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**PRESENTATION BY:**

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**NOVEMBER 2006 BACKGROUND MEMORANDUM FOR THE  
INTERNATIONAL INSOLVENCY INSTITUTE'S PROPOSAL  
TO UNCITRAL CONCERNING INTERNATIONAL  
INSOLVENCY/ARBITRATION**

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**MEMORANDUM**

**TO:** UNCITRAL General Secretary  
**FROM:** International Insolvency Institute  
**DATE:** November 28, 2006  
**RE:** Background Memorandum Concerning International Insolvency Institute's Proposal to UNCITRAL concerning International Insolvency/Arbitration

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This Memorandum provides background for the International Insolvency Institute's proposal to UNCITRAL concerning greater use of international arbitration in international insolvency matters.

**I. The Issue Presented**

Is it possible to increase the influence of the basic concepts contained in the UNCITRAL Model Bankruptcy Law and the UNCITRAL Legislative Guide on Insolvency Law by providing for greater use of international arbitration in bankruptcy cases of multi-national debtors?

**II. Background**

The bankruptcy case of a debtor with assets and operations in many countries (a "Multi-National Debtor" or a "Debtor") presents issues about whether creditors, lien claimants and courts in countries outside the country where a bankruptcy case is pending ("Foreign Countries," "Foreign Courts" or "Foreign Creditors") will recognize and enforce the orders of a bankruptcy court presiding over a Multi-National Debtor's bankruptcy case (a "Bankruptcy Court").

Most nations have their own bankruptcy laws ("**National Bankruptcy Laws**"). Some of these National Bankruptcy Laws, including those of the U.S. and the U.K., express worldwide jurisdiction over property of the Debtor as well as claims against the Debtor and its assets ("**Extraterritorial National Laws**"). Many other National Bankruptcy Laws express jurisdiction only over assets within the country in which the Bankruptcy Court sits ("**Non-Extraterritorial National Laws**").

Bankruptcy Courts dealing with a Multi-National Debtor and operating under Extraterritorial Bankruptcy Laws need some method of enforcing their orders concerning the Debtor's assets outside their borders. Bankruptcy Courts dealing with a Multi-National Debtor operating under Non-Extraterritorial Bankruptcy Laws need some way of obtaining orders governing the Debtor's assets outside their borders.

There are relatively few multi-national treaties concerning bankruptcy. There are also relatively few bi-lateral treaties concerning bankruptcy. Hence, enforcement of Bankruptcy Court orders in other nations has traditionally been left to comity, and to other applicable international law concepts derived from custom and usage.

UNCITRAL has propounded a model bankruptcy law (the “UNCITRAL Model Bankruptcy Law”) that contemplates a system of cooperation among countries in the bankruptcy case of a Multi-National Debtor. This system contemplates a main bankruptcy case in the country with the greatest connections to the Multi-National Debtor, that is where such a Debtor has its “center of main interest” (a “Main Case”), with ancillary bankruptcy cases in other countries where the Debtor has operations or assets (an “Ancillary Case”). These Ancillary Cases are intended: (1) to control the Debtor’s assets located in these non-Main Case countries, (2) to coordinate with the Main Case (possibly by permitting assets from the non-Main Case country to be distributed to creditors through the Main Case) and (3) to enforce orders from the Main Case.<sup>1</sup> The Main Case and the various Ancillary Cases will be referred to hereafter as the “Cases,” and any one such as a “Case.”

The European Union has adopted a Regulation reflecting many of the principles of the UNCITRAL Model Bankruptcy Law. Certain other countries (including the United States) have also incorporated the UNCITRAL Model Bankruptcy Law into their National Bankruptcy Laws. However, the UNCITRAL Model Bankruptcy Law has to date only been adopted by approximately 10 countries around the world.

UNCITRAL has also adopted a *Legislative Guide on Insolvency Law* (the UNCITRAL “Legislative Guide”) describing basic principles contained in effective insolvency laws. The World Bank has adopted *Principles and Guidelines for Effective Insolvency and Creditors Rights Systems* (the World Bank “Principles”) containing similar material for consideration in insolvency reform in various nations. As more National Bankruptcy Laws are influenced by the Legislative Guide and the Principles, it will be easier to use the UNCITRAL Model Bankruptcy Law to coordinate between a Main Case and Ancillary Cases in other countries.

It is not clear how long it will take before substantially all nations have adopted National Bankruptcy Laws influenced by the Legislative Guide and the Principles. It is also not clear how long it will take before substantially all nations have adopted the UNCITRAL Model Bankruptcy Law as a basis for coordinating with and enforcing the orders of a Main Case in another country.

So the question presented is whether increased use of international arbitration in a bankruptcy context can hasten the spread of the concepts in the UNCITRAL Legislative Guide as well as in the UNCITRAL Model Bankruptcy Law. Increasingly, bankruptcy courts have shown a willingness to refer bankruptcy related issues to arbitration under national arbitration statutes. For example, in the United States, two recent decisions from courts in New York and Philadelphia have held that even “core” bankruptcy questions must, in certain circumstances, be referred to arbitration pursuant to the terms of an existing arbitration agreement. In *In re Mintze*, 434 F.3d 222 (3<sup>rd</sup> Cir. 2006) the Third Circuit Court of Appeals held that a bankruptcy court proceeding to invalidate a lien on the debtor’s residence allegedly obtained by the lender in violation of consumer protection laws had to be referred to arbitration based on an arbitration provision in the underlying loan documents. In *MBNA Am. Bank, N.A. v. Hill*, 436 F.3d 104 (2<sup>d</sup> Cir. 2006) the Second Circuit Court of Appeals held that a bankruptcy court proceeding concerning a lenders violation of the automatic stay during a bankruptcy case should be referred to arbitration in the particular circumstances of that case.

The recognition by bankruptcy courts that national arbitration statutes may require that issues otherwise within the courts’ jurisdiction be referred to arbitration may signal a concomitant willingness of bankruptcy courts to refer matters to international arbitration. As national bankruptcy courts gain more exposure to international arbitration, will the benefits of wider adoption of the concepts promoted by UNCITRAL become apparent? As described below, we believe that the answer is yes, and that UNCITRAL should appoint an Insolvency Arbitration Committee to deal with these issues.

### **III. Consensual Nature of Arbitration/Forced Coercive Nature of Court Assertion of Jurisdiction**

Arbitration can aid the bankruptcy of a Multi-National Debtor because it has an excellent enforcement mechanism.

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<sup>1</sup> An important limitation on this cooperation is the “public policy” exception contained in the UNCITRAL Model Bankruptcy Law, which provides that recognition and co-operation not be granted where matters taking place in the Main Case are at odds with the public policy of the country where an ancillary case is sought to be opened.

Court jurisdiction is based on the power of nations which have the coercive power of state officials. Their jurisdiction may apply broadly even to persons and assets which assert that they are not subject to jurisdiction (“Coercive Jurisdiction”). Because enforcement of this Coercive Jurisdiction is implemented only pursuant to national authorities, it can be enforced in Foreign Countries only pursuant to (1) treaties or (2) comity given by courts of other countries.

By contrast, international arbitration is a private system which is based upon an agreement to arbitrate (“Consensual Jurisdiction”). Once agreed to, however, arbitration has an impressive worldwide enforcement mechanism through the New York Convention. Pursuant to the original Geneva Conventions, the New York Convention was signed in 1958, and more than 150 nations are now signatories to it. If an entity has consented to arbitration and an arbitration is properly initiated against it, any award that is ordered may be enforced in any of the over 150 signatory states under the New York Convention.<sup>2</sup>

To determine whether a Consensual Jurisdiction arbitration system can be useful in the bankruptcy of a Multi-National Debtor, it is useful to understand the essential functions of the bankruptcy process, to be able to consider on a function-by-function basis whether they are suitable to arbitration. These essential functions fall into three categories, the details of which are defined below in footnotes: (1) Lawsuit Type Actions (involved in (a) the Claims Allowance Process and (b) Claim Assertion Causes of Action); (2) Debtor Financing activity (involved in (a) Debtor Asset Sales, (b) Debtor Loans and (c) Debtor Equity Investments) and (3) the Plan of Reorganization Process (involving (a) Claims Treatment under a Plan of Reorganization, (b) Claims Discharge and (c) Discharge Protection).<sup>3</sup>

#### **IV. General Discussion of the Application of International Arbitration to Bankruptcy Case Functions**

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<sup>2</sup> UNCITRAL has also propounded a Model Law on Arbitration which has now been adopted by a number of countries providing another basis for international cooperation in arbitration matters.

<sup>3</sup> Bankruptcy reorganization generally involves creating an estate (the “Debtor’s Estate”) against which creditors can file claims (“Claims”), the Debtor can object to such Claims (and even file counterclaims), and the Bankruptcy Court can then adjudicate the net allowed amount of the Claim against the Estate (the “Claims Allowance Process”). Generally, this process is aided by the setting of a bar date (the “Bar Date”) so that Claims filed after such a date are disallowed. Claims can thus be allowed (becoming an “Allowed Claim”) or disallowed (becoming a “Disallowed Claim”), either because the Bankruptcy Court sustains the Debtor’s objection to a Claim or because the Claim was not filed before the Bar Date. Allowed Claims receive some form of payment out of the Debtor’s Estate at the end of the bankruptcy case.

To prohibit immediate enforcement and repossession by creditors during the bankruptcy, there is often a stay during the bankruptcy case of pre-bankruptcy Claim collection activity (the “Bankruptcy Stay”).

Debtors can generally sue non-debtor third parties to replenish/build up the Debtor’s Estate by pursuing causes of action: (1) for preferences or fraudulent conveyances to recover assets improperly transferred out of the Debtor’s Estate after it became insolvent (“Avoidance Power Causes of Action”) and (2) for other affirmative causes of action based upon contract, fraud, statute or other applicable law (“General Lawsuit Causes of Action”). (Avoidance Power and General Lawsuit Causes of Action are collectively “Claim Assertion Actions”).

To make a reorganization financially viable, it is often important to permit the Debtor to refinance: (1) through the sale of assets, giving comfort to the buyer that these assets are not encumbered by Claims against the former Debtor owner or liens granted by the former Debtor owner (“Debtor Asset Sales”) or (2) through loans, with liens granted on the Debtor’s assets with a particular priority versus any other lien claimant (a “Debtor Loan”). Another form of investment in a bankrupt Debtor is an equity investment made at the consummation of a plan of reorganization, relying on the Claim Allowance Process and Discharge Protection (defined below) to invest in a restructured company as it emerges from bankruptcy (“Debtor Equity Investment”).

As a bankruptcy reorganization case nears conclusion, a plan of reorganization can be developed and approved to describe how Allowed Claims will be classified and treated—*i.e.*, paid (a “Plan of Reorganization” and “Claims Treatment”). As a result of a Plan of Reorganization, certain Allowed Claims will receive the proposed Claims Treatment (in place of their full pre-bankruptcy Allowed Claim amounts), and Disallowed Claims will be discharged forever (“Claims Discharge”). A Plan of Reorganization thus grants protection to the Debtor from creditors: (1) asserting Claims after the reorganization that the creditor did not file in the bankruptcy case before the Bar Date, (2) asserting Claims that were disallowed pursuant to a claim objection or (3) asserting Claims in their original pre-bankruptcy Claim amount (collectively “Discharge Protection”).

**A. Arbitration of Claims Allowance Issues**

International arbitration could also be quite useful in the Claims Allowance Process for a Multi-National Debtor. The Claim's Allowance Process generally proceeds by the setting of a Bar Date for the filing of claims against the debtor's estate (including its assets), the filing of proofs of claim, objection to the proofs of claim (if any), and the adjudication of the claim by the bankruptcy court. When creditors file a proof of claim, they submit to Bankruptcy Court jurisdiction, and the Debtor can object to a filed claim, defending and counterclaiming as if the claim were a lawsuit seeking money from the Debtor. These counterclaims can seek, among other things, recoveries of preferential and fraudulent transfers from the Debtor.

In the bankruptcy Case of a Multi-National Debtor, claimants often reside in Foreign Countries, remote from where the Case is pending. These creditors might actually prefer to litigate any claims allowance issues in arbitral panels in countries nearer to where they live. Likewise, a Multi-National Debtor might wish to refer certain of these claims allowance matters to arbitration, especially if it has any fear that a Foreign Creditor who loses a claims allowance issue before the Bankruptcy Court might refuse to abide by the Bankruptcy Court's order, and especially if the Debtor wishes to assert a counterclaim and enforce a judgment that the estate might win on such a counter claim.

**B. Arbitration of Enforcement Issues Relating to Orders Entered on Central Bankruptcy Financial Issues**

There would be substantial policy issues involved with referring to an arbitral panel the initial decision of central bankruptcy issues involved in the Debtor Financing and Plan of Reorganization Process, such as a Multi-National Debtor's: (1) sale of assets, (2) obtaining loans, (3) obtaining court approval for a plan of reorganization and (4) obtaining exit financing for such a plan of reorganization (collectively "Central Bankruptcy Financial Issues"). However, after the Bankruptcy Court has decided Central Bankruptcy Financial Issues and issued orders concerning them, there may be disputes about whether a party has breached such orders and the proper remedy for such breach ("Order Enforcement Issues"). It might be useful and appropriate to permit the parties to agree to submit such Order Enforcement Issues to an international arbitral panel.

Under this approach, a Bankruptcy Court in a Main Case could decide Central Bankruptcy Financial Issues such as: (1) that a Debtor Loan should be made with certain liens subordinated, (2) that a Debtor Asset Sale should be made free and clear of liens or (3) that a certain Plan of Reorganization should be approved containing certain Claims Treatment for Allowed Claims, with all Disallowed Claims enjoined from further collection activity.

If a Multi-National Debtor then alleges that a lien claimant residing in a Foreign Country (whose lien was either made junior in a Debtor Loan order, or removed from the asset being sold in a Debtor Asset Sale order) has asserted a lien in breach of the Bankruptcy Court's order, then the Bankruptcy Court might permit the parties to agree to arbitrate this dispute. The alleged breacher might agree to such an arbitration because it might prefer to have an arbitral panel decide whether it breached a court order instead of the court which entered the order at issue. The Debtor might agree to such arbitration because of better prospects of enforcement if a breach is found.

**C. Arbitration of Claims Allowance Issues Involving Foreign Investment Law Disputes**

Many corporations will need bankruptcy reorganization because their assets are about to be, or have been, expropriated to state ownership. In these cases there will be substantial issues under bankruptcy and non-bankruptcy law about whether this expropriation should be permitted at all, and, if done, how much compensation should be paid. Often this expropriation will be in alleged violation of the Foreign Investment Laws of a country having a significant relationship to the Debtor, which contemplate that such disputes be referred to arbitration. Bankruptcy Courts may be called upon to try to exercise control over these circumstances through orders staying the taking of the Debtor's assets, while such arbitrations go forward. This will require coordination between (1) the arbitration and the (2) Bankruptcy Stay/Bar Date/Claims Allowance functions in the Bankruptcy Case. There will be significant questions about just how many of these disputes can, and should, be referred to the arbitration. For example, should the bankruptcy court exercise its powers to try to stay the taking of a Debtor's assets, or should the Bankruptcy Stay issues be referred to the arbitration to be decided under the rubric of "interim measures."

These same issues may be presented by Bilateral Investment Treaties, most of which contemplate arbitration of disputes.

**D. Arbitration of Disputes Between a Debtor's Estates**

International arbitration could be quite useful in resolving disputes between a Main Case and the various Ancillary Cases that are pending at the same time for a Multi-National Debtor. The UNCITRAL Model Bankruptcy Law contemplates a Main Case in a Multi-National Debtor's "center of main interest," with multiple Ancillary Cases concerning that same Debtor in other jurisdictions where the Debtor operates or has assets. Each such Case will probably view that it has a separate estate of the Debtor's assets that are subject to its jurisdiction (a Multi-National Debtor's multiple "Estates"). Disputes might arise between these multiple Cases and Estates (for this one Multi-National Debtor) as to which country is, indeed, the center of main interest and, thus, which Case is, indeed, the Main Case. Disputes might also arise between these multiple Estates over the use and disposition of the Debtor's assets located in various countries. For example, the UNCITRAL Model Bankruptcy Law provides that a Bankruptcy Court in an Ancillary Case need not let assets go from its jurisdiction to be distributed in another case for the Debtor in ways that violate its national policies or discriminate against its local creditors.

The UNCITRAL Model Bankruptcy Law states that Bankruptcy Courts presiding over the separate Cases for the same Multi-National Debtor shall cooperate by whatever methods they choose, encouraging flexibility and creativity. It would appear that this cooperation could include the various Estates for one Multi-National Debtor agreeing to arbitrate their disputes. Cooperation could also take the form of the appointment of one or more mediators to try to resolve disputes between estate representatives and/or the courts presiding over the various estates.

**E. Agreements to Arbitrate Certain Central Financial Issues**

As discussed above, a dominant issue in international insolvency law in recent years has been the development of effective and enforceable laws relating to enterprise insolvency. While the UNCITRAL Model Law on Cross-Border Insolvency, the UNCITRAL Legislative Guide and the INSOL International Statement of Principles for a Global Approach to Multi-Creditor Workouts (Oct. 2000) show much progress, there is still much divergence among local laws and in the local enforcement of insolvency legislation and security interests. Foreign investors depend not only on the existence of a bankruptcy code on paper, but on the power and willingness of courts to enforce it, sometimes to the disadvantage of local citizens. Beyond the issue of enforcement is the question of the cost and delay of any formal insolvency proceeding.

To expedite proceedings, several countries have adopted statutory alternatives to full insolvency proceedings, which in some cases resemble the U.S. prepackaged plan of reorganization. The goal of such proceedings is to obtain largely consensual results between the enterprise and its largest creditors, and to limit the adjustment of debt to the largest creditors in order to achieve a needed result quickly and inexpensively.

It is possible that arbitration principles could be applied to provide a procedure that would be even more efficient, fair and less expensive than a prepackaged plan in resolving disputes among the principal creditors of an enterprise, and make that resolution more enforceable. For example, a borrower could agree with its principal institutional lenders, major suppliers and bondholders through an Indenture provision, to arbitrate certain specified issues after a default. The arbitrator could be a restructuring expert skilled in the international area, given the task of making final decisions where the parties could not agree -- for example, as to the percentage of the value of the enterprise allocable to each stakeholder group based upon a determination of enterprise value. It is not contemplated that this form of arbitration would supplant a workout, or an effort to achieve a consensual resolution among the parties. All bargaining, however, takes place against the backdrop of the legal principles that will be applied by a fact finding and order issuing authority in the event of non-agreement.

Principles which have had long success in arbitration of international commercial disputes could present many advantages in fostering a consensual resolution. For example:

1. The parties could agree on a law to govern the substantive issues, thus standardizing international practice and procedure.
2. Arbitrators could be chosen who would be an expert in the area of restructuring and who would have the confidence of the parties.
3. Arbitration could provide a mechanism for determining specific issues where complete creditor consent might be difficult to obtain – for instance, where a debtor proposes to obtain new or “DIP” financing, with a priority over all existing major debt.
4. Arbitration could possibly provide a mechanism to make a generally consensual workout enforceable against an objecting minority or a silent minority.
5. Arbitration could greatly increase the likelihood of a workout being enforceable locally, even if some of the results of the arbitration were contrary to the interests of the local owners of the enterprise. National courts are used to enforcing arbitration awards. There may be certain types of transactions which could not be enforced through arbitration – for example, a sale free and clear of liens – but most transactions should be enforceable through arbitration principles.

It is emphasized that this type of arbitration is not designed to affect the rights of those creditors and others who do not expressly agree to the arbitration process. As is the case with most prepackaged plans of reorganization, trade creditors, “involuntary creditors” and small creditors would ordinarily be left unimpaired. Large creditors would agree to the arbitration, as they agree to a prepackaged proceeding, because of the benefits derived from the process. Small creditors, who do not consent to arbitration, would benefit from the process, if it is faster, more efficient and less injurious to the business than a full bankruptcy proceeding.

This type of arbitration may encounter more theoretical and practical difficulties than some of the others discussed in Sections IV A-D above; presumably, a new type of arbitration and a new arbitration panel would have to be created. Nevertheless, we believe the issue merits further study.

## **V. Request to UNCITRAL**

We will ask UNCITRAL to form an Insolvency Arbitration Committee, composed of persons from the insolvency practice and the arbitration practice, to study greater use of international arbitration of certain insolvency matters, as generally described in Sections IV A-E above. We propose that this Insolvency Arbitration Committee initially focus on the following broad issues:

1. Are there any insolvency/bankruptcy issues that would prohibit use of international arbitration for any of the five types of matters listed in Section IV A-E above, or other matters that the Committee thinks should be considered? If so, can these issues be resolved? Further, are there things that bankruptcy courts can do to facilitate the use of international arbitration of insolvency matters?
2. To what extent do existing “insolvency exceptions” in arbitration conventions and practice apply to limit use of international arbitration in the types of matters listed in Sections IV A-E above? If they do create any limit, should they be changed, and how can they best be changed?

- a. Arguably, international arbitration is already able to support the bankruptcy process in many of the areas listed above. The existing “insolvency exceptions” in some arbitration conventions probably do not, or should not, apply to the discrete disputes contained in these matters, but rather may be intended to apply only to the initial decision of certain Central Bankruptcy Financial Issues.
  - b. The Insolvency Arbitration Committee should investigate whether these “insolvency exceptions” should be clarified as to what they do, and do not, apply to, and whether they should be amended or deleted.
3. Do any of the types of matters listed in Sections IV A-E above involve disputes that are not arbitribal? If so, what can and should be done to establish that they are arbitribal disputes?
  - a. Arguably, the matters listed in Sections IV A-D above all present clear distinct disputes that are not qualitatively different from disputes already regularly referred to arbitration. This might even be true of the kind of issues described in Sections IV E above.
4. Finally, develop UNCITRAL procedures and guidelines to facilitate use of international arbitration of the matters listed in Sections IV A-E above, and of any other insolvency matters that are suitable to such arbitration.