recognizing that English common law has traditionally believed the importance of universality in international insolvency proceedings and that the underlying principle of universality requires foreign courts' recognition and assistance); Rubin v. Eurofinance SA [2012] UKSC 46 [51] (appeal

produce results as close as possible to those that would emerge from a single global proceeding.

Modified universalism lies at the heart of the Model Law.[16] The traditional concept of "territorialism," or the "grab rule," has been largely abandoned.[17] Unlike territorialism, modified universalism requires a "central" proceeding that serves a coordinating role, as well as a sophisticated, policy-sensitive approach for choice of law.[18] The most important task of a system of modified universalism is to identify the jurisdiction that should host the central proceeding.

Under the Model Law, the "main" insolvency proceeding is the one opened at the debtor's center of main interests, or COMI.[19] The preferred result under the Model Law is that the main proceeding should be the central one that coordinates the global insolvency process. This Article discusses circumstances in which that might not be true or might not be entirely true.

## II. A Moratorium with Global Effect

The purposes of insolvency law cannot be vindicated without court control of the affairs of a debtor.[20] To apply insolvency law properly to a

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taken from Eng.) (accepting the "general principle of private international law . . . that bankruptcy (whether personal or corporate) should be unitary and universal." (quoting *In re* HIH [2008] UKHL 21, [6]–[7] (appeal taken from Austl.))); ALI–ILL GLOBAL PRINCIPLES, *supra* note 11, princ. 10; Jay Lawrence Westbrook, *Choice of Avoidance Law in Global Insolvencies*, 17 BROOK. J. INT'L L. 499, 517 (1991) ("[Modified universalism] accepts the central premise of universalism, that assets should be collected and distributed on a worldwide basis, but reserves to local courts discretion to evaluate the fairness of the home-country procedures and to protect the interests of local creditors.").

16. *See, e.g.*, Lynn M. LoPucki, *Global and Out of Control?*, 79 AM. BANKR. L.J. 79, 82–83, 86 (2005) (summarizing the history behind the promulgation of the UNCITRAL Model Law, which incorporated the universalists' "home country" concept); *see generally* UNCITRAL MODEL LAW, *supra* note 2.

17. *See* Jay Lawrence Westbrook, *Universalism and Choice of Law*, 23 PA. ST. INT'L L. REV. 625, 625 (2005) (noting that these traditional approaches have been replaced by modified universalism).

18. *See id.* at 631–32 (explaining that, under the modified universalism approach, courts should consider the usual choice of law factors like place of contracting, the parties' choice of law, principal place of business, principal location of assets, location of most creditors, and the like); *see also* WESTBROOK ET AL., A GLOBAL VIEW, *supra* note 14, at 238 (discussing how the degree of adaptability of insolvency laws in different jurisdictions affects modern universalism and choice of law).

19. UNCITRAL MODEL LAW, *supra* note 2, art. 17(2)(a); *see also* WESTBROOK ET AL., A GLOBAL VIEW, *supra* note 14, at 236 ("Under the lead of the European Union Regulation and the UNCITRAL Model Law it becomes nowadays increasingly accepted that the correct place for opening the main proceeding should be the center of the debtor's main interests.") (internal citations omitted); Susan Block-Lieb, *The UK and EU Cross-Border Insolvency Recognition: From Empire to Europe to "Going It Alone"*, 40 FORDHAM INT'L L.J. 1373, 1395–1400 (2017) (explaining the application of the COMI test to British and European laws); Lynn M. LoPucki, *Universalism Unravels*, 79 AM. BANKR. L.J. 143, 143 (2005) (describing the universalism approach under the Model Law as applying the COMI country's law to control a company's worldwide bankruptcy).

20. *See, e.g.*, Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEXAS L.

global market requires the power to halt collection efforts all over the world as quickly as possible to prevent the great loss of value that would result from a mad scramble for assets by creditors. Control is also necessary to ensure the allocation of that value in an orderly and fair way. The Model Law provides for an automatic moratorium or injunction upon recognition of a main proceeding by another jurisdiction.[21] The injunction provides the necessary cooperation by enjoining seizures by creditors, thus giving the courts control of the relevant assets in both the main and recognizing jurisdictions. The Model Law also permits interim injunctive relief prior to recognition.[22] However, the scope of this recognition injunction is not explicitly global and is subject to the constraints and limitations imposed under the law of the recognizing state,[23] so it is not a complete protection against creditor or debtor activity inconsistent with the necessary court control. That protection is also limited insofar as it may require some time to obtain relief in other jurisdictions after the filing of the main proceeding.

A better solution would be a worldwide injunction, or "stay" (in some countries a "moratorium"). No country in the world claims the power to impose a stay everywhere on the planet. But its closest approximation is what I would call an "indirect global stay," which is a stay that applies to any person (or legal entity) subject to the personal jurisdiction of a court and forbids that person from acting anywhere in the world in a way inconsistent with the court's insolvency moratorium.[24] Such a stay is limited because it applies only to persons subject to the court's personal jurisdiction, but it is global insofar as it restricts such persons' activities everywhere in the world.[25] While such a stay does not bind an actor not subject to personal jurisdiction in the country issuing the stay, it can block a large amount of debtor and creditor activity globally if the issuing court has personal

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REV. 795, 823 (2004) (discussing the importance of control in enforcing the collective process of bankruptcy); Oscar Couwenberg & Stephen J. Lubben, *Corporate Bankruptcy Tourists*, 70 BUS. LAW. 719, 742 (2015) (noting that the global stay available in U.S. bankruptcy proceedings provides better protection of debtors' assets and therefore was one of the reasons foreign corporations were attracted to the idea of filing bankruptcy in the United States).

21. UNCITRAL MODEL LAW, *supra* note 2, art. 20(1)(a).

22. *See id.* art. 19(1) (allowing courts to grant urgent relief upon application for recognition of a foreign proceeding).

23. *See id.* art. 29 (noting that the Model Law does not necessarily import the consequences of the foreign law into the insolvency system of the enacting state but that the relief granted may be aligned with a comparable proceeding commenced under the law of the enacting state).

24. I offer this phrase because I have not seen a term used to describe this sort of effect that a national court may give to an insolvency moratorium.

25. *See* Jay Lawrence Westbrook, *Multinational Insolvency: A First Analysis of Unilateral Jurisdiction*, *in* NORTON ANNUAL REVIEW OF INTERNATIONAL INSOLVENCY 11, 17–18 (2009) (explaining the personal jurisdiction requirement for the U.S. Bankruptcy Court to exercise control over bankruptcy proceedings, and the court's power to have effects on debtors' assets and actions outside of the United States).

jurisdiction over major creditors of a given debtor. For example, such a stay issued in Manhattan as to Debtor Corporation would bind JPMorgan Chase, which is undoubtedly subject to the orders of the bankruptcy court in that place. Because U.S. law says the order constrains that bank everywhere in the world,[26] the stay may prevent a large amount of activity against Debtor Corporation's assets in which that very large lender might otherwise engage.

## III. Control Countries

Because it depends on personal jurisdiction, a stay has its greatest effect when the issuing court is located in a country in which a number of major international creditors do substantial business and therefore are subject to the personal jurisdiction of that court.[27] A court in a country that is an economic backwater might not have personal jurisdiction over many important creditors in a given case, but a country located in a financial center may have great indirect power to constrain creditor activity everywhere.[28] The bankruptcy courts in Manhattan are a good example, given that a substantial percentage of the world's financial institutions do business there. I will call countries whose courts are in that position "control countries." Three of the

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26. *See, e.g.*, U.S. Lines, Inc. v. GAC Marine Fuels Ltd. (*In re* McLean Indus.), 76 B.R. 291, 295–96 (Bankr. S.D.N.Y. 1987) (finding creditors subject to the U.S. court's jurisdiction and enforcing as to property in Hong Kong and Singapore a worldwide automatic stay). Bankruptcy is not the only area in which the United States sometimes issues injunctions that include conduct outside its borders. *See, e.g.*, United States v. First Nat'l City Bank, 379 U.S. 378, 410 (1965) (affirming the imposition of a temporary injunction in an action by the United States for foreclosure of a tax lien as against a Uruguayan corporation); *see also* Richmark Corp. v. Timber Falling Consultants, 959 F.2d 1468, 1482 (9th Cir. 1992) (contempt sanctions issued against a Chinese party for non-compliance with discovery order); *In re* Grand Jury Proceedings Bank of Nova Scotia, 740 F.2d 817, 829 (11th Cir. 1984) (contempt sanction issued against a Cayman Island party for non-compliance with discovery order); Rogers v. Webster, No. 84-1096, 1985 U.S. App. LEXIS 13968, at *9–10 (6th Cir. Oct. 22, 1985) (ordering delivery of stock certificates located in Canada to Michigan); *In re* Gaming Lottery Sec. Litig., 96 Civ. 5567 (RPP), 2001 U.S. Dist. LEXIS 1204, at *18–19 (S.D.N.Y. Feb. 13, 2001) (ordering delivery of bank accounts in Scotland to New York); Koehler v. Bank of Bermuda Ltd., 12 N.Y.3d 533, 541 (2009) (ordering delivery of stock certificates located in Bermuda to New York). Many other countries do the same. *See, e.g.*, David Capper, *Worldwide Mareva Injunctions*, 54 MOD. L. REV. 328, 329–30 (1991) (U.K. Mareva injunctions).

27. *See, e.g.*, Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, 474 B.R. 76, 81 (S.D.N.Y. 2012) (upholding bankruptcy court's extraterritorial application of the automatic stay, rendering a creditor's action in the Cayman courts void); *In re* Nortel Networks Inc., No. 09–10138–KG, 2011 WL 1154225, at *1 (D. Del. Mar. 29, 2011) (affirming bankruptcy court's order enjoining administrative proceedings against the debtor in the United Kingdom in a multinational company's bankruptcy proceeding); *In re* McLean Indus., Inc., 76 B.R. at 295–96. For a current sweeping example, see Order Restating and Enforcing the Worldwide Automatic Stay, *In re* Seadrill Ltd., No. 6:17-BK-60079 (Bankr. S.D. Tex. Sept. 13, 2017), ECF No. 91.

28. *See* Westbrook, *supra* note 25, at 17–18 ("[T]he effect of the automatic stay may be to block collection efforts anywhere in the world by any creditor that does business in the U.S., including most of the major international lenders, underwriters, and investors.").

countries that will often be in that position are the United Kingdom, the United States,[29] and now Singapore.[30]

While control countries may well serve as home to central proceedings for multinational insolvencies—that is, might host the central proceeding for a given case—their final insolvency judgments may be of limited value unless they are recognized and enforced in countries that have territorial control of the debtor's assets. The specific requirements for market-wide recognition are discharge (or nonenforcement) of prior debts and recognition of changes in title to property.[31] After a reorganization plan has been approved by a court with proper jurisdiction, only the debts recognized in the plan should be enforceable in any country.[32] Following either a reorganization or a liquidation, there must also be global acceptance of the effect of the proceeding on title to property, especially as to the results of sales.[33] If an insolvency-court judgment encounters substantial local

29. There may be some question about the extent of personal jurisdiction in such matters. *See* Daimler AG v. Bauman, 134 S. Ct. 746 (2014) (sharp limitation on general jurisdiction); Walden v. Fiore, 134 S. Ct. 1115 (2014) (limiting specific jurisdiction). This line of cases may suggest difficulty in obtaining jurisdiction over foreign entities in bankruptcy proceedings, but the Supreme Court has told us repeatedly that bankruptcy is an exceptional sort of legal procedure with special rules. In the area of the Tenth Amendment, for example, the Court has found that states may be subject to federal judgments in a way not possible in other sorts of federal lawsuits. *See* Cent. Va. Cmty. Coll. v. Katz, 546 U.S. 356, 362 (2006) ("Bankruptcy jurisdiction, at its core, is in rem."); Tenn. Student Assistance Corp. v. Hood, 541 U.S. 440, 447 (2004) ("The discharge of a debt by a bankruptcy court is similarly an in rem proceeding."). *See also* Jay Lawrence Westbrook, *Interpretation Internationale*, 87 Temple L. R. 739 at nn.37–39 (2015). The "in rem" analysis of those cases is especially applicable to the automatic stay.

30. *See* Companies (Amendment) Act 2017, § 211B(1)(d) (Sing.) (allowing Singapore courts to issue an order "restraining the commencement, continuation or levying of any execution, distress or other legal process against any property of the company"). This provision was added in the recent reform in which the Model Law was adopted. NAT'L ARCHIVES OF SINGAPORE, FACT SHEET ON THE COMPANIES (AMENDMENT) BILL 2017 AND LIMITED LIABILITY PARTNERSHIPS (AMENDMENT) BILL 2017, http://www.nas.gov.sg/archivesonline/data/pdfdoc/20170310004/Factsheet%20on%20CA%20and%20LLP%20Act%20amendments_media.pdf [https://perma.cc/3F23-HXHG].

31. *See* ALI-III GLOBAL PRINCIPLES, *supra* note 11, princ. 27.1 (requiring each administrator in parallel international insolvency proceedings to obtain court approval of any action affecting assets or operations in a particular jurisdiction if approval is required under the laws of that jurisdiction). As to discharge, a control country would be able to bind a number of creditors by a discharge injunction like that arising from a chapter 11 plan in the United States, but there would likely be many smaller local creditors and property owners who would not be bound. The result would be highly inefficient and litigious. The same thing would be true of property-rights rulings including the validity of sales. Of course, it may be possible in a given case to buy out all such creditors and owners at a reasonable cost. There might remain problems of public policy and judicial conflict, especially at the COMI.

32. *See, e.g.*, *id.* princ. 37 & cmt. (recognizing a plan of reorganization adopted by a main proceeding under stated conditions, including notice).

33. *See id.* princ. 29, 36, 37 & comts. (demanding that each state assist and recognize the sales that generate maximum value for debtor's assets, and designating the reorganization plan adopted by a main proceeding as final and binding upon the debtor and every creditor when the issuing state

resistance to recognition and enforcement, the reorganization or sale may be a fiasco.

The need for a consensus on the standard for choosing a central court is actually increased as countries adopt an indirect global stay because its adoption will itself create a greater possibility of conflict among jurisdictions, especially control countries. Thus, a court who claims the role of the central court as to a debtor should seek to adopt standards that will encourage other courts to accept that court's jurisdiction as legitimate and to enforce the results obtained in the central court. Where that is true, efficient and effective coordination of international insolvency proceedings can be achieved.

## IV. Choice of Central Court

### *A. Incorporation versus COMI*

Some courts continue to look to the traditional notion that the central court should be the one presiding where a debtor company is incorporated.[34] A recent Scottish decision has strikingly highlighted the anomalies in the registration approach as applied in a globalizing world.[35] It adopted the common law idea that the law of the jurisdiction of incorporation controls the affairs of the corporation to apply Scotland's law to a thoroughly Indian company. In so doing, it stated that it was following the Privy Council in the *Singularis* case but ignored the Model Law, which applied in Scotland as it did not in *Singularis*.[36]

The Pacific Andes bankruptcy, discussed below, further illustrates the defects of the incorporation approach: diffusing control of a multinational insolvency and adding to expense and difficulty. It increases the likelihood of wasteful expense and inefficient results. It is noteworthy that in the recent

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court has international jurisdiction over the debtor and there is no pending parallel proceeding).

34. *See, e.g.*, Singularis Holdings Ltd. v. PricewaterhouseCoopers [2014] UKPC 36, [12] (appeal taken from Berm.) (elaborating on the common law rule of comity that recognizes the vesting of a company's assets under the law of its incorporation); Case C-341/04, Eurofood IFCS Ltd. v. Bank of Am. (*in re* Eurofood IFCS), N.A., 2006 E.C.R. I-3813, I-3844–45 (finding the center of the debtor's main interests in the country of its incorporation instead of the country of its administration). Some courts have reached that result only because they did not proceed beyond the presumption in the Model Law. *Cf. infra* note 40. For more detailed discussion, see Jay Lawrence Westbrook, *Locating the Eye of the Financial Storm*, 32 BROOK. J. INT'L L. 1019, 1028–30 (2007).

35. *In re* Hooley Ltd. [2016] CSOH 141 (Scot.).

36. *See In re* Hooley Ltd. [2016] CSOH 141 [33]–[36] (Scot.) (finding foreign proceedings in India as ancillary to insolvency proceedings in Scotland because Scotland is the debtor's place of incorporation). In reaching its decision, the court cited *Singularis*, a case involving countries that had not adopted the Model Law and therefore applied common law principles. *Singularis*, UKPC 36, [1], [9].

*Opti-Medix*[37] case the Singapore court focused on COMI-type factors for choosing a central court rather than the old incorporation doctrine.[38]

COMI (the location of the "main" proceeding) is the central-court concept generally accepted in the United States, the European Union, and elsewhere.[39] In the Model Law, the place of incorporation remains as an initial presumption about the center of the debtor's affairs,[40] but ease of manipulation and lack of connection to economic reality have made that standard subject to challenge in contentious insolvency cases.[41] On the other hand, the empirical work that I and others have done in the United States has shown that COMI is rarely subject to serious dispute in U.S. cases under the Model Law.[42] In turn, the finding of COMI in a jurisdiction provides a strong, legitimate basis for recognition of that jurisdiction's proceeding as central and promotes deference to its rulings to the maximum extent possible under local laws.[43]

### *B. Non-COMI Central Court*

Nonetheless, there are circumstances in which it may be plausible to argue for a central court other than the COMI court:

1. Where the case cannot be filed in the COMI court;[44]

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37. Re Opti-Medix Ltd. [2016] SGHC 108 (Sing.).

38. *See id.* at [24]–[25] (using the COMI test and recognizing the main insolvency proceedings in Japan, where the debtor's principle businesses were carried out).

39. 11 U.S.C. § 1502(4) (2012); Regulation 2015/848 of the European Parliament and of the Council of 20 May 2015 on Insolvency Proceedings (Recast), 2015 O.J. (L 141) 19, 21–22; UNCITRAL MODEL LAW, *supra* note 2, art. 2(b); Block-Lieb, *supra* note 19, at 1395–1400.

40. UNCITRAL MODEL LAW, *supra* note 2, at 8 ("In the absence of proof to the contrary, the debtor's registered office, or habitual residence in the case of an individual, is presumed to be the centre of the debtor's main interests.").

41. *See, e.g.*, *In re* Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd., 374 B.R. 122, 129 (Bankr. S.D.N.Y. 2007) (refusing to recognize Cayman Islands proceedings despite Cayman Islands being the place of the debtor's incorporation); *In re* BRAC Rent-A-Car Int'l Inc. [2003] EWHC (Ch) 128 [1], [4]–[5] (Eng.) (finding English court's jurisdiction to make an administration order over debtor company, which is incorporated in Delaware, United States, because debtor's center of main interest is in England and it had no employees in the United States); MG Rover [2005] EWHC 874 (Ch) (Eng.) (finding MC Rover France's center of principal interest located in England despite the company registration in France).

42. *See* Jay Lawrence Westbrook, *An Empirical Study of the Implementation in the United States of the Model Law on Cross Border Insolvency*, 87 AM. BANKR. L.J. 247, 261–62 (2013) (reporting that the COMI-based objection was raised only in 64 out of 573 chapter 15 cases in the study, and the argument was seriously litigated in only 7% of the overall cases).

43. Westbrook, *supra* note 34, at 1032–33. Sometimes local laws will not permit a grant of all of the relief that the central court has prescribed. For example, in a few countries it may not be possible to do anything that affects the rights of a secured creditor.

44. *See* Stipulation as to Republic of Marshall Islands Law, *In re* Ocean Rig UDW, Inc., 570 B.R. 687 (Bankr. S.D.N.Y. 2017) (No. 17-10736 (MG)) (Marshall Islands have no bankruptcy or insolvency laws).

2. Where the insolvency system in place in the COMI jurisdiction is simply unable to properly manage a multinational case, so that a filing in a control court would better serve all or virtually all the debtor's stakeholders; and
3. Where it is claimed that there is consent to the non-COMI court as the central court.

The first case is self-explanatory.

The most common situation under the second heading may be where the laws of the COMI country do not permit invocation of an indirect global stay and the debtor cannot be efficiently reorganized or liquidated on a global basis without such a stay. As long as the debtor company has a significant connection with a control court, it may be in the best interests of all concerned to permit that court to take over the case and manage it on a worldwide basis. On the other hand, the control court might still defer to the COMI court, providing the stay as assistance to that court, something that happened between the United States and Japan some years ago.[45] Another example is a debtor whose COMI jurisdiction lacks any reorganization proceeding in its laws, while the debtor is a solvent company with a cash-flow problem such that virtually all of its stakeholders would benefit from a reorganization under a modern statute.

A recent case of a corporate group, Pacific Andes Resources Development Limited, includes some elements of both examples. Pacific Andes had subsidiaries in Peru that were in insolvency proceedings there, while its parent holding company filed in Singapore, which may have been its COMI.[46] It appears that neither Peru nor Singapore was able at that time to impose an indirect global stay,[47] so some of its lenders proceeded to file full insolvency proceedings and take other actions in several other jurisdictions. The debtor group responded by filing several of its affiliates in a chapter 11 proceeding in New York, where the bankruptcy court had personal jurisdiction over the key creditors and thus could enforce an indirect global stay.[48]

The case illustrates some of the serious issues that can arise when a potential control country (here, the United States) assumes jurisdiction. First,

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45. Arnold M. Quittner, *Cross-Border Insolvencies – Ancillary and Full Cases: The Concurrent Japanese and United States Cases of Maruko Inc.*, 4 INT'L INSOLVENCY REV. 171, 181 (1995).

46. *See In re* Pac. Andes Res. Dev. Ltd. [2016] SGHC 210, [4] (Sing.) (noting that PARD was listed on the Singapore Exchange and carried out business activity in Singapore). "China Fisheries" is another common name for this case.

47. *See id.* at [53] (denying a global stay).

48. *See In re* China Fishery Grp. Ltd. (Cayman), No. 16-11895 (JLG), 2016 WL 6875903, at *1–3 (Bankr. S.D.N.Y. Oct. 28, 2016) (granting creditors' motion for the appointment of a chapter 11 trustee).

the United States had no substantial connection with the corporate group or any of its affiliates.[49] American jurisdiction was founded on a fictional connection arising from the deposit of money with the group's law firm in New York.[50] If one believed action by the U.S. court was justified nonetheless because of the absence of an alternative jurisdiction able to impose the necessary multinational stay, the court could have deferred to the Singaporean or Peruvian courts, using its control–country power in aid of coordination by the central court. Instead, it chose to take over the case and appoint a trustee to seek a solution on a worldwide basis.[51] While I am not involved in the case and do not know the details, I cannot believe that a U.S. court should take a central role absent a substantial connection with the debtor or the debtor group.[52]

Another separate insolvency proceeding was filed after the U.S. court acted, this time in the British Virgin Islands (BVI) where some of the Pacific Andes group affiliates were incorporated.[53] Lack of perceived legitimacy of the U.S. proceeding may have been part of the reason for this additional filing. Overall there have been proceedings in four or five jurisdictions and a great need for international coordination.

Pacific Andes would have been a quite different case if the debtor had had substantial assets or operations in the United States. That fact combined with the special position of the United States as a control country might have justified the United States acting as the central court and the COMI court might have agreed. If the COMI court did not agree, the courts, directly or

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49. *See id.* at *2 (recognizing that the Debtors China Fishery Group comprise a small part of the Pacific Andes Group of companies and have no assets in the United States apart from retainers pre-paid to advisors).

50. *See id.*

51. *See id.* at *20 (asserting that a trustee would be able to review and address Debtors' balances and investigate accounting irregularities without conflicts of interest, facilitate between hostile parties in the proposal, and evaluate the optimal way to maximize and realize the value of the Peruvian business; it should be said that the trustee has apparently been doing all that pretty well). It remains to be seen if the prestige of the American courts can overcome the fictional nature of this jurisdictional assertion.

52. *Cf. In re* Patriot Coal Corp., 482 B.R. 718, 747 (Bankr. S.D.N.Y. 2012) (referring to domestic venue, explaining that a forum like Manhattan would always trump many other fora if only efficiency mattered). In that case, Judge Chapman also noted that the location of key corporate functions matters more when the company is seeking to reorganize. *Id.* at 753–54. *See generally* Gregory W. Fox, *Patriot Coal: Interest of Justice Trumps Convenience of the Parties*, 32 AM. BANKR. INST. J., Feb. 2013, at 20. The larger point, for another day, is that bankruptcy implicates many public interests that should be considered by the courts most closely connected with the debtor company by real economic ties.

53. *See* Bank of Am., N.A. v. Pac. Andes Enter. (BVI) Ltd. (*In re* Pac. Andes Enter. (BVI) Ltd.), BVIHC (COM) 132 (2016), at https://www.eccourts.org/bank-america-n-v-pacific-andes-enterprises-bvi-limited-et-al/ [https://perma.cc/T2QN-3MY8] (allowing the Debtors' corporate group's insolvency to proceed in the British Virgin Island court and appointing joint liquidators over the debtors).

through the professionals, could seek a middle ground in negotiations, as discussed below.[54] In that situation, at least three courts important to the result—Singapore, the BVI, and the United States—would be adherents to the Model Law and thus required by statute to communicate and cooperate.[55]

A closely related point is the claim in some cases that a court other than the COMI court has "better law" and should therefore take the central role.[56] In a broad sense, that is the basis for a court to exercise the role of a central court in the cases discussed above where the COMI court cannot enforce an indirect global stay effectively or where that jurisdiction lacks a reorganization law and a reorganization is clearly best for all concerned. However, this justification blurs in a more nuanced circumstance where a COMI country has the necessary legal tools, but its laws will not permit the relief that some or all of the parties would like to see.

A leading example of this last situation in the United States involved a foreign airline that had regular flights to New York, along with many other destinations.[57] It presumably had assets of the usual sort associated with regular airline activities in the United States, but its COMI was clearly in another country.[58] Despite recently enacted modern legislation in the COMI country, the U.S. bankruptcy court found that the United States had "better law" for the case because of the favorable treatment that U.S. bankruptcy law provided to airplane lessees.[59] It is hard to see just why the U.S. Bankruptcy Code necessarily represented better choices than the decisions the legislators in the COMI country had made for their companies in their recent enactment—especially as applied to their national airline. This example illustrates why the "better law" ground may be subject to serious challenge as to the legitimacy of a non-COMI court's assumption of the role of central

54. *See infra* text accompanying notes 87–90.

55. *See* UNCITRAL MODEL LAW, *supra* note 2, at 95 (explaining that articles 25 and 26 mandate cross-border cooperation by providing that the court and the insolvency representative "shall cooperate to the maximum extent possible"). Note that the statutory language is not precatory. For more discussion of Model Law communication requirements, see generally Jay Lawrence Westbrook, *The Duty to Seek Cooperation in Multinational Insolvency Cases*, *in* THE CHALLENGES OF INSOLVENCY LAW REFORM IN THE 21ST CENTURY 361 (Henry Peter et al., eds., 2006), *reprinted in* ANNUAL REVIEW OF INSOLVENCY LAW 187 (Janis P. Sarra ed., 2004).

56. *See* Westbrook, *supra* note 54, at 23–28 (explaining the "better law" arguments). *See also In re* Aerovias Nacionales de Colombia S.A. Avianca, 303 B.R. 1, 10–11 (Bankr. S.D.N.Y. 2003) (pointing out that both the creditors and debtors had benefitted from application of U.S. law and that applicable Colombian bankruptcy law was relatively new and untested); *In re* Monitor Single Lift I, Ltd., 381 B.R. 455, 469 (Bankr. S.D.N.Y. 2008) (noting the additional protections that U.S. bankruptcy laws provide to debtors).

57. *In re* Avianca, 303 B.R. at 1.

58. *Id.* at 3–4 (finding that Avianca has 14 locations in Colombia and 12 locations in other countries, mostly in Central and South America, and that Avianca employed 4,153 employees in Colombia and 28 in the United States, but allowing Debtor's chapter 11 proceeding to continue in the United States).

59. *Id.* at 10–11.

court. That role may thus be seen as illegitimate and may provoke a justified refusal to enforce the result.

Another case in which there is reason to question a non-COMI assumption of jurisdiction would arise where the debtor is not eligible to file an insolvency proceeding in the COMI country. For example, in the United States and some other countries, an insurance company cannot file for bankruptcy;[60] there is a separate procedure for distressed insurers that is initiated by regulators. Should an English court permit an American insurer to file an insolvency proceeding in England? It would not be inconsistent with the Model Law if the English court simply accepted the filing and maintained the status quo in England, along with protection of English creditors, in close consultation with the American regulators and with a proceeding brought in the United States. A plenary proceeding with a claim to global effects on the U.S. insurance company and its stakeholders would not be legitimate.

The third ground to support non-COMI management of a case is consent.[61] In the airline case discussed above, it appeared that the great majority of creditors preferred the United States as a forum.[62] Yet the decision arose from precisely the fact that one substantial creditor objected to United States management.[63] Absent unanimous agreement (which might suggest an out-of-court solution in the first place), it seems problematic to rest non-COMI case management on consent. The ultimate practical solution that balances cost and fairness may require negotiation among courts as well as the parties unless the circumstances permit a buyout of the dissenting creditors. This solution should start from the idea that the proceeding should be centered in the COMI jurisdiction absent strong reasons to the contrary.[64]

A situation that may involve consent is the quandary posed by the "solitary non-COMI proceeding."[65] The airline case was an example here, too. It is clear that the non-COMI jurisdiction (in that case, the United States) has the right to deal with the case as to its creditors and the assets it controls,

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60. 11 U.S.C. § 109(b)(2) (2012).

61. *See* TRANSNATIONAL INSOLVENCY: COOPERATION AMONG THE NAFTA COUNTRIES, INTERNATIONAL STATEMENT OF UNITED STATES BANKRUPTCY LAW 76 (AM. LAW INST. 2003) (stating that the U.S. courts can exercise control over debtors' overseas assets and prohibit creditors access to these assets only if (1) the U.S. courts have jurisdiction over the creditors, or (2) "[the creditors] have consented to United States jurisdiction").

62. *In re Avianca*, 303 B.R. at 8.

63. *Id.* at 7–8.

64. Any exceptions create the risk of unjustified deviations because of the disincentives discussed below.

65. I use this name to refer to a proceeding that could have been brought in its COMI jurisdiction but was not. *See* Westbrook, *supra* note 25, at 16–17 (defining the "solitary nonmain proceeding").

provided no COMI proceeding is filed. But a series of such cases would be a return to the inefficiencies and inequities of territorialism.

Instead, the non-COMI jurisdiction should maintain the status quo (possibly including the exercise of an indirect global stay) but order extensive notice to all creditors, including those in the COMI jurisdiction, along with notice to the appropriate court and officials responsible for insolvency matters in the COMI jurisdiction. If no proceeding is filed within a reasonable time, the non-COMI court could then proceed on a worldwide basis. If a proceeding is filed in the COMI jurisdiction, the non-COMI court still could maintain the status quo for the benefit of a worldwide proceeding led by the COMI court. In this way, a global-market approach could be maintained while adapting to the realities of a specific case.[66]

## V. Obstacles to Cooperation in Coordination Through a Central Court

Although a variety of factors challenge that multinational coordination, the three most important are as follows:

1. The variations in national policies concerning allocation of values realized in insolvency proceedings;
2. The treatment of corporate groups; and
3. The incentives for professionals to resist centralization.

### *A. Differing Policies and Priorities*

Several factors may result in varying allocations of value in a given case, but the most important are differences in national policies about social or commercial priorities. It is important to realize that these differences in policies comprise not merely traditional liquidation-distribution rules, but broader issues of preferred results. For example, some countries will be more concerned with preserving employment while others will emphasize a quick return to creditors. Given these varying policies and a natural concern for local stakeholders, courts must be persuaded that the overall benefits of cooperation in multinational cases exceed the costs of accepting a compromise in the application of local priorities and social policies.[67] The

66. On some occasions, the COMI is unclear. This problem can arise where the principal executive office and the principal assets of the debtor are in different jurisdictions. The awkward result is best resolved by negotiation as discussed below, with each jurisdiction maintaining the status quo in the meantime. *See infra* text accompanying notes 87–90.

67. *See* Jay Lawrence Westbrook, *Theory and Pragmatism in Global Insolvencies: Choice of Law and Choice of Forum*, 65 AM. BANKR. L.J. 457, 465 nn. 27–28 and accompanying text (1991) (exploring this issue).

case for their cooperation must include their agreement that the court seeking to act as the central court is truly entitled to assume that role.

### *B. Corporate Groups*

A corporate group presents an important, common, and sometimes difficult case, largely because of legal technicalities. The group should ordinarily be understood to require the same unified treatment as an individual company. Generally, when a corporate parent files a bankruptcy proceeding, its COMI should be considered the COMI for the group. However, there are sometimes obstacles to this common-sense solution. First, some laws insist that each subsidiary must file in its own COMI as if it were an entirely independent entity[68]—a result that elevates form over substance in the great majority of cases. Second, because subsidiaries are routinely incorporated in various jurisdictions for tax and other reasons, jurisdictions that insist on an incorporation-based COMI almost guarantee a scattered and diffuse set of filings—as in the Pacific Andes case.[69] The diffuse filings make liquidation inefficient[70] and reorganization very difficult. Although some have concerns about ignoring the corporate form, permitting the affiliates to file with the parent in no way requires some form of consolidation of assets and liabilities other than for purely administrative purposes.[71]

### *C. Disincentives of Professionals*

The third serious obstacle to centralized coordination is the natural desire of professionals—lawyers, accountants, investment bankers, and others—to seek substantial opportunities for professional employment in the jurisdictions where they practice. A number of cases have failed to achieve coordination in recent years at least in part because of this difficulty. When the professional fees and costs for a company like Nortel in North America

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68. *See* U.N. Secretariat, Centre of Main Interests in the Context of an Enterprise Group, Note by the Secretariat, ¶¶ 5, 16, UNCITRAL Working Grp. V (Insolvency Law), U.N. Doc. A/CN.9/WG.V/WP.114 (Feb. 13, 2013) [hereinafter Centre of Main Interests] (reporting that an entity-by-entity approach to COMI of members of an enterprise group has been maintained, and the difficulty of defining COMI for enterprise group demands a focus on facilitating coordination and cooperation between the various courts); U.N. Secretariat, Treatment of Corporate Groups in Insolvency, ¶ 4, UNCITRAL Working Grp. V (Insolvency Law), U.N. Doc. A/CN.9/WG.V/WP.76/Add.2 (Mar. 6, 2007) [hereinafter Treatment of Corporate Groups] (noting that the Model Law does not specifically address the concept of COMI as it might apply to a corporate group).

69. Treatment of Corporate Groups, *supra* note 68, ¶ 6 (indicating that if the COMI test were adopted for each individual member in a corporate group, it would likely lead to insolvency proceedings being commenced in different jurisdictions).

70. See the discussion of Nortel, *infra* text accompanying notes at 72–82.

71. A second obstacle to a simple group COMI, where the subsidiaries file with the parent, is that sometimes the parent does not file. All these situations cry out for negotiated solutions, often requiring substantial judicial encouragement.

can reach nearly $2 billion,[72] it is understandable that local practitioners would oppose coordination procedures that they believe will leave them substantially excluded and that local judges would feel social pressure to prevent that exclusion. On the other hand, the *Nortel*[73] case paradoxically demonstrates the enormous benefits of coordination.

Nortel was a true multinational group engaged in the development and marketing of certain kinds of high-tech gear all over the world.[74] The parent company was based in Canada, as was the main operating subsidiary, while much of its business involved a subsidiary in the United States.[75] It also had subsidiaries in Europe, notably in the United Kingdom. Insolvency proceedings were filed in those three jurisdictions, although the United Kingdom court did not participate in the major international decisions in *Nortel*.[76] The results in the case represented the high and the low of recent multinational insolvencies:

*High*. After reorganization failed, the parties cooperated to sell the debtor's assets on a global basis, in large pieces that spanned many countries. In particular, the global sale of intellectual property yielded many billions of dollars.[77] The cooperative disposition, without regard to jurisdiction or geography, produced far more value than any isolated, jurisdiction-by-jurisdiction sales could have achieved. This result represented modified universalism at its best.

*Low*. After the great sales success, the parties could not agree on allocation of the roughly $7 billion in proceeds, rejecting repeated pleas by the U.S. and Canadian courts that the parties resolve the issue by negotiation or arbitration.[78] The final resolution took years, resulting in the nearly

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72. Jeff Montgomery, *Nortel OK'd for $14.2M Payout Amid 'Pandora's Box' Warnings*, LAW360 (June 6, 2016), https://www.law360.com/articles/803875/nortel-ok-d-for-14-2m-payout-amid-pandora-s-box-warnings [https://perma.cc/T3C4-GLH9] (reporting that the professional fee payouts in the case reached more than $1.9 billion in the United States by June 2016).

73. *In re* Nortel Networks, Inc., 669 F.3d 128 (3d Cir. 2011). I gave an opinion as an expert witness in the case on behalf of the UK pension creditors.

74. *Id.* at 130–31.

75. *Id.* at 131.

76. *Id.*

77. Nortel Networks Inc. v. Ernst & Young Inc. (*In re* Nortel Networks Inc.), Nos. 15-196(LPS), 15-197(LPS), 2016 WL 2899225, at *1 & n.1 (D. Del. 2016) (introducing the background of this litigation related to the allocation of the $7.3 billion proceeds of court-supervised sales of assets, principally an extensive portfolio of patents).

78. *See, e.g.*, *In re* Nortel Networks, Inc., 669 F.3d at 143. The court observed:

> Mediation, or continuation of whatever mediation is ongoing, by the parties in good faith is needed to resolve the differences. No party will benefit if the parties continue to clash over every statement and over every step in the process. This will result in wasteful depletion of the available assets from which each seeks a portion.

*Id.*

$2 billion of professional fees and costs.[79] The resolution of the case required joint management between the Canadian and U.S. courts, including a joint televised trial and coordinated (although independent) decisions by the two courts.[80] While the courts involved did a wonderful job in managing the awkward jumble of litigation, it seems clear that large amounts of money and time would have been saved had either court been permitted to manage the case centrally, albeit with mutual consultation at every stage.

In the *Nortel* case, as in other large cases in recent years, there was a failure to act quickly at the start of the case to seek recognition and coordination among the courts involved. The result is two or more independent insolvency proceedings with limited cooperation. The Lehman insolvency is a notable example. In the Lehman case, recognition and coordination were not even sought for many months.[81] In *Nortel*, the efforts were less laggard, but still too little and too late to produce the best results. Early cooperation permits the establishment of protocols and lines of authority in a cooperative direction from the start. It also has the benefit of being put in place before tactical considerations have become so apparent as to make it difficult for parties to agree.[82]

I do not suggest for a moment that the professionals in these and other cases planned, much less conspired, to delay or defeat coordination so they could feather their own nests. But I do think that the incentives for professionals are such that they require judicial encouragement to focus on international cooperation and recognition from the very start of a case—or indeed, during workout negotiations prior to any insolvency filing.[83] I think

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79. Montgomery, *supra* note 72.

80. *In re* Nortel Networks Inc., 2016 WL 2899225, at *1; *see also* Tom Hals, *Nortel Cleared to End Bankruptcy, Distribute $7 Billion to Creditors*, REUTERS (Jan. 24, 2017), https://www.reuters.com/article/us-nortelnetworks-bankruptcy/nortel-cleared-to-end-bankruptcy-distribute-7-billion-to-creditors-idUSKBN1582TO [https://perma.cc/CDR8-UZ4S] (reporting that the two courts were linked by video throughout the proceedings).

81. After the filing of bankruptcy, it took the insolvency administrators of the eighteen Lehman's affiliates seven months to work out a coordination and cooperation protocol. Lehman Bros. Holdings Inc., *Cross Border Insolvency Protocol for the Lehman Brothers Group of Companies* (May 12, 2009), https://www.insol.org/Fellowship%202010/Session%209/Lehman%20protocol%20executed.pdf [https://perma.cc/N3KF-L3RE]. For further discussion, see Hon. Allan L. Gropper, *The Model Law After Five Years: The U.S. Experience with COMI*, *in* LESSONS LEARNED AND PROBLEMS EXPOSED IN CROSS-BORDER CASES: THE JUDICIAL PERSPECTIVE (Int'l Insolvency Inst. ed., 2010), https://www.iiiglobal.org/sites/default/files/Allan_Gropper.pdf [https://perma.cc/Z7L3-JSLL].

82. There is a sort of Rawlsian proposition here that parties will be more cooperative and focused on common interests—like maximization of value—when the rush of events at the start of a case provides something of a "veil of ignorance." *See generally* JOHN RAWLS, A THEORY OF JUSTICE 17 (rev. ed. 1999).

83. If a clear judicial signal is sent that, after filing, professionals will be asked pointed questions about pre-filing negotiations with regard to these cooperation issues, professionals will be encouraged to give them attention even before filing.

that judicial encouragement may also serve to overcome difficulties of coordination among professionals who are naturally motivated to consider tactical and strategic advantages for their clients and who lack a broad vision of the needs of the case as a whole. In short, there is a substantial need for judicial activism to guide the parties toward the best results. Where such activism may be found, there will be opportunities for professionals to advance the interests of their clients by being in the forefront of an internationalist approach and being seen by the courts as taking cooperative and efficiency-promoting positions.

## VI. Strategies for Coordination

At the heart of the needed process is communication. When we were working on the UNCITRAL negotiations that produced the Model Law in the mid-Nineties, our inclusion of provisions concerning communication, including direct communication among courts, was regarded by many as radical and dangerous.[84] But we persisted in that effort through the American Law Institute Transnational Project. Others took up the banner in the Global Principles effort at the International Insolvency Institute.[85] These communications have increasingly become routine, although not always timely. Most recently, the creation of the Judicial Insolvency Network (JIN) and its Guidelines further extend those initiatives.[86] A special virtue of the

84. *See* U.N. Secretariat, Cross-Border Insolvency: Possible Issues Relating to Judicial Cooperation and Access and Recognition in Case of Cross-Border Insolvency, ¶¶ 99–100, UNCITRAL Working Grp. V (Insolvency Law), U.N. Doc. A/CN.9/WG.V/WP.42 (Sept. 26, 1995) (recognizing that communications between judges "may raise varying degrees of concern in particular in legal systems that are not accustomed to such initiatives by judges, and also concerns about procedural safeguards for the parties"); UNCITRAL, Rep. of the Working Group on Insolvency Law on the Work of the Eighteenth Session, ¶ 82, U.N. Doc. A/CN.9/419 (Dec. 1, 1995) (discussing judicial communication as an aspect of cooperation); AM. LAW INST., TRANSNATIONAL INSOLVENCY PROJECT: INTERIM REPORT 7–8 (1999) (reporting that some of the proposals being considered "are necessarily controversial," and special difficulties existed in implementing any particular approach to cooperation); Memorandum from Jay Lawrence Westbrook to Nat'l Bankr. Review Comm'n, Am. Law Inst. Transnational Insolvency Project 3 (July 29, 1997) ("The [UNCITRAL] insolvency project began with countries very reluctant to take substantial steps toward cooperation with foreign proceedings.").

85. ALI-III GLOBAL PRINCIPLES, *supra* note 11.

86. *See generally* GUIDELINES FOR COMMUNICATION AND COOPERATION BETWEEN COURTS IN CROSS-BORDER INSOLVENCY MATTERS (Judicial Insolvency Network ed. 2016), http://www.insol.org/emailer/January_2017_downloads/doc1a.pdf [https://perma.cc/6RRL-QESH] (providing rules to improve the interests of those involved in cross-border insolvency proceedings by "enhancing coordination and cooperation amongst courts under whose supervision such proceedings are being conducted"). Recently, the chief bankruptcy judge for the Southern District of Florida has ordered the adoption of JIN Guidelines on court-to-court communication and cooperation. Adoption of Guidelines for Communication and Cooperation Between Courts in Cross-Border Insolvency Matters, Administrative Order 2018-03 (Bankr. S.D. Fla. 2018), http://www.flsb.uscourts.gov/sites/flsb/files/documents/news/AO_2018-03_Adoption_of_Guidelines_for_Communication_and_Cooperation_Between_Courts_in_Cross-Border_Insolvency_Matters.pdf

JIN initiative comes from the fact that the establishment of personal relationships among commercial judges from different countries is a key to success in multinational cases. In that regard, not the least important benefit of the JIN Guidelines is the likelihood that they will tend to produce early direct communication by judges (with due notice to all) and will incentivize professionals to act quickly as well.

It may be useful to offer one example of an approach that can produce coordinated results. Some years ago, a financial company in North America called Inverworld collapsed in scandal, revealing that it had defrauded large numbers of investors in the United States and a number of Latin American countries of hundreds of millions of dollars.[87] The accountants had uncovered quite substantial assets for distribution, although much less than enough to pay creditors in full. Insolvency proceedings were brought in the United States, the Cayman Islands, and England.[88]

The representatives of various parties in the case agreed to a protocol that led to dismissal of the English insolvency proceeding, upon certain conditions protecting the claimants therein, and the allocation of functions between the two remaining courts.[89] The U.S. court was to resolve the outstanding legal and factual issues relating to entitlements as among various classes of investors, while the Cayman Islands court was to oversee the creation and operation of the mechanism of distribution of proceeds to claimants. Each court was to take the other court's actions as binding and thus to prevent parallel litigation. Ultimately, the process agreed to in the protocol led to a worldwide settlement at a cost far less than would have attended a three-court struggle.[90]

The key point is that there was substantial communication directed to the global case and its resolution. The judges involved actively encouraged the professionals to engage in cross-border negotiations with an emphasis on non-litigious solutions despite plausible conflicting claims for several groups of claimants under each of the seven arguably applicable laws. The professionals from each jurisdiction were importantly involved. Judicial activism combined with a first-rate performance by the professionals produced spectacularly fast, fair, and efficient results.

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[https://perma.cc/ANB6-WLVP].

87. San Antonio Express-News v. Blackwell (*In re* Blackwell), 263 B.R. 505, 506 (W.D. Tex. 2000).

88. *Id.*

89. See Jay Lawrence Westbrook, *International Judicial Negotiation*, 38 TEX. INT'L L.J. 567, 571 (2003) for a detailed discussion of the *Inverworld* case. I should mention I was appointed "special counsel" in the case and given a role similar to that of an examiner under § 1104(c) of the Bankruptcy Code. *See* 11 U.S.C. § 1104(c) (2012).

90. Westbrook, *supra* note 89, at 571.

## VII. Conclusion

Globalization continues to accelerate; new supply chains form every day. It is fueled by the enormous wealth it creates, despite the inevitable debacles it leaves in its wake. Globalization of the management of financial distress will be its companion. Some insist the process must await elegant ruminations about the evolution of the common law or endless debates over treaties about cross-border insolvency, but they will be disappointed. Economics will incentivize procedures to make cross-border insolvency proceedings efficient, and citizens will demand procedures to make it fair. Those results require cooperation around a coordinating central jurisdiction and the internationalization of the relevant professions. While legislation is necessary, the courts will, as always, be confronted with issues that run ahead of the legislative process. Indeed, court decisions will often drive that process. Judges and lawyers will continue to build the international insolvency system even though it's a bit like completing the assembly of an aircraft while in flight.

It is an exciting time to be an international lawyer or judge and not a time for the timid.

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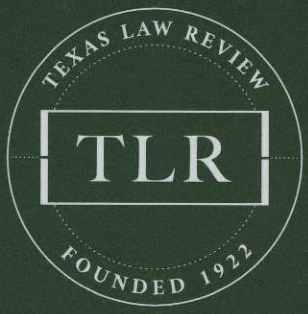
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