

# The critical discussion on theories in cross-border insolvency: universalism, territorialism, and modified universalism

Ziyi Wang

University of Leeds, Leeds, West Yorkshire, LS2 9JT, United Kingdom

**Abstract:** Investment and trade activities brought about by economic globalisation have led to an increase in the number and scale of cross-border insolvency cases, attracting the attention of the international community as well as that of scholars, and the theoretical study of cross-border insolvency has evolved from the traditional universalism and territorialism to the modified universalism. The choice of theory is closely related to the level of economic and social development of the country at that time and the legislative trend of the international community. Modified universalism had been accepted by an increasing number of countries, regions and international organisations because of its flexibility in judicial practice.

**Keywords:** cross-border insolvency, universalism, territorialism, modified universalism

## 1. Introduction

With the rapid development of economic globalization, economic exchanges between countries have become more frequent, and international investment and trade activities and cross-border insolvency cases have also increased. The term 'cross-border insolvency' was first used by the United Nations Commission on International Trade Law (UNCITRAL), but no clear definition was given.<sup>[1]</sup> It is generally accepted that 'cross-border insolvency' refers to insolvency in which the relevant creditors, debtors and the debtor's estate are located in two or more countries or areas. In other words, it is insolvency with international or multi-jurisdictional elements.

As the estate of the insolvent business and its creditors may be located in different countries or regions, insolvency cases against the same economic entity may take place in several countries simultaneously. Accordingly, UNCITRAL has replaced the concept of 'corporate groups' with 'enterprise groups' to better reflect the nature of multinational enterprise groups and address cross-border insolvency issues. An enterprise group is made up of separate companies in different nations that are connected through some means of control and coordination,<sup>[2]</sup> and it is the most important and most complex economy in cross-border insolvency cases.

Scholars have deeply studied the legal aspects of cross-border insolvency and have developed traditional theories, including universalism and territorialism. In response to the shortcomings of these two theories, scholars have also proposed modified universalism. In this article, I will examine the basic concepts of the three aforementioned theories, sort out the main international rules and critically analyse the strengths and weaknesses of each of these theories.

## 2. Universalism

### 2.1. Definition of Universalism

Universalism is an international doctrine. Its core philosophy or ultimate aim is 'one court, one law', meaning that in any cross-border insolvency case, the insolvency legislation of one country should be applied to all matters involving insolvency that is filed before its courts. According to pure universalism, in a perfect society, 'all courts and legal systems must uphold all judgments of the domestic courts in the interests of international comity'.<sup>[3]</sup> That is, the debtor's estate should be transferred to its home state for liquidation, regardless of where it is located, and all creditors should also assert their claims uniformly in the courts of that country. Other countries' courts should recognise the insolvency proceedings' validity based on the comity principle.

However, there are some problems with the theory of universalism. First, universalism is a challenge to national sovereignty. In the absence of an international treaty, it is hard to demand that a state give up control over bankrupt estates that are within its purview, acknowledge the legitimacy of other states' legal systems, and recognize and uphold their decisions.<sup>[4]</sup> Even proponents of universalism emphasize the need to give way to national interests.<sup>[5]</sup> Second, when the same set of rules governs all legal issues arising in an insolvency case, conflicts inevitably occur with the relevant national insolvency laws, and universalist concepts do not offer resolutions to these disputes. Finally, the debtor's 'home state' criterion is uncertain, and the doctrine of universalism lacks the supporting measures to determine the country of jurisdiction. A situation may arise where, because the home states of most multinational enterprise groups are developed countries, less developed countries would have to follow the insolvency regimes of developed countries. A system under universalist theory would thus result in discrimination against the legal systems of less developed countries.<sup>[3]</sup>

## **2.2. UNCITRAL Model Law on Cross-Border Insolvency**

Despite the significant increase in cross-border insolvency cases since the end of the twentieth century, the insolvency rules of individual countries and the international community have not been updated accordingly. To address this pressing reality, various governments and international organizations have worked to create a set of international insolvency procedures to balance the competing interests of various nations and to address the issue of cooperation and coordination between national courts in cross-border insolvency. Of the many international rules, the UNCITRAL Model Law on Cross-Border Insolvency, adopted by the United Nations Commission on International Trade Law in 1997, is currently the most widely accepted and influential international rule in various countries.

The Model Law incorporates the principle of universalism and sets out rules for the courts of a host state to deal with requests from the courts of other nations for the recognition of insolvency proceedings. Other countries can file transfer claims against the debtor's property in the host state. However, before the claims can take effect, the other state needs to apply for a stay of the debtor's various activities in host state.<sup>[6]</sup> The process is as follows: First, the Model Law gives the foreign representative the authority to ask the court of the host state to intervene directly in the insolvency processes in this state and the capacity to recognize foreign insolvency proceedings. The Model Law distinguishes between the concepts of the state where the centre of principal interests is located and the state where the establishment is located to classify the proceeding as either a 'foreign main proceeding' or a 'foreign non-main proceeding'.<sup>[7]</sup> Then, upon entry into force of the above procedure, this state automatically stays any proceedings or enforcement action with respect to the insolvency case.<sup>[8]</sup> Finally, the Model Law allows the foreign representative to administer or sell all or part of the assets located in host state to protect and maintain the value of a property that, by its nature or other circumstances, may be devalued or otherwise in danger.<sup>[9]</sup>

Currently, the international community lacks the conditions to achieve universalism in its ideal state. The Model Law, as an international rule based on the doctrine of universalism, promotes the cession of partial jurisdiction by states gradually and progressively.<sup>[10]</sup> Although the Model Law is not an international convention and is not mandatory, it is a legal text that can be used as a reference for individual countries to ensure that they can safeguard their interests while promoting the harmonization of cross-border insolvency rules across countries, given the current difficulties in reaching international consensus on cross-border insolvency. In the long run, with the convergence of national legal systems, the birth of an international convention on cross-border insolvency is highly likely.

## **3. Territorialism**

### **3.1. Definition of Territorialism**

In cross-border insolvency cases, territorialism holds that the courts of a state have exclusive jurisdiction over the insolvency estate in its territory and that the property of the same company is subject to the jurisdiction of the relevant state courts because it is located in different states.<sup>[11]</sup> Territorialism asserts that the effects of insolvency proceedings before the courts of this state against an insolvent debtor extend only to property in this state and are not binding to property outside that state. Moreover, a local court's judgment in the insolvency of an insolvent debtor in this State does not affect a further declaration of insolvency of the same debtor by a court in another State. Territorialism is

known as the 'Grab Rule' because each country is motivated to apply its laws to collect foreign debtors' assets and to defend its creditors' interests.<sup>[12]</sup> The central tenet of territorialism, as an expression of state sovereignty, is the doctrine of vested rights. As such, territorialism rejects a global perspective on cross-border insolvency and asserts that the effects of a country's insolvency declaration can only extend to the territory of the country in which the insolvency is declared.<sup>[13]</sup>

### **3.2. Advantages and Disadvantages of Territorialism**

As an expression of national sovereignty, territorialism highlights the use of domestic judicial principles and insolvency procedures, maximizing the protection of the interests of domestic creditors while preserving national sovereignty. In addition, the emphasis on using local insolvency procedures and principles is highly beneficial and convenient for local creditors, who are relatively more familiar with the local system. It also enhances ex ante legal predictability and avoids creating problems for creditors due to unfamiliarity with the law and the conditions for its application. For multinational enterprise groups, territorialism also avoids the serious problem of universalism - the identification of the 'home state' of the multinational enterprise group in cross-border insolvency cases - which reduces disputes and saves judicial costs to a certain extent.

However, there are certain disadvantages to territoriality. First, territorialism refuses to recognize extraterritoriality: one country has no control or control over the commencement of insolvency proceedings in other countries. At the same time, various countries seek to expand the scope of their jurisdiction in cross-border insolvency cases. Commencing several insolvency proceedings in different countries inevitably results in procedural conflicts, making it difficult for creditors to pursue their rights to payment. This waste of judicial resources results in the multiplication of judicial costs. Second, the creation of numerous insolvency proceedings leaves the insolvent estate in a separate status, making it very difficult for debtors to reorganize their assets.<sup>[14]</sup> Third, the differences in insolvency procedures and principles between countries inevitably lead to an unequal and unpredictable distribution of the insolvent estate. Moreover, the lack of coordination between insolvency proceedings opened under territorialism may create opportunities for some creditors and debtors to take advantage, such as picking and choosing courts and transferring their assets.<sup>[15]</sup> This situation often arises in the insolvency of multinational enterprise groups. In this case, the foreign creditor is clearly at a disadvantage to the local creditor. Excessive isolation of foreign jurisdictions in territorialism might result in a lack of transparency in pertinent data. It is possible for a foreign creditor to be unaware that some of its assets have been the subject of insolvency proceedings in another nation. Therefore, the occurrence of any insolvency case means the loss of sovereignty in another country. In addition, territorialism is detrimental to the development of economic globalization. In today's globalized economy, the tendency for capital to circulate throughout the world is inevitable, and a single form of territorialist settlement cannot be adapted to this economic trend.

In particular, insolvency proceedings may occur in several countries simultaneously for multinational enterprise groups. Still, under the territoriality doctrine, only creditors of the local branch in host state can participate in insolvency proceedings. This implies that the courts in the various nations where different departments are situated may use their insolvency laws to make different decisions regarding the administration and distribution of the debtor's assets, which may ultimately have a different impact on the insolvency outcomes for branches that are part of a single multinational enterprise group.

### **3.3. Gibbs Rule**

Gibbs rule, currently in force in the UK, is based on the doctrine of territorialism and protects the interests of local creditors by refusing to recognize the extraterritorial effect of debt payments in foreign insolvency proceedings. Gibbs rule is built on the idea of defending the economic interests of local creditors and the community, and the requirements for the application of insolvency law are characterized by territorialism.<sup>[16]</sup> Under Gibbs rule, English courts require the application of the law chosen by the parties. This requirement protects the English home economy, the interests of which are vested in English creditors, so Gibbs rule is essentially a judicial way of protecting the interests of English creditors. Under Gibbs rule, a creditor may be able to claim compensation in England if a judgment under the law of another country confers a lesser benefit to the English creditor than that conferred by English law.

As the principle of territorialism takes more account of the interests of creditors in the home state,

the following question arises: How should the order of payment of secured and unsecured creditors be considered when a business is liquidated in insolvency?

In the UK, there is a clear hierarchy of creditors when a company goes into insolvent liquidation. Secured creditors often have the highest tier status and are given priority. This may include banks and lenders responsible for assets in inventory, with banks often being the first to be considered for payment in actual cases because they usually hold a fixed charge over property or other business assets and have strong enforcement powers. Once a business goes into liquidation, the bank initiates a seizure of the assets it holds. After all secured creditors have been compensated, the unsecured creditors, as creditors who can only claim the money that the company owes them after it pays the secured creditors, are effectively impaired in their right to be paid to some extent. Unsecured creditors often include employees, customers and suppliers of the insolvent company. They can only receive a certain amount of money through the prior sale of assets and following claims by secured creditors. However, these gains are usually minimal in the liquidation process. When a company enters liquidation, each group of creditors must receive payment in full before the funds can be distributed to subsequent creditors, which is unfair to unsecured creditors.

#### **4. Modified Universalism**

As a result of the above analysis, it is clear that both territorialism and universalism have drawbacks. An orderly and efficient solution is essential in the face of the continuing increase in cross-border insolvency cases. Therefore, scholars and advocates of universalism have begun to reflect on and revise the theory of universalism. They proposed modified universalism in light of the practical needs of cross-border insolvency.

##### ***4.1. Definition of Modified Universalism***

Modified universalism is based on universalism but does not require a competent court and applicable legal rules for cross-border insolvency cases. The host state has the power to cooperate with foreign insolvency proceedings based on the need to protect the interests of its creditors; that is, the host state may not recognize the extraterritorial effects of insolvency proceedings in other countries according to its own needs. 'While maintaining the idea of universalism, modified universalism grants the court of the host state discretion to judge whether the insolvency processes in the home state are fair and to safeguard the interests of its creditors.'<sup>[3]</sup> The host court may use the criterion that 'compliance with the foreign court's request does not impair the legal rights of the parties, much less contradict the public policy of the State' while exercising its discretion.<sup>[17]</sup>

##### ***4.2. Advantages and Disadvantages of Modified Universalism***

The first advantage of modified universalism is that it allows the courts of the host state to balance their interests and preserve state sovereignty while inheriting a single universalist procedure. Second, due to the flexibility of its model, modified universalism is better suited to today's situation, where there are many differences in national cross-border insolvency legislation. Finally, modified universalism is more practical. As a long-term solution, it provides a more realistic path to cross-border insolvency by balancing the relative unity of insolvency proceedings with the need to preserve national sovereignty.<sup>[18]</sup>

However, modified universalism still has some shortcomings: First, it gives a certain amount of discretion to the host state's courts. This discretion may be abused, for example, by the host state declaring that the regime of another state is not favourable to the interests of its creditors and refusing to cooperate. This cannot be controlled because the host state's courts have discretionary powers, and modified universalism does not place specific limits on that discretion. The result is that an effective cross-border insolvency regime cannot be developed internationally. Second, how the home state of a multinational enterprise group is determined is not explicitly defined by modified universalism. The uncertainty caused by the absence of particular regulations makes it difficult for creditors to protect their legal rights.

##### ***4.3. The European Insolvency Regulation***

International organizations are struggling to address cross-border insolvency issues, and several

regional organizations are exploring solutions to these problems. Among them, the EU Regulation, as a typical representative of modified universalism, is a model of regional cooperation on cross-border insolvency.

The EU Regulation and the Model Law both establish a jurisdictional system based on the court where the debtor has its primary interests and the court where the establishment is located as an addition. In other words, the main insolvency proceedings may be initiated by the court of the nation where the debtor's primary interests are situated. In contrast, the court where the establishment is located can only commence ancillary proceedings. Under the Regulation (recast), the main insolvency proceedings have a universal effect in the EU, and insolvency judgments will automatically be recognized in other member states from the entry into force of the judgment in the country where the proceedings began. Additionally, without additional procedures, decisions directly connected to insolvency proceedings, settlement agreements accepted by the court, and judgments terminating proceedings are instantly recognized in other member states. The rules of the respective national insolvency laws will apply to the main and subordinate proceedings to respect local legal regulations and social order.

The EU Regulation allows the insolvency representative of a main proceeding, subject to local law, to exercise the full powers of the court where the main proceedings are held in the territory of each EU member state. The 2015 Regulations (recast) further improve and strengthen the regime on coordination and cooperation between main and subordinate proceedings based on the 2000 Regulations. The Regulations (recast) provide for cooperation between insolvency practitioners in main and secondary insolvency proceedings involving the same debtor. To facilitate coordination of main, territorial and secondary insolvency proceedings involving the same debtor, the court applying for the opening of insolvency proceedings or a court that has opened such proceedings shall cooperate with any other court applying for the commencement of or initiating such proceedings. The courts and insolvency representatives of the different proceedings should also cooperate to the maximum extent possible without violating their laws and creating conflicts of interest.

In addition, the insolvency representative or the debtor may, if it considers it necessary, request the publication and registration of a notice of judgment opening insolvency proceedings in any other member state by the publication procedures and registration requirements established in that member state. Although the EU Regulation makes registration conditional on the law of the member state in which the register is kept, allowing such registration (i.e., recognition and enforcement of foreign insolvency judgments) cannot be contrary to a state's public policy. A member state may refuse recognition and enforcement if the effect of that recognition or enforcement is manifestly contrary to the public policy of that state, particularly its fundamental principles or the constitutional rights and freedoms of individuals.

In recent years, multinational enterprise groups have received a great deal of attention as the frequency and complexity of cross-border insolvency cases increase. This is demonstrated by the addition of a cooperation and coordination mechanism for the insolvency of multinational enterprise groups in the 2015 Regulations (recast). First, when insolvency proceedings involve two or more members of an enterprise group, cooperation may take place in any form between insolvency practitioners, between courts with jurisdiction and between insolvency practitioners and courts. Provided that such cooperation facilitates the efficient administration of those proceedings, it is not contrary to the rules applicable to those proceedings and does not create any conflict of interest. Second, the insolvency practitioner may apply to any court with jurisdiction in the current insolvency proceedings for opening group coordination proceedings. Although the EU Regulation does not clearly define 'public policy', the mandatory nature of the EU Regulation has resulted in a high degree of uniformity in national insolvency proceedings. In such circumstances, it is difficult for member states to refuse the recognition or enforcement of judgments on public policy grounds.

The 2015 Regulations (recast), based on the law relating to insolvency, extend the scope of application to include public collective proceedings for rescue, adjustment of debts, reorganization or liquidation of the undertakings concerned and interim proceedings. The revised Regulation responds to the need for development by adding insolvency procedures applicable to multinational enterprise groups. While affirming the universal validity of insolvency proceedings, the Regulation grants a certain degree of autonomy to insolvency representatives and meets the requirements of member states to protect their sovereignty and interests.

## 5. Conclusion

With the increase in cross-border insolvency cases brought about by the rapid development of economic globalization, various countries and international organizations have been exploring and proposing a series of theories and doctrines to resolve legal issues in cross-border insolvency cases. This article focuses on three theories: universalism, territorialism and modified universalism.

The doctrine of universalism calls for an idealized insolvency process (i.e., 'one court, one law'). However, due to the uneven development of individual countries and the differences in their legal systems and social environments, it is currently impossible to achieve idealized universalism. The Model Law is based on the theory of universalism. It promotes the gradual cession of jurisdiction by countries, which to a certain extent promotes the harmonization of national cross-border insolvency rules and supports the ultimate goal of universalism.

Territorialist approaches were adopted by most national courts in cross-border insolvency cases, as they maximized the preservation of national sovereignty and protected local creditors' interests. However, as the number of cross-border enterprise group insolvencies has increased, territorialism has become controversial due to the need to commence multiple insolvency proceedings simultaneously, resulting in a waste of judicial resources and inefficient proceedings. As a rule currently in force in the UK, Gibbs rule requires the application of insolvency law with the characteristics of territorialism, which also raises the issue of the order in which secured and unsecured creditors are to be paid in insolvency proceedings.

Modified universalism takes a compromised approach, inheriting the doctrine of universalism while offering the host state's courts a certain amount of discretion. However, the doctrine is prone to abuse of control due to a lack of restrictions on this discretion. The EU Regulation, as a typical representation of modified universalist theory, has been amended to expand the scope of application of insolvency procedures and add insolvency procedures applicable to multinational enterprise groups, providing a model for cross-border insolvency legislation in other countries and regions.

In summary, each of the three theories has its own advantages and disadvantages. In practice, the choice of theory and the establishment of systems embodied in the practical activities of countries around the world are closely related to the level of economic and social development of that country at the time as well as legislative trends in the international community. At present, modified universalism is more widely accepted by countries, regions and international organizations because it is a more flexible model that can be adapted to different legal systems and social contexts in judicial practice.

## References

- [1] United Nations Commission on International Trade Law (1997). *UNCITRAL Model Law on Cross-Border Insolvency*.
- [2] Committee on International Jurisdiction and Cooperation (2012). *Judicial Guidelines for Coordination of Multi-National Enterprise Group Insolvencies III*.
- [3] Edward S. Adams and Jason L. Finke (2009). "Coordinating Cross-Border Bankruptcy: How Territorialism Saves Universalism." *Columbia Journal of European Law*, 15(43).
- [4] John J. Chung (2006). "The New Chapter 15 of the Bankruptcy Code: A Step Toward Erosion of National Sovereignty." *Journal of International Law and Business*, 27(1).
- [5] Elizabeth Buckel (2013). "Curbing Comity: The Increasingly Expansive Public Policy Exception of Chapter 15." *Georgetown Journal of International Law*, 44(3).
- [6] Pottow, John A. E (2005). "Procedural Incrementalism: A Model for International Bankruptcy." *Virginia Journal of International Law*, 45(4).
- [7] United Nations Commission on International Trade Law (1997). *UNCITRAL Model Law on Cross-Border Insolvency*, 9-14.
- [8] United Nations Commission on International Trade Law (1997). *UNCITRAL Model Law on Cross-Border Insolvency*, 20-24.
- [9] United Nations Commission on International Trade Law (1997). *UNCITRAL Model Law on Cross-Border Insolvency*, 19(b)
- [10] Pottow, John A. E (2005). "Procedural Incrementalism: A Model for International Bankruptcy." *Virginia Journal of International Law*, 45(4).
- [11] Lynn M. LoPucki (2000). "The Case for Cooperative Territoriality in International Bankruptcy." Available at: <https://repository.law.umich.edu/mlr/vol98/iss7/3>.

- [12] Lucian Arye Bebchuk and Andrew T. Guzman (1999). "An Economic Analysis of Transnational Bankruptcies." *The Journal of Law and Economics*, 42(2).
- [13] Westbrook, Lawrence; Booth, Charles D.; Paulus, Christoph G.; Rajak, Harry (2010). "A Global View of Business Insolvency Systems." Washington, DC: World Bank and Brill.
- [14] Frederick Tung (2001). "Fear of Commitment in International Bankruptcy." 33 *George Washington International Law Review*. Available at: [https://scholarship.law.bu.edu/faculty\\_scholarship/1794](https://scholarship.law.bu.edu/faculty_scholarship/1794)
- [15] Paul J Omar (2002). "The Landscape of International Insolvency Law." *International Insolvency Review*, 11(3).
- [16] John Anthony Edwards Pottow (2006). "Greed and Pride in International Bankruptcy: The Problems of and Proposed Solutions to 'Local Interests'." *Michigan Law Review*, 104(8).
- [17] Kent Anderson (2000). "The Cross-Border Insolvency Paradigm: A Defense of the Modified Universal Approach Considering the Japanese Experience." *University of Pennsylvania Journal of International Law*, 21(4).
- [18] Irit Mevorach (2018). "The Future of Cross-Border Insolvency – Overcoming Biases and Closing Gaps." *online edn, Oxford Academic*, Available at: <https://doi.org/10.1093/oso/9780198782896.001.0001>.