Avoidance Actions and Choice of Law in Multinational Insolvency Proceedings

Contents

Introduction

This paper examines choice of law rules for avoidance actions in multinational insolvency proceedings and considers how they should apply in ancillary or secondary insolvency proceedings. Part I examines the nature of avoidance and claw-back actions, the importance of such actions inside and outside of bankruptcy proceedings and the role of ancillary or secondary proceedings in multinational bankruptcy. Part II looks at how choice of law rules apply to avoidance actions in ancillary or secondary proceedings in accordance with the UNCITRAL Model Law, EU Regulation and the US Bankruptcy Code. Part III explores the position taken by leading proponents of modified universalism and cooperative territoriality in respect of avoidance actions and considers the optimal choice of law provisions in secondary or ancillary bankruptcy proceedings.

Part I – Avoidance Actions and Ancillary Proceedings

Avoidance Actions

The modern rules of law which allow for the avoidance and claw-back of transactions detrimental to creditors can be traced back to the *actio Pauliana* of Roman Law and the Act of Elizabeth of 1571. These rules allow transactions that unfairly disadvantage or defraud creditors to be nullified or reversed. Such transactions are typically categorized as either fraudulent conveyances or preferences.[1]

Fraudulent conveyances are dispositions by debtors at nil or undervalue that see losses foisted onto creditors by putting the transferred assets out of their reach. Fraudulent conveyance actions can be brought by individual creditors as well as in collective proceedings and, as such, are applicable outside of a bankruptcy procedure.[2]

Preferences are payments or transfers by a debtor to a creditor that prefer the recipient creditor over the general body of creditors, who must then shoulder a greater burden of the collective losses arising as a

[1] Boraine, André, INSOL International Technical Series No. 7: Avoidance Provisions in a Local and Cross-border Context; A Comparative Overview, p. 2.
[2] Ibid

result of the debtor's insolvency. In contrast to fraudulent conveyances, preference law is generally applicable only in the context of an insolvency or bankruptcy proceeding.[3]

The representative of an insolvent estate can significantly enhance the outcome for the general body of creditors by successfully bringing avoidance actions to recover the proceeds of fraudulent conveyances or preference payments.[4] Avoidance rules vary considerably across jurisdictions, particularly in respect of; the length of look-back period within which transactions may be avoided or clawed-back, whether the transferee entered into the transaction in good faith, and which transactions are protected from avoidance or claw-back under safe-harbour rules. Consequently, the choice of law rules that determine which country's avoidance rules apply in an insolvency proceeding can have significant consequences for creditors and pre-bankruptcy transferees.

The potential for avoidance actions being brought also has consequences outside of bankruptcy. For instance, if there were no claw-back of preference payments, and creditors could retain pre-bankruptcy payments in full, creditors would be incentivized to seek payment urgently from any debtor they suspected to be at risk of insolvency. As a result, debtors would file for bankruptcy more quickly and in greater numbers.[5] Furthermore, the risk that a transaction may be avoided, or monies clawed back later, creates additional uncertainty for parties contemplating commercial transactions and increases the amount of due diligence they must carry out to mitigate it. Predictable avoidance laws also allow commercial lenders to accurately assess and price credit risk thereby facilitating the efficient allocation of capital.[6]

There are clearly strong moral and commercial imperatives for lawmakers to write avoidance provisions into law. However, lawmakers, in designing avoidance provisions, also need to strike the right balance between protecting creditors' rights and not inhibiting commercial activity. This can be achieved through the design of the specific avoidance provisions or by exempting certain transactions from them (e.g. under safe-harbour rules). Achieving this balance is important regardless of whether the insolvency proceedings in question are main or ancillary.

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[3] Ibid. The terms "insolvency proceeding" and "bankruptcy proceeding" are used interchangeably throughout.
[4] Schorr, Segaal, Avoidance Actions Under Chapter 15: Was Condor Correct? Fordham International Law Journal, Volume 35, Issue 1, 2006, p.355.
[5] Warren, Elizabeth, Chapter 11: Reorganizing American Business, p.110.
[6] Brief for the Securities Industry and Financial Markets Association, the Institute of International Bankers, and the Chamber of Commerce of the United States of America as Amici Curiae, p.6, p.14, HBSC Holdings Plc et al v Picard USC 19-277.

Secondary or Ancillary Proceedings

As the term suggests, secondary or ancillary court proceedings are proceedings which are auxiliary or subordinate to another proceeding considered to be the principal proceeding.[7] In respect of multinational bankruptcy cases, the concept of secondary or ancillary proceedings is most closely associated with the theory of modified universalism, in which a main proceeding in the debtor's home country is supported by cooperation received from secondary or ancillary proceedings in other jurisdictions relating to the same debtor.[8] In a system based on the principles of territoriality, no bankruptcy proceedings are considered to be main, secondary or ancillary.[9] Notwithstanding this, for the purpose of this paper, secondary or ancillary proceedings will mean bankruptcy proceedings commenced in a state other than the state in which the debtor's centre of main interest is located.

Part II - Statutory Background

UNCITRAL Model Law on Cross-Border Insolvency

The Model Law on Cross-Border Insolvency ("Model Law"), adopted by the United Nations Commission on International Trade Law ("UNCITRAL") in 1997, provides a framework for cooperation between nations in respect of cross-border insolvency cases.[10] The Model Law provides for the recognition of foreign insolvency proceedings, and for the provision of associated relief, through ancillary proceedings in the state in which it is enacted[11]. In doing so, it recognizes a foreign representative's right to bring avoidance actions in the enacting state but is silent on whether a foreign representative can apply the avoidance law of the state in which the foreign proceeding is taking place[12]. Although UNCITRAL considered including

[7] https://dictionary.thelaw.com/ancillary/ (last visited 1.18.2020); Steele v. Insurance Co., 31 App. Div. 389, 52 N. Y. Supp. 873.
[8] "Home country" is used throughout to mean the state in which the debtor's centre of main interest is located.
[9] LoPucki, Lynn M., Cooperation in Internationalist Bankruptcy: A Post-Universalist Approach, p. 742.
[10] UNCITRAL Model Law on Cross-Border Insolvency: The Judicial Perspective (Updated 2013), p. 9.
[11] Because the Model Law allows for the recognition of non-main foreign proceedings, the state recognizing such proceedings under the Model Law could conceivably be the debtor's home country. If so, the recognition proceedings in the enacting state would fall outside of this paper's definition of ancillary proceedings.
[12] *See* The Guide to Enactment and Interpretation of the UNCITRAL Model Law on Cross Border Insolvency, para. 201 ("Article 23, paragraph 1 expressly provides that, as an effect of recognition of the foreign proceeding under article 17, a foreign representative has standing to initiate actions under the law of the enacting state to avoid or otherwise render ineffective legal acts detrimental to creditors. The provision is drafted narrowly in that it neither creates any substantive right regarding such actions nor provides any solution involving conflict of laws; the Model

choice of law rules in the articles of the Model Law, as adopted it allows the matter of avoidance actions to be governed by the laws of the enacting state.[13] Accordingly, Article 23 of the Model Law only goes so far as to entitle a foreign representative to the same powers to bring avoidance actions as a local insolvency representative.[14]

US

The US version of the Model Law, Chapter 15 of the US Bankruptcy Code, was enacted into law in 2005. For the most part, Chapter 15 is an almost verbatim reproduction of the Model Law. It even uses the same numeric system to reference its articles. However, in a notable departure from the Model Law, Chapter 15 does not allow a foreign representative to avail of the avoidance provisions of US Bankruptcy Code. To do so they must commence a plenary proceeding under one of the other chapters of the code, typically Chapter 7 or Chapter 11.[15] This means foreign representatives can enjoy the same avoidance rights as a domestic trustee or debtor-in-possession, but only if they commence a plenary U.S. bankruptcy proceeding.

Chapter 15, like the Model Law, is silent on the importation of foreign avoidance law. However, in applying Chapter 15, US Courts have allowed foreign representatives to use foreign avoidance provisions in ancillary Chapter 15 proceedings. In the *Condor*[16] case, the foreign representative, a Nevis Trustee, sought avoidance of $300m using Nevis law, and was granted same in the US Court of Appeals for the Fifth Circuit. In a separate decision in the *Fairfield Sentry* case, the US Court allowed BVI avoidance law to be applied but limited its application only to assets located within the US.[17] Additionally, foreign representatives have been able to assert avoidance actions under US State Law.[18] Therefore, under Chapter 15, a foreign representative may be able to select between the most favourable avoidance provisions available under foreign, state and federal bankruptcy law.

Law does not address the right of a foreign representative to bring such an action in the enacting state under the law of the State in which the foreign proceeding is taking place.")

[13] Supra, note 4, p.362;

[14] Supra, note 4, p.366

[15] USC 5121, (a) 7

[16] In re Condor Ins Ltd, 601 F3d 319 (5th Cir.2010)

[17] In re Fairfield Sentry, Ltd., 458 B.R. 665 (S.D.N.Y. 2011).

[18] In Laspro Consultore LTDA v. Alinia Corp. (In re Massa Falida Do Banco Cruzeiro Do Sul S.A.) (Bankr. S.D. Fla 2017)

A typical Chapter 15 case recognizes proceedings that have been commenced in the debtor's home country, a foreign main proceeding. Because a foreign representative can avail of foreign avoidance laws without commencing a plenary proceeding under another chapter of the US bankruptcy Code, it can be argued that, in respect of foreign main proceedings, the US system favours the application of the foreign avoidance rules of the debtor's home country over the avoidance rules of the US Bankruptcy Code. Although this assertion is somewhat complicated by the fact that a foreign representative may also invoke US State avoidance provisions without a plenary proceeding.

EU Insolvency Legislation

In the EU, cross-border insolvency is governed at a supra-national level by Regulation (EU) 2015/848 ("EU Regulation"). The EU Regulation applies only to insolvency proceedings opened in respect of debtors whose centre of main interest is located within the EU; it does not apply if the debtor's centre of main interest is outside the EU.[19]

The EU Regulation provides that should an insolvency proceeding be opened in the member state where the debtor's centre of main interest is located, it will be the primary or main proceeding and all other EU insolvency proceedings relating to the debtor will be secondary proceedings.[20] The laws of the member state where the primary proceeding has been opened will be applicable to the insolvency proceeding generally and will also determine the rules applicable to avoidance actions.[21] Secondary proceedings can be commenced in another member state if the debtor has an establishment there and in such proceedings the avoidance rules that apply are those of the member state where the secondary proceedings have been commenced.[22] There is an exception however; should the laws of another member state govern a transaction, yet not allow it to be avoided, the choice of law provisions of the EU Regulation cease to apply.[23]

As a matter of choice of law in avoidance actions, the EU Regulation clearly prefers the law of the debtor's centre of main interest. However, the application of these laws is not by way of separate ancillary

[19] Regulation (EU) 2015/848, Preamble (25).
[20] Ibid, Art. 3(1), 3(3).
[21] Ibid, Art. 7(m).
[22] Moss, Fletcher and Isaacs on the EU Regulation on Insolvency Proceedings, para 4.09.
[23] Supra Note 19, Art. 16.

proceedings, rather it is the result of the EU Regulation extending the jurisdiction of the home country court.[24]

Part III - Discussion

Universalism vs Territorialism

Modern thinking on cross-border insolvency falls between the twin poles of territorialism and universalism. Territorialism takes a nationalist approach to multinational insolvency cases, and argues for separate proceedings in each country in which the debtor's assets are located; each proceeding governed by local law for the primary benefit of local creditors.[25] Universalism, on the other hand, proposes a single insolvency proceeding, in the jurisdiction of the debtor's centre of main interest, dealing with all the debtor's worldwide assets, in accordance with its substantive law, on behalf of all creditors, regardless of location.[26]

Territorialism is the default insolvency system in many countries. However, because it deals only with a portion of the debtor's assets, it is recognized as being value-destructive when the debtor's assets, as a whole, or as a going concern, are greater than the sum of its parts.[27] Hence, there is also a tempered version of territorialism, cooperative territoriality, in which separate proceedings are coordinated by communications between the governing courts.[28]

To realize universalism in its pure form would require the entire world to adopt a global insolvency law.[29] Consequently, "modified" universalism, in which a main proceeding in the debtor's home country is supported by ancillary proceedings elsewhere, is promoted as a pragmatic universalist solution, which recognizes the difficulties faced by lawmakers at a national or supra-national level. Modified universalism

[24] Ibid, Preamble (35)
[25] Westbrook, Jay L., Universalism and Choice of Law, 23 Penn State International Law Review 625 (2005); 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. p. 284. (2008).
[26] Westbrook, Jay L., Choice of Avoidance Law in Global Insolvencies, 17 Brook. J. Int'l L. 499. 514-515 (1991).
[27] Levenson, D.C., Proposal for reform of Choice of Avoidance law in the Context of International Bankruptcies from a U.S. Perspective, American Bankruptcy Institute law Review, Vol. 10, No. 1, Spring 2002, para.III; Aristotle, Metaphysics 8.6 [=1045a]
[28] Supra, note 9.
[29] Supra, note 26.

has been the ascendant thesis in recent years.[30] The Model Law and the EU Regulation are both legislative expressions of modified universalism.

Choice of Law

Many issues in cross-border insolvency have two choice of law aspects. Non-bankruptcy law (e.g. contract law, avoidance law etc.) will often govern matters such as the value of a creditor's claim or whether an asset belongs to the bankruptcy estate, whereas bankruptcy law will determine creditor priority and how the estate will be distributed. A territorialist jurisdiction will always default to its own local bankruptcy law, whereas in a universalist system the court may have to defer to the bankruptcy laws of the location where the debtor has its centre of main interest.[31]

With choice of avoidance law rules, there are a number of options for lawmakers to consider: local law, law of the debtor's home country, law of the home country of the transferee, a choice of law analysis by the court on the basis of the number of contacts of each jurisdiction with the transactions ("centre of gravity of transaction"), or some combination of the above. Unsurprisingly, territorialists prefer to apply local avoidance rules, while universalists prefer the avoidance laws of the debtor's home. The trend in the US courts prior to the adoption of Chapter 15 was towards a choice of law analysis that examined the centre of gravity of a transaction to determine which country's law should govern its avoidance.[32] However, this method received criticism due to its unpredictability.[33]

There is no obvious reason for the optimal choice of law rules for avoidance actions to differ between secondary or ancillary proceedings and main proceedings. In either forum the choice of law rules for avoidance actions should have regard to the following: being predictable and transparent, the rules which govern how the recovered proceeds will be distributed, reducing credit risks, being inexpensive to implement and discouraging forum shopping.[34]

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[30] Ibid.
[31] Westbrook, Jay L., Universalism and Choice of Law, 23 Penn State International Law Review 625 (2005) p. 626.
[32] Supra, note 4, p380.
[33] Westbrook, Jay L., Avoidance of Pre-Bankruptcy Transactions in Multinational Bankruptcy Cases [Changing Law for Changing Times: The Thirteenth Biennial Meeting of the International Academy of Commercial and Consumer Law], 42 Texas International Law Journal 899 (2007), p. 902.
[34] Wood, Philip R., Principles of International Insolvency, Sweet & Maxwell, 2007, 1-007; Levenson, D.C., Proposal for reform of Choice of Avoidance law in the Context of International Bankruptcies from a U.S. Perspective, American Bankruptcy Institute law Review, Vol. 10, No. 1, Spring 2002, p. 2.

Viewpoint of Leading Scholars

One of the leading proponents of universalism, Jay L. Westbrook, argues that because the outcome for creditors from avoidance actions arises from the combination of avoidance rules and bankruptcy law, to achieve a coherent policy objective, the rules for avoidance actions should have the same nationality as the bankruptcy laws that will distribute any proceeds recovered. Otherwise the outcome for creditors will be arbitrary, and possibly contrary to the policy aims for which the laws were adopted. For this reason, and because a home country rule is more predictable than a transaction analysis approach, Westbrook concludes that the avoidance laws of the debtor's home country are the best choice in a system based on the principles of modified universalism.[35]

In contrast, one of universalism's most ardent critics, Lynn. M LoPucki, argues that "modified universalism is without a coherent doctrine governing avoiding powers". Using the example of a small business, supplying the local branch of a foreign debtor, being subject to foreign avoidance laws, even though every aspect of the transaction was domestic, LoPucki highlights the inappropriateness of applying the avoidance law of the debtor's home country in secondary proceedings. LoPucki acknowledges Westbrook's principle of matching a jurisdiction's rules of avoidance with its rules of distribution but argues that the solution fails under a modified universalist system because the priority laws of other nations come into play. Instead, he argues that the principle can be adapted more successfully to a territorialist regime by treating any cross-border transfer as a transfer to another entity, the estate of the foreign country effectively being another entity in bankruptcy.[36]

Conclusion

If we accept, as the leading scholars examined here do, that the rules of law which apply to avoidance actions should complement the rules of priority and distribution in the associated insolvency proceeding, it follows that both choices of law should be determined on the same basis. In a pure form of universalism, this would always be by choosing the laws of the home country. In a system based on modified universalism there will be circumstances where it is more appropriate for the law of the state where the

[35] Supra, note 33.
[36] Supra, note 9.

secondary or ancillary proceedings have been commenced to govern both the insolvency proceedings and associated avoidance actions.

It is heartening to note that this conclusion is largely reflected in the two bankruptcy systems examined in this paper. Under the EU Regulation, unless a secondary proceeding is commenced, the law governing both the insolvency proceeding and any avoidance actions will be that of the debtor's centre of main interest. If such a secondary proceeding is commenced it will be the law of the member state in which the proceeding is opened that will govern both the insolvency proceedings and avoidance actions arising therein[37]. Similarly, Chapter 15 allows a foreign representative to apply the avoidance law of the location of the foreign proceeding being recognised, whose bankruptcy laws will also govern distribution; the avoidance provisions of the US Bankruptcy Code will only apply if a plenary proceeding is opened in the US, which will be governed by US bankruptcy rules.[38]

[37] Subject to the exception in respect of safe harbor laws in Art.16 of the EU Regulation.
[38] Noting that a foreign representative may apply State law in Chapter 15.

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Author statement

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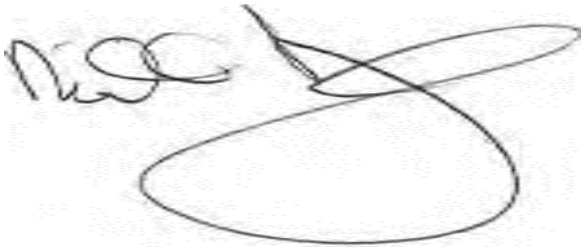

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