American Enterprise Institute for Public Policy Research

Financial Services Outlook

March 2010

# Debtor Selection: Resolving Insolvent, Globally Active Financial Firms

By Peter J. Wallison

*The Lehman Brothers bankruptcy in the fall of 2008 threw a sharp and critical light on the inadequacies of the world's system for resolving insolvent, globally active financial institutions. The resolution of the Lehman insolvency is being administered in the United States, but the unusual circumstances associated with the filing of the petition seriously disfavored the creditors of its subsidiaries abroad and probably caused unnecessary losses for all of its creditors worldwide. The prevailing system for resolving bankrupt companies is territorial. In a territorial system, the country where the assets are located when the insolvency occurs has the authority to decide how those assets are distributed. The results can be quite arbitrary under the best of circumstances and unnecessarily add to the costs of credit for all financial firms. Creating a universal system, in which the rules of all countries are harmonized, would be a daunting task and would take too long to negotiate at a time when technology is driving the development of a global financial market. This* Outlook *recommends the adoption of a system called "debtor selection"—analogous to a U.S. corporation's choice of a chartering state—in which financial firms would choose the legal system under which they would be resolved in the event of their insolvency, and, by treaty, all signatory nations would agree to enforce the insolvency rules of the jurisdiction selected in advance by the debtor.*

The collapse of Lehman Brothers in September 2008 is mostly remembered as the beginning of a horrific period in international financial markets. Banks and other financial institutions stopped lending to one another, and spreads in the financial markets widened to previously unknown levels. These events gave rise to everything from doubts about the future of capitalism to a proposal for substantial new regulation of the financial markets by the Obama administration. Subsequent events have demonstrated that predictions about the end of capitalism were somewhat premature, and the administration's proposed legislation is still a work in progress. But the Lehman bankruptcy demonstrated one thing about which there can be no doubt: the system for dealing with the bankruptcy of a globally active financial firm is seriously inadequate. With globalization growing rapidly, especially in finance, it is vitally important that policymakers consider how to provide some degree of certainty about the outcome of a financial firm's insolvency when its activities and assets are spread around the world.

Peter J. Wallison (pwallison@aei.org) is the Arthur F. Burns Fellow in Financial Policy Studies at AEI. This *Outlook* draws upon a paper presented at the University of Pennsylvania's Wharton School in February 2010.

**Key points in this *Outlook*:**

- As globalization continues, the current territorial bankruptcy system for resolving financial firms yields arbitrary results and is otherwise inadequate.
- While harmonizing international bankruptcy laws might be a workable solution, it cannot be accomplished in a reasonable time, if at all; widespread financial globalization is occurring now.
- A debtor-selection system, in which firms choose the legal system under which they will be resolved in the event of insolvency, addresses many of the problems with the current system, while creating incentives for improvements in national legal systems that approach the benefits of harmonization.

The prevailing transnational insolvency structure today is known as the territorial system. Under this regime, the rights of creditors are largely determined by the insolvency laws of the countries where a firm's assets are located when it becomes insolvent. The disadvantages of this are obvious and were clearly exposed in the Lehman bankruptcy. As a matter of the firm's normal functioning, the cash assets of Lehman's foreign subsidiaries were routinely brought back to New York each night for investment by the parent company. When Lehman filed its bankruptcy petition at four o'clock in the morning on Monday, September 15, 2008, it still held much of this cash. The U.S. bankruptcy court had no authority to release it to Lehman's subsidiaries abroad, and doing so would have disadvantaged many U.S. creditors. As a result, many of Lehman's subsidiaries were immediately rendered illiquid and unable to meet their obligations. This, in turn, triggered bankruptcy filings among these subsidiaries and many unnecessary losses. Arbitrary outcomes like this substantially increase creditors' risks and, therefore, the cost of credit for globally active financial institutions.

There is little likelihood that governments will be able to come to a comprehensive agreement on how a bankrupt financial firm will be treated in their courts. The political and values issues associated with the treatment of creditors are too difficult to resolve at that level.

To address this problem, scholars have focused on two possible structures: first, a "universal system" in which all of the national insolvency laws—at least in developed countries—are harmonized by negotiation or concerted action, or second, a system in which the debtor and its creditors agree on a particular regime in each credit agreement. Legal scholars Lucian Arye Bebchuk and Andrew T. Guzman, in arguing for a universal system, note that "the large and growing amount of transnational activity and recent experiences with large bankruptcies demonstrate that the continuing internationalization of commercial dealings demands some form of international bankruptcy procedures."[1] As they suggest, although the territorial system has served reasonably well for centuries, the growing number of globally active financial firms and the speed with which financial assets can be moved across national boundaries suggest that major reforms are necessary to reduce what are likely to be highly arbitrary outcomes in any future insolvency.

There is much to be said for a universal system under these circumstances, and the United Nations Commission on International Trade Law (UNCITRAL) adopted a Model Law on Cross-Border Insolvency in an effort to achieve harmonization.[2] The effort has not been fully successful, however; although both the United States and Great Britain have adopted the model law, major complaints about the Lehman bankruptcy proceeding, which is going forward in the United States, have emerged in Great Britain and elsewhere. Bebchuk and Guzman note that even U.S. bankruptcy law, which is "the high-water mark of international cooperation in the area of bankruptcy," still exhibits many examples of favoritism for local creditors.[3] They cite the Second Circuit Court of Appeals, for example, which said in a 1985 case that "comity would not be granted [in an insolvency case] if it would result in prejudice to United States citizens."[4] Great Britain has not been blameless, either. In 2008, in the midst of the financial crisis and to protect British depositors, the United Kingdom invoked a British law that permitted it to take over the British assets of an insolvent Icelandic bank.[5] Given that Great Britain is a signatory to the UNCITRAL model law, the actions of the British government in this case indicate how difficult it will be to achieve harmonization of national insolvency laws so that the outcome of a financial firm's insolvency will be roughly predictable by its creditors. As Alexander Kipnis observed:

> National decisions about economic priorities are influenced by a host of factors, ranging from development objectives to attraction of foreign capital to moral judgments. These unique economic priorities become expressed in national bankruptcy systems. In the present day, these systems exhibit a dizzying array of different choices about the scope of the estate, claim recognition, class treatment, creditor priority, available remedies, and just about all other aspects of bankruptcy proceedings. It is this rich diversity of policy choices on the global scale that makes transnational bankruptcy so unpredictable and a uniform regime desirable. . . . If substantive consensus cannot be achieved in Europe, there is little hope that a consensus on substantive law can be had on a global scale.[6]

In other words, there is little likelihood that governments will be able to come to a comprehensive agreement—desired by the proponents of a universal system—on how a bankrupt financial firm will be treated in their courts. The political and values issues associated with the treatment of creditors are too difficult to resolve at that level.

The second system, in which the parties to a loan agreement, for example, agree to a particular venue for resolving the insolvency of the debtor, would provide some degree of certainty but may also introduce yet more confusion and legal complexity. A debtor might end up specifying different jurisdictions—or not specifying any jurisdiction—for resolving other or different financing arrangements, leaving everything in a jurisdictional muddle. For example, the debtor may agree with its bank creditors that resolution of their claims will occur in U.S. courts but then file the bankruptcy petition in Germany, where many of the firm's assets are located. How would German law or a German court address the bank's effort to apply U.S. law, when that would disadvantage German creditors? There can be no definitive answer to this question. Just as the United Kingdom stepped away from the UNCITRAL model law when political circumstances required it, a private agreement between an insolvent firm and one or more of its creditors is unlikely to stand in the way of a government or court when the well-being of its own citizens—not parties to that agreement—is at stake.

## A Debtor-Selection System

These issues led me to the proposal described in this *Outlook*[7]—a system analogous to a U.S. corporation's selection of its state of incorporation. In that system, when a corporation chooses the state of its incorporation, the corporation, as well as its shareholders, directors, management, and creditors are bound in matters of corporate governance by the corporate laws of the chartering state, although the organization retains the option to reincorporate through merger into another state. In the same way, internationally active financial institutions could specify in their charters or in another semipermanent and public way the national insolvency regime under which they would be resolved. This would ensure that all creditors are put on notice concerning the solvency regime under which their claims would be resolved in the event of insolvency. The debtors' choice would be backed by a treaty in which the signatory countries would agree that the courts or other instrumentalities of their respective insolvency systems would enforce the decisions of the insolvency regime chosen by the debtor. This is what I refer to as a debtor-selection system.

> The debtor-selection system has the best chance of success in providing some of the important results desired in a transnational-resolution system—in particular, certainty of result, ease of administration, and the creation of the right incentives for participating countries.

As I will argue in this *Outlook*, the debtor-selection system has the best chance of success in providing some of the important results desired in a transnational-resolution system—in particular, certainty of result, ease of administration, and the creation of the right incentives for participating countries—while avoiding the many deficiencies of the current territorial system and the difficulty of achieving harmonization of insolvency laws.

## Implementing a Debtor-Selection System

Many ambiguities, uncertainties, and delays are inherent in the current territorial system for resolving insolvent financial institutions, despite developments like the UNCITRAL model law that were specifically designed to address these challenges. A debtor-selection system would significantly ameliorate these problems. For example, the UNCITRAL model law and the European Union Convention require that an insolvency proceeding be commenced in the jurisdiction that is the "center of the debtor's main interests," or where the bulk of the debtor's assets and operations are located.[8] This definition can introduce a great deal of harmful delay in the resolution process. Disputes about the location of a debtor's interests—including whether this is determined by the location of the debtor's assets, its management headquarters, or by other means—will not be easily resolved. Financial institutions are especially susceptible to losses caused by delay in determining what law will govern the disposition of their assets. The skills and knowledge of their personnel are often their most valuable assets, and their greatest resources could quickly move to competitors. Where an unambiguous venue for the insolvency proceeding has not been predetermined, the issue of jurisdiction may need to be litigated, preventing the expeditious commencement of an insolvency proceeding.

A debtor-selection system avoids this problem because, under this system, the debtor and all of its creditors will have agreed in advance where the resolution will occur. Thus, when the bankruptcy petition is filed, the applicable law is already known.

As suggested above, a debtor-selection system would be implemented through an international treaty in which the signatory governments would agree not to substitute or interpose their own bankruptcy or resolution regimes for the regime chosen by the debtor, and to honor the writ of the court administering the resolution regime in the courts of the signatory parties. Other provisions would enhance the purposes of debtor selection. For example, the signatories should also provide for a notification system to enable creditors to determine quickly which jurisdiction the debtor has chosen and to alert the appropriate courts in that jurisdiction that they will be the venue in which the bankruptcy petition is filed. Each signatory jurisdiction should also establish a communication system that allows the bankruptcy court receiving the petition to stay all proceedings and other actions in the other signatory countries through a notice of its own jurisdiction in the matter.

Government policy cannot and should not affect the question of whether a debtor is solvent when a loan matures, but government policy can and should be influential in reducing the operational or legal risks associated with a loan.

## Key Issues in Any System of Transnational Resolution

A debtor-selection system will have an important effect on the insolvency or equivalent laws in the signatory countries. If adopted, it should encourage countries to modernize and enhance their insolvency-resolution regimes so as to encourage more financial-institution debtors to choose their systems. Nevertheless, it is certainly too much to say that this international competition will result in a race to the top. Many balances must be struck in a bankruptcy regime, and what may attract one group of financial firms might put off another. The most that can be said for a debtor-selection system is that it sets up a series of incentives that, over time, could approximate the results of a successful system of harmonization. In the balance of this *Outlook*, I will discuss the implications of a debtor-selection system for a number of issues that any system for resolving failed financial institutions should address.

**Defining Insolvency.** A clear definition of insolvency is especially important for financial institutions. In many jurisdictions, insolvency refers to balance-sheet insolvency, which means a firm's liabilities exceed its assets. The UNCITRAL model law does not define the term but creates a presumption that a proceeding recognized by a foreign jurisdiction as an insolvency proceeding is entitled to the rights conferred by the model law. However, financial debtors need to be considered under a broad definition of insolvency that includes the inability of the debtor to meet its financial obligations as they come due. This is because a financial debtor is more likely than other types of enterprises to have to cease doing business because of mere illiquidity. Since one of the objectives of a bankruptcy regime is to preserve value for creditors, a court's quick imposition of a stay to stop the movement of assets in the bankruptcy of a financial-institution debtor is more likely than in the bankruptcy of other types of enterprises to preserve the debtor's assets or make it possible for a financial debtor to be reorganized and rehabilitated. Accordingly, jurisdictions likely to be selected by financial debtors should use a broad definition of insolvency in their bankruptcy regimes. In a debtor-selection system, financial firms will have the option to choose jurisdictions where a broad definition of insolvency prevails.

**Determining the Companies to Which the Rules Will Apply.** This is a more difficult problem than it might seem, irrespective of how a debtor chooses an insolvency regime, because there is no clear definition of what a financial institution is. Of course, if the debtor-selection system were to apply to all companies, and not just financial firms, this would not be an issue. However, the purpose of the debtor-selection system is to address the particular problems associated with financial firms, and in order to provide consistency of result and other benefits for these institutions it is necessary to know in advance whether a particular company is within or outside this special transnational system. Most financial firms are easily identified as such, but mixed firms with both operating and financial arms, such as General Electric, can be difficult to classify. A debtor-selection system solves this problem. In the absence of any accepted definition of a financial company, it would allow debtors to classify

themselves so that creditors would know in advance which country's laws would apply in the event of insolvency. An operating company that has a financial arm would have a choice about whether to participate. If it designates itself as a financial firm for this purpose, its creditors would have greater certainty about how their claims will be treated in the event of its insolvency. Because assets can easily move through a corporate chain, all aspects of a nonbank financial institution, including nonfinancial subsidiaries and departments, should be resolved under the same rules in order to meet the objectives of the debtor-selection system. In the specific case of Lehman, for example, the company filed for bankruptcy when most of its cash assets were in the United States, but if this filing had been made before the cash was in New York, how would the bankruptcy have been handled? Had all of Lehman's subsidiaries designated different resolution regimes, the territorial system that the debtor-selection system is intended to eliminate would have prevailed. Accordingly, a parent company's choice of insolvency regime should apply to all of its subsidiaries.

On the other hand, a bank with many subsidiaries presents special problems. Its supervisor may insist that it be resolved in the home country, especially if the bank has insured deposits. The problem gets more complex if the parent bank has branches or subsidiary banks abroad. The rule for subsidiary banks would presumably be the same as for the parent—the home-country supervisor of the subsidiary would control the subsidiary's resolution—but the rule for a foreign branch might be different. In that case, the branch would be resolved under the rules of the bank's home country. The treaty could eliminate the sequestering of assets by the host country, known as ring fencing, for branches. Bank holding companies also present an interesting issue. The holding company could choose any jurisdiction for its own resolution, while its subsidiary banks would be resolved under the laws of their home countries. This could present problems if the holding company and bank are financially entangled, but under U.S. law these entanglements are minimized by regulations that limit transactions between holding companies and their subsidiary banks.

A key question is whether the system should be limited to financial firms that are "systemically important." There is no need for this limitation. Indeed, no one has any idea when a company is systemically important or what factors might make it so. The implementation of a debtor-selection system would not and should not depend on whether the debtor is deemed systemically important. The system would be available to any firm with significant operations in more than one country. To be sure, firms could attempt to specify regimes that are remote and difficult for their creditors to access, but there is no need to set up rules to prevent this. Creditors should be sophisticated enough to realize that they must be aware of the jurisdiction in which resolution would occur; the additional risk created by declaring a remote jurisdiction should be reflected in the interest rate or other provisions of the financing. Similarly, if a financial institution chooses to change its jurisdiction of resolution, its creditors should have an opportunity to withdraw from the credit relationship if they perceive that the change in venues would increase their risks.

Lehman's U.S. creditors were the lucky beneficiaries of a system that allowed them to get a better return on their claims at the expense of the foreign creditors of the Lehman subsidiaries.

**Ensuring Consistency of Result.** Consistency of result is one of the most important objectives for any system of resolution. All creditors should be able to understand the consequences of making a loan to a financial institution. Many risks are associated with lending, of course, including the possibility that the debtor will be unable to pay when the debt matures. These risks are factored into the interest rate and other features of a loan. Government policy cannot and should not affect the question of whether a debtor is solvent when a loan matures, but government policy can and should be influential in reducing the operational or legal risks associated with a loan. These risks can be reduced by creating such things as a stable legal and dispute-resolution system, a stable currency, and a market in which there are many users and suppliers of credit so lending rates generally reflect a market judgment on business risks. One of the most important elements of such a system is a bankruptcy regime in which lenders can estimate the priority of their claims in an ensuing resolution. Where an effective system is in place, the risk premium attached to a loan will be lower, thereby increasing the productivity produced by financial-sector lending.

A debtor-selection system would significantly enhance consistency of result. Creditors would be able to judge how

their particular financing arrangement would be treated in the bankruptcy regime the financial-institution debtor has chosen. In addition, if financial institutions are ultimately required to prepare some form of living will—a description of how they will be resolved in the event of insolvency—certainty about the applicable bankruptcy regime would be of great assistance in determining in advance how a resolution would proceed.

**Protecting the Debtor and Creditors.** As one of their principal purposes, all insolvency regimes strive to protect the debtor and its assets against creditors' attempts to seize assets. This also protects creditors who do not have the opportunity to seize assets and who would suffer greater losses than creditors able to mitigate their losses through asset seizure or other self-help. At its root, bankruptcy proceedings work to protect the debtor and creditors in an effort not only to achieve fairness but also to achieve consistency of result.

At its root, bankruptcy proceedings work to protect the debtor and creditors in an effort not only to achieve fairness but also to achieve consistency of result.

Accordingly, almost all bankruptcy or resolution regimes impose a stay to prevent seizure of assets or other actions adverse to the debtor and other creditors as soon as the bankruptcy petition is filed. A treaty that establishes a debtor-selection system should provide that immediately upon the filing of the petition in the jurisdiction chosen by the debtor a stay as defined in the debtor-selected country will be imposed under the laws of all the signatory countries where the debtor has operations or assets. Modern communications should permit notice of the stay to be transmitted almost immediately to every relevant jurisdiction.

The system will probably operate much the way the choice of law process operates in the United States when the parties to a contract have specified the contract's governing law. In that case, the court applies the law of the chosen jurisdiction in interpreting and enforcing the contract, not the local law generally applicable in the court where the case is being adjudicated.

Finally, one of the essential principles of the treaty would have to be that foreign debtors and creditors would have the same rights under the insolvency laws of the signatory country selected by the debtor as domestic debtors and creditors.

**Determining Location of Assets.** One of the most difficult problems in the territorial system is determining where assets are located. This is especially difficult for creditors of financial companies, which can move financial assets from place to place with the touch of a button. That problem is resolved by the debtor-selection system. A bankruptcy court in the jurisdiction chosen by the financial-institution debtor will have immediate control of all the debtor's assets, assuming they are in a signatory country, as soon as the petition is filed.

Had a debtor-selection system been in place at the time of Lehman's bankruptcy, it might have prevented controversy over the location of the assets of Lehman's foreign subsidiaries. As noted above, the cash assets of Lehman's foreign subsidiaries were routinely brought back to New York overnight. When Lehman filed for bankruptcy, it still held much of this cash. This immediately rendered its foreign subsidiaries illiquid and unable to meet their obligations, triggering other bankruptcy filings among the subsidiaries and leading to many unnecessary losses. Under a debtor-selection system in which the treaty contained the necessary provisions to prevent ring fencing and assure equal treatment for creditors from all signatory countries, the court where the Lehman bankruptcy petition was filed could have ordered the retransfer of funds to Lehman's subsidiaries abroad and still retained complete control of how the assets of the parent would be distributed in the bankruptcy. This might have preserved the value of the subsidiaries abroad: they could have been sold, and the proceeds could have been used to pay the creditors of the parent. As it turned out, Lehman's U.S. creditors were the lucky beneficiaries of a system that allowed them to get a better return on their claims at the expense of the foreign creditors of the Lehman subsidiaries. Alternatively, the debtor-selection system would likely have enabled the foreign subsidiaries to continue to function until they could have been sold off. Their creditors would have been paid and the balance returned to the U.S. parent for the benefit of U.S. creditors.

Accordingly, assuming that a bankruptcy proceeding begins in a foreign signatory country while the principal assets of the debtor-financial institution are located in the United States, the U.S. courts (assuming the United States is a signatory to the same treaty) would assist the foreign court in marshalling assets and policing the stay as applicable in the foreign proceeding. In keeping with other transnational insolvency provisions, such as the North American Free Trade Agreement, the

European Union Convention on Insolvency Proceedings, and the UNCITRAL model law,[9] the U.S. court would not be obligated to apply any rulings or requirements of the foreign jurisdiction that manifestly violate U.S. public policy. An effective treaty would likely define this exception narrowly.

**Maximizing Asset Values.** The debtor-selection system can create incentives for signatory countries to adopt provisions in their laws that enhance the rights of creditors by implementing policies that will maximize asset values. One of the objectives of bankruptcy law is to preserve the assets of the debtor so as to maximize their equitable distribution among the various creditors according to their class priority. Among the insolvency rules that seek to accomplish this in many regimes are provisions for avoidance of burdensome executory contracts and the clawback of preferences. Creditors will prefer countries with provisions in their insolvency laws likely to maximize asset values over countries that do not, but debtors may have a different view of some of these provisions. Countries must find the right balance; over time, it is likely that the best balance would attract the most debtors and creditors. Accordingly, each country will face pressure from local debtors and creditors to improve the balance of equities between the two so that both will find the country's solution acceptable. This could also help generate some international harmonization.

> The signatory countries that will win out in the debtor-selection contest are likely to find a good balance between the rights of management and creditors and the divergent interests of creditors.

**Recognizing the Bargain between Debtor and Creditor.** The importance of recognizing the deal that the debtor and creditor initially made is at the heart of the resolution process. Creditors will not only want to know what the rules are, but also that once they are placed with respect to a class that class includes only those similarly situated and not others whose claims are not of equal standing. To the extent that classes are not fixed, or are subject to adjustment based on political considerations in the signatory country, creditors will be taking risks that will show up as a premium in the interest rate or other provisions of credit agreements. Both debtors and creditors should want to avoid such a premium, and both are likely to avoid specifying countries as the jurisdiction for resolution that do not clarify these elements either in the appropriate substantive law or the associated procedures. Again, the mutual desire of both creditors and debtors for certainty on this question will provide an incentive for changes in the laws and procedures of signatory countries as needed.

**Balancing Liquidation versus Reorganization.** Not all principles that should be addressed in an insolvency law reflect an agreement between debtors and creditors. One of the most contentious concerns is whether the debtor or the creditors will control the bankruptcy. Creditors themselves are often divided on this issue; secured creditors tend to prefer a liquidation of the debtor while unsecured creditors tend to favor reorganization of the firm when there is a chance that they can recover some of their losses. The debtor, naturally enough, tends to prefer to control the resolution process, which gives the existing management of the debtor an opportunity to eliminate burdensome contracts, make agreements with creditors of various kinds, and restore the company to health. Ultimately, the decision that the creditors have to make is whether the debtor's business is viable, and the procedures under the insolvency law would have to be flexible enough to allow this decision to be made at the appropriate time.

A number of issues are implicated in the decision to liquidate or reorganize, not just the difference between secured and unsecured creditors. For example, the country's perspective will affect the results. Whether it views bankruptcy as a moral or economic matter will determine whether the managements of bankrupt companies get a second chance. Whether the country favors entrepreneurship and risk taking over prudent management and whether creditors in the country are willing to accept less than what they might otherwise get in order to have a chance at a greater, but riskier, recovery will contribute to the decision to liquidate or reorganize the firm.

There is no clear solution to account consistently for these differing views. A firm that intends to fund itself with unsecured debt would probably tend to prefer a jurisdiction that is favorable to debtor-controlled reorganization, while a firm that expects to fund itself with secured debt might be able to get marginally better terms on its debt in a jurisdiction that gives creditors more control over the resolution process. There is some experience with government decisions of this nature. In the United States, corporations have to select a state of incorporation. Most

of them initially select the state in which they are located, but they are free to select any state. This sets up a contest among states vying for incorporations and the associated franchise taxes. One might think that this would mean the successful states have offered corporations the best environment—the opportunity, for example, to take a wide range of actions without shareholder approval—but this is not the case. In this state competition, Delaware has emerged as the clear winner; it has captured most of the corporate charters from corporations not operating in the state. Many academic studies have examined why this occurred, and the most common conclusion is that Delaware created a fair balance between the rights of the corporation and the rights of the shareholders, and supported its choices with a capable and expeditious judicial system. Because of this balance, Delaware corporations are not penalized for choosing that state as their state of incorporation; indeed, there are indications that they gain from it.

The same situation is likely to emerge when financial debtors choose their resolution jurisdiction. The signatory countries that will win out in the debtor-selection contest are likely to find a good balance between the rights of management and creditors and the divergent interests of creditors, and they will ensure a high-quality judicial system capable of making expeditious decisions untainted by political considerations.

## Conclusion

The fairest and most effective transnational bankruptcy regime would be a universal system in which all countries have essentially the same bankruptcy laws, but achieving this seems far out of reach today. Historical resolution mechanisms, legal concepts, and value systems vary widely across countries, making harmonization very difficult. With globalization proceeding at a fast pace, it is unlikely that a universal system could be put into place before more bankruptcies of globally active financial firms occur. Similarly, the current territorial system produces arbitrary and occasionally chaotic results and makes it virtually impossible for companies to create useful or accurate living wills. The risks for creditors may also be increasing risk premiums on debt that could be eliminated by a system that offers more certainty. The debtor-selection system need not be limited to systemically important companies, can be implemented through a treaty that is far easier to negotiate than a universal system, and provides the certainty of result that is essential for any economic system based on the primacy of private contractual relations. Just as important, a debtor-selection system creates incentives for a gradual improvement in bankruptcy laws among participating countries.

## Notes

1. Lucian Arye Bebchuk and Andrew T. Guzman, "An Economic Analysis of Transnational Bankruptcies," *Journal of Law and Economics* 42 (October 1999): 775.

2. The United Nations Commission on International Trade Law (UNCITRAL) developed the Model Law on Cross-Border Insolvency in 1997; it was explicitly intended to form the basis for the harmonization of the insolvency laws of many countries. Thus far, it has been adopted principally by common-law countries, including the United States, Great Britain, Australia, New Zealand, and Canada. Japan has also adopted it. See UNCITRAL, *UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment* (New York, May 30, 1997), available at www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model.html (accessed March 23, 2010).

3. Lucian Arye Bebchuk and Andrew T. Guzman, "An Economic Analysis of Transnational Bankruptcies," 781–83.

4. *Cunard Steamship Company Limited v. Salen Reefer Services Ab*, 773 F.2d 452 (2d Cir.1985).

5. The Landsbanki Freezing Order 2008, no. 2668, October 8, 2008, available at www.opsi.gov.uk/si/si2008/uksi_20082668_en_1 (accessed March 22, 2010).

6. Alexander M. Kipnis, "Beyond UNCITRAL: Alternatives to Universality in Transnational Insolvency" (working paper, Social Science Research Network, July 3, 2006), 38–39.

7. I first proposed the debtor-selection system in the following, to be published in a forthcoming book. See Peter J. Wallison, "The Principles That Should Guide Transnational Resolutions" (paper presented at "Cross-Border Issues in Resolving Systemically Important Financial Institutions," Wharton School, University of Pennsylvania, February 12, 2010).

8. See UNCITRAL, *UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment*, Art. 2(b); and European Union Council, *Convention on Insolvency Proceedings*, Council Regulation no. 1346/2000 (May 29, 2000), Art. 3(1).

9. For example, see UNCITRAL, *UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment*, Art. 6; European Union Council, *Convention on Insolvency Proceedings*, Art. 26; and "North American Free Trade Agreement," December 17, 1992, available at www.nafta-sec-alena.org/en/view.aspx?x=343 (accessed March 23, 2010).