A Commitment Rule for Insolvency Forum

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The Model Law on Cross-Border Insolvency ('Model Law') was promulgated by the United Nations Commission on International Trade Law ('UNCITRAL') in 1997. During its now more-than-a quarter century life, it has been adopted in more than 60 jurisdictions around the world and, in our view, has played a major role in the improvement and successful management of insolvency proceedings with a cross-border element.

The Model Law is built on the idea of 'modified universalism'. Therefore, it envisions the commencement of a main proceeding in a *single* jurisdiction even if non-main proceedings can also be opened and the laws of other jurisdictions can still be relevant for certain aspects of the proceeding. Once main and non-main proceedings are opened, the Model Law establishes a set of rules to facilitate cooperation and assistance for the successful management of insolvency proceedings.

The adoption of modified universalism as a regulatory model to deal with cross-border insolvency is a sensible one. Indeed, in contrast to those favoring the adoption of a fragmented (or 'territorialist') approach, we argue that the existence of a centralized procedure is a superior option. Still, there is room for improvement. Specifically, the Model Law's use of the debtor's center of main interest (the 'COMI rule') to determine the proper forum for a foreign main procedure is flawed. The COMI rule, as it currently exists in the Model Law, creates uncertainty and litigation costs and opens the door to opportunistic behavior by debtors. Moreover, these problems are exacerbated by the fact that countries around the world have interpreted the concept of COMI differently (putting more or less weight on the presumption of the registered office and the different factors that need to be assessed for the rebuttal of the presumption), and they have adopted different approaches to assess the time at which the COMI needs to be determined. For instance, while the United States and Singapore determine the COMI based on the date when the application for recognition is filed, the United Kingdom and Australia use the date of the filing of the foreign proceedings and the date of the hearing of the recognition application, respectively, as the relevant dates to determine the debtor's COMI.

In our view, the COMI rule presents the worst of all worlds by allowing debtors to manipulate forum at the time of filing while preventing them from committing to an efficient forum ahead of time, and then opening the door to expensive litigation regardless of where they do file. This state of affairs undermines the legitimacy of insolvency proceedings and prevents market negotiations that produce value for creditors and contribute to the effective reorganization of viable businesses. By stifling markets, the COMI rule hinders the development of financial markets, entrepreneurial innovation, and economic growth more generally.

In a recent article, we propose a better approach—one we call the 'Commitment Rule'—for the choice of insolvency forum. This approach develops the proposal that we submitted to the Secretariat of UNCITRAL Working Group V (Insolvency) in an open letter sent on 14 September 2023. In short, the Commitment Rule suggested in our article allows debtors to signal an advance commitment to a particular insolvency forum. To make this commitment public and binding, the debtor must put it in their company's constitution, as one of us suggested in an article published in 1997. This upfront and observable commitment eliminates uncertainty and opportunistic manipulation. Moreover, it would allow companies to choose a more efficient insolvency forum that can benefit debtors, creditors, and society at large. Hence, this approach can be particularly beneficial for countries without developed restructuring ecosystems, which often include emerging markets and developing economies, and therefore countries where the adoption of active policies to promote entrepreneurship, access to finance, and economic growth is most needed.

Against the views expressed by some detractors of our proposal, the Commitment Rule should not lead to the choice of an insolvency forum that is detrimental for sophisticated lenders. Otherwise, the debtor would be exposed to an increase in the cost of debt or even lose access to credit markets altogether. Therefore, the real risk of opportunistic behavior when initially choosing the insolvency forum only exists in the context of vulnerable creditors, such as tort claimants and employees, that do not have the ability, information, or bargaining power to adjust the conditions of their claims. To mitigate this risk (which is equally present under the current COMI rule), we suggest different strategies. For example, if countries seriously want to protect these creditors, a defined group of vulnerable creditors (decided locally by each jurisdiction) such as tort claimants and employees can be given a preferential treatment in the ranking of claims and the lack of respect for this priority may serve as a cause for denying recognition, even on the basis of 'public policy', of any insolvency proceeding initiated by the debtor in a foreign jurisdiction.

Despite the superiority of the Commitment Rule when it comes to promoting predictability, reducing litigation costs, preventing opportunistic forum shopping, and facilitating the choice of more efficient insolvency systems, it could be argued that the adoption of this rule may constitute a degree of rigidity that may hamper the change of insolvency forum for valid reasons – that is, when it can be desirable for the creditors as a whole. Aware of this situation, we suggest various approaches to facilitate the change of insolvency forum while preserving the benefits of the Commitment Rule.

If UNCITRAL wants to favor predictability over flexibility, we argue that the Commitment Rule might include a requirement that debtors changing the forum in their constitution need to provide notice to all the pre-existing creditors. Then, if no creditor (or if fewer than a certain percentage of creditors) objects within a reasonable period of time (eg, 3-4 weeks), the forum change would become effective. By adopting this approach, none of the company's pre-existing creditors would be required to accept an insolvency forum that was not accepted at the moment of extending credit. This would be the most creditor-protective approach.

A second approach potentially adopted by UNCITRAL may consist of requiring approval of a majority or super-majority of the creditors. That approach would provide more flexibility. Nonetheless, it may create other costs, such as holdout problems and a potential increase in the cost of credit from sophisticated lenders pricing their loans on the basis that they may be required to be subject to an unwanted insolvency forum.

For that reason, building on a proposal suggested in an article co-authored by one of us, we argue that UNCITRAL should consider a third approach consisting of allowing debtors to choose how the insolvency forum would be changed should the need arises. Put differently, the debtor would just follow the rules governing the constitutional provision establishing the insolvency forum. To facilitate the implementation of this approach, we provide a non-exhaustive list of amendment rules that companies could potentially adopt, depending on the type of flexibility that they want to have and the signal that they want to send to their lenders. For example, these amendment rules may include: (i) requiring consent by, or not having the veto of, a minimum number or percentage of creditors; (ii) putting a delay on the effective date of a change in the constitution; (iii) allowing the change of the insolvency forum provided that it is approved by a particular individual (for example, an arbitrator, advisor, or designated independent director) or group of people (eg, board of directors, company's independent directors, or an external committee of legal and financial advisors). The debtors will write their amendment rules considering the demands and expectations of the credit markets. Again, sophisticated lenders take the adopted rules into account when they price their loans. Debtors, knowing this, will have incentives to choose a method that is trustworthy, value-enhancing, and protective of the interests of the creditors. As discussed above, vulnerable creditors would be protected separately through other mechanisms that may include a priority (if adopted locally, not in the Model Law) or a public policy exception for the recognition of the proceeding.

Therefore, this approach would facilitate the change of insolvency forum while providing a level of protection to creditors that does not currently exist.

In our view, while the COMI rule provides the worst possible scenario in terms of predictability, litigation costs, access to finance, and freedom to choose a value-enhancing insolvency forum, the Commitment Rule presents a rare “win-win” legal reform requiring no major tradeoff. It would reduce strategic forum shopping and minimize litigation costs while preserving beneficial former choice to promote the development and selection of efficient insolvency forums, which benefits all stakeholders. These improvements support the development of financial markets, entrepreneurial innovation, and economic growth more generally. Therefore, we urge UNCITRAL to consider adopting the Commitment Rule as part of the Model Law.

The authors’ complete article can be accessed here.

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