AMERICAN BANKRUPTCY INSTITUTE

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International Insolvency Regimes at a Crossroads: Choosing a Direction for Insolvency Law Reform

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E. Patrick Shea, Moderator
Gowling WLG; Toronto

Sumant Batra
Kesar Dass B & Associates; New Delhi, India

Rebecca Hume
Kobre & Kim LLP; Grand Cayman, Cayman Islands

Victor A. Vilaplana
Foley & Lardner LLP; San Diego

CONCURRENT SESSION

2017

PUERTO RICO BANKRUPTCY

I think I'll go back to San Juan.
I know a boat you can get on.
Everyone there will give big cheer.
Everyone there will have moved here.
(West Side Story 1961)

I. The Problem

A. Immigration – 45% poverty rate, unemployment 11% double US maintained

B. Huge Debt - nearly $120B PR plus instrumentalities (compared to $18B in Detroit)

C. Lack of Autonomy

Puerto Rico my heart's devotion
Let it sink back in the ocean
Always the hurricanes blowing
and the money owing
(West Side Story 1961)

II. The Response

A. PR Corporation Debt Enforcement and Recovery Act 2014

B. PR v Franklin California Tax Free Trust, 579 U.S. ____ (2016)

1. PR enacts Recovery Act 2014 to permit the restructuring of $20 billion in debt owing by 3 instrumentalities of PR

2. U.S. Supreme Court rules that the Recovery Act void because preempted by Section 903(1) of the Bankruptcy Code

3. States cannot enact law that permits debt composition, only Congress can

C. PR Oversight Management and Economic Stability Act (2016) ("PROMESA") enacted by Congress in 2016

III. Promesa

A. Automatic Stay

- Upon enactment stay of collection or enforcement went into effect

- Stay in effect until 2/15/17 unless extended by Oversight Board for 75 days or Federal Court for 60 days

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- ♦ If PR or instrumentality commences debt restructuring under Title III Promesa procedures such provisions provide a separate stay under the bankruptcy code.

B. Oversight Board

- ♦ 7 person board appointed by US Congress & President
- ♦ Authority to place PR itself or a "covered" instrumentality into a debt restructuring proceeding
- ♦ Require and approve fiscal plan and budget – very broad powers

C. Fiscal Plans & Budgets

- ♦ Operation of PR or instrumentality, plans to pay debts, eliminate deficits, maintain essential public services

D. Debt Adjustment

- ♦ Incorporate numerous provision of the bankruptcy code
- ♦ Includes auto stay, carry on business, DIP financing, avoidance powers
- ♦ Includes provisions from Ch 9 dealing with "special revenue" and "safe harbors"
- ♦ To be eligible, OB must approve: (1) entity engaged in good faith efforts to enter into voluntary agreement to restructure debt, (2) has approved fiscal plan and (3) no "qualifying modification" of its bond debt
- ♦ Ch 9 plan confirmation requirement adopted plus plan must be consistent with Promesa and fiscal plan
- ♦ Only OB can submit plan
- ♦ Proceeding before federal district court in PR

E. Collective Action (Title VI)

- ♦ Achieve modification of bonds without 100% consent of bondholders
- ♦ Alternative to Title III procedures
- ♦ Bond can be modified ("a qualified modification") if: (a) modification approved by OB or (b) 2/3 in amount of voting bondholders and at least 50% of the total principal amount approve

Soon before expiration of Promesa auto stay, PR filed (5/3/17) for bankruptcy under Title III Promesa in PR and Chief Justice Robert appointed US District Judge (5/5/17) Laura Taylor Swain (SDNY) to preside over case

- ♦ Fight between classes of bondholders – GO debt versus sales tax backed bonds (COFINA) not technically a bk case since not filed under Title 11 – but Promesa did incorporate 98 provisions from B.C. so will look very familiar to bankruptcy practitioners.
- ♦ PR filed and 2 days later COFINA filed (as PR agency which sold sales tax backed bonds)
- ♦ PR Highways & Transportation Authority also filed under title III
- ♦ PR Sales Tax Financing Corp (COFINA also Title III debtor)
- ♦ Employees Retirement System of the Government of the Commonwealth of PR (also Title III debtor)
- ♦ PR Electric Power Authority (PREPA) files 7/2/17

The financial Oversight Management Board for PR as representative of the commonwealth of PR signs petition

BANKRUPTCY REFORM

I. Motives

A. Attract business – a hub for restructuring work (Singapore, Dubai)

B. Improve investment climate – greater certainty

C. Promote commercial activity – predictability

D. Protect favored classes of creditors

E. Coordinate multi-national insolvencies

II. Mexico

A. LCM enacted in 2000, amended in 2005 and again in 2014

B. Latest amendment – response to Vitro and other concerns

C. Mexico – 2014 Amendments

1. Intercompany and insiders debt subordinated (Vitro issue)

2. Avoid cramdown by vote of intercompany or insider creditors

3. Relationship between bondholders and bond trustee

4. DIP financing

5. Dealing with corporate groups

6. Imminent insolvency

7. Bankruptcy remoteness – fideicomiso

8. Time limits

9. Specialized courts

III. Brazil

A. Current law enacted in 2005

B. Economic crises – increase in cases petitioning for judicial reorganization

C. Currently pending is law to adapt UNCITRAL Model Law on Cross-Border Insolvency

D. Current Law

1. Provide for restructuring/reorganization not just liquidation
2. Provide for court supervised proceeding similar to Chapter 11
3. Automatic stay, DIP management
4. Debtor to propose plan

IV. Chile

A. Law enacted January 2014 to take effect October 2014

B. Promotes reorganization versus liquidation e.g. insolvency and restricting law, not bankruptcy law

C. Other semantic changes to remove or mitigate stigma

D. 2 types of reorganization

1. Extra judicial reorganization
2. Judicial reorganization

E. Reorganization supervisor

F. Liquidator

G. Specialized courts

H. Limited stay period

I. Allows for separate claim classification, allows secured creditors to retain lien

J. Expedited plan approval process

K. DIP financing with limitations

V. Argentina

A. Bankruptcy law enacted in 1995, subsequently amended in 2001-2002

B. Law provides for in-court organization or pre-packaged reorganization (“APE”)

C. In Court

1. Limited exclusivity period
2. Creditors super majority approval
3. Creditor can propose plan after exclusivity

4. DIP model and automatic stay

5. Lengthy process – 3 years or more

6. No DIP financing

7. Stay not applicable to secured creditors

D. APE

1. Shorter and less costly

2. Still recognized as "foreign proceeding" under Model Law

3. Pre-pack approval by super majority of creditors

4. Can negotiate pre-default (unlike in-court)

5. No stay during negotiations

	ARGENTINA	BRAZIL	MEXICO	CHILE
Involuntary reorganization proceeding that can be initiated by creditors?	No	No	Yes	No
Secured creditors subject to automatic stay?	No	Yes, unless they hold instruments (e.g. fiduciary liens) exempt from stay	Yes, but can enforce on non-essential assets	Yes, but can enforce on non-essential assets
Other significant exclusions from automatic stay?	No	Yes (e.g., holders of “fiduciary liens” and “foreign exchange advances”)	No	Yes (e.g., labor claimants)
Prevents voting by intercompany debt?	No	No	Yes, subject to “25 percent rule”	Yes
Can creditors propose a plan?	Yes, but only following expiration of exclusivity period	No	Yes	No
Absolute priority rule?	No	No	No	No
Grants super-priority status to DIP financing?	No	Yes	Yes	Yes
Strict time limits on completing procedure?	No	No, but maxi- mum 180-day stay	Yes—365 days	Yes—90 days
Management remains in place during proceeding?	Yes	Yes, unless judge replaces them	Yes	Yes
Management has ability to sell asset during proceeding?	Yes, subject to court approval	Yes, but only non-fixed assets without court approval	Yes, but essential assets are sold via court proceeding	Yes, up to 20 percent without creditor support
Pre- packaged insolvency proceeding?	Yes, but with flaws	Yes, but challenging to implement	Yes	Yes
Adopt UNCITRAL Model Law	No*	No	2000	2014

*But ***See*** 1889 and 1940 Treaties.

Prepared substantially from chart contained in “A New world for LatAm Creditors: Insolvency Reform in Latin America,” Cooper, Brenneman and McBride, June 2015 Pratt’s Journal of Bankruptcy Law

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INTERNATIONAL INSOLVENCY REGIMES AT A CROSSROADS: CHOOSING A DIRECTION FOR INSOLVENCY LAW REFORM, AN OFFSHORE PERSPECTIVE

Rebecca Hume
Partner
Kobre & Kim (Cayman)

The last 15 years have seen many offshore jurisdictions modernise their insolvency laws to facilitate international co-operation, with a key driver being the increasing number of cross-border insolvencies with an offshore component. This article looks at the reforms in some of the main offshore centres, namely the Cayman Islands ("Cayman"), British Virgin Islands ("BVI") and Bermuda. We examine the paths they have chosen to embark upon, how they are faring and any changes that are on the horizon.

The underlying legal framework in these jurisdictions is the English common law and equity (predominantly), with an overlay of the applicable constitution and local statute law. The ultimate appellate tribunal is the Judicial Committee of the Privy Council which sits in London and is comprised of essentially the same judges who sit in the English Supreme Court. Each jurisdiction recognises that having an orderly and effective insolvency system is crucial to financial stability and growth. However, their approach has not always been through statutory reform – in some instances reform has been achieved by the judiciary through the "common sense" application of the jurisdiction's existing insolvency laws.

The Cayman Experience

Prior to 2009, Cayman's insolvency laws were ultimately derived from [Part V of] the English Companies Act 1862 (which did not distinguish between solvent and insolvent liquidations), the English Insolvency Rules 1986 and a body of local case law. It was complex and unsuitable for a sophisticated provider of offshore financial services. In 2006 the Cayman Islands Law Reform Commission published recommendations for reform. Its report made three key recommendations:

- The existing law on corporate insolvency was too complex and should be updated;
- Tailored rules relevant to the jurisdiction were needed; and
- Existing judicial co-operation in cross-border cases should be codified.

The effect any changes might have on Cayman's financial services industry was recognised to be an important consideration. The Law Commission therefore paid close attention to the preservation of Cayman's capital markets and asset finance business. The report stated that it was "*critically important to, maintain* [the] *current status as a "creditor friendly jurisdiction""*. Consistent with this, the report concluded that:

a) There would be no corporate rescue provisions allowing management to impose a moratorium upon creditors but remain in control;
b) There should be a collective right for creditors to choose their own liquidator; and
c) There should be more onerous reporting provisions for liquidators so that creditors would be kept informed about the progress of a liquidation and could provide their views.

On 1 March 2009 the Companies Amendment Law 2007 came into force together with the Companies Winding–Up Rules 2008, the Insolvency Practitioners Regulations 2008 and the Foreign Bankruptcy Proceedings (International Co-operation) Rules 2008. The fundamental principle that underlies Cayman's current insolvency laws is the *pari passu* treatment of unsecured creditors, regardless of nationality. The general principle is that unsecured creditors share equally in the assets of an insolvent company that are available for distribution.

At the same time, a new Part XVIII of the Companies Law was added to allow the recognition of foreign office holders and the granting of ancillary relief. This was instead of adopting the UNCITRAL Model Law on Cross-Border Insolvency (the "Model Law"). This was not an attractive option for Cayman because most Cayman-incorporated companies have their business activities elsewhere and sometimes in more than one jurisdiction. The Model Law was designed around trading companies with premises and employees within the jurisdiction. If Cayman had adopted the Model law, the interpretation of centre of main interests or "COMI" by jurisdictions like the U.S. would have meant that very few insolvencies of Cayman corporate entities would be overseen by the Cayman court, which would have detrimentally impacted Cayman as a leading international financial centre. Through the enactment of Part XVIII of the Companies Law, Cayman has shown its willingness to cooperate in cross-border insolvency matters to keep pace with the legitimate demands of financial markets within the wider global economy. Since 2009 the Cayman court has recognized numerous foreign office holders and give them assistance where needed. A high profile example of which was recognising Irving Picard as Trustee of Bernard L. Madoff Investment Securities LLC.[1]

Maintaining a creditor and investor friendly insolvency regime as part of its overall legal system has proved a major factor in Cayman maintaining its position as a leading jurisdiction for the formation of hedge and private equity funds, structured finance vehicles and Cayman Islands companies, partnerships and trusts.

Another important demonstration of Cayman's support for its financial services industry is the protection of secured creditors' rights when it comes to the enforcement of contractual rights on

[1] 2010 (1) CILR 231

insolvency. For example, the current Part V of the Companies Law specifically recognizes and protects the rights of secured creditors to enforce their security in accordance with its terms, outside any Cayman insolvency process.

The 2009 overhaul of Part V also introduced provisional liquidation to Cayman where: (a) there is a risk of asset misuse or dissipation of assets; or (b) to enable a "soft" provisional liquidation for restructuring, a concept which Cayman adopted from Bermuda, which had developed it during the late 1990s as discussed below. A "soft" provisional liquidation allows a provisional liquidator to be appointed for the purpose of implementing a compromise or scheme of arrangement with creditors. Since the effect of provisional liquidation is to grant an automatic stay on all proceedings including enforcement action against the company's assets, the company has the necessary breathing space to reach a compromise with its creditors or to agree a scheme of arrangement, if possible.

Schemes of arrangement are derived from the modern English Companies Act. Its original purpose was to facilitate the restructuring of a solvent company or group of companies. It is not a formal insolvency process; instead, it provides a mechanism for putting in place a court-sanctioned arrangement between a company and its members or creditors (or classes of them). The scheme must be approved by over 50 per cent by number and over 75 per cent by value of those attending and voting within each relevant class of stakeholder at each Court-convened meeting and must then be sanctioned by the court. Unless the scheme is proposed within a liquidation process, the automatic stay will not apply while the scheme is being proposed and approved.

Following the decision in *China Milk*[2] in 2011, Cayman companies had been accessing this restructuring regime by the directors presenting a petition in the name of the company to wind it up. In late 2015, imperfections in the Companies Law were exposed in the *China Shanshui* case[3]. The Cayman court held that the directors do not have standing to present a petition for the winding up of the company or to apply for the appointment of joint provisional liquidators on the company's behalf absent authority from an express power in the company's articles of association (bylaws) or a shareholders' resolution. The effect of the *China Shanshui* case is to make restructuring through a "soft" provisional liquidation more difficult in Cayman as it may be difficult or unattractive to obtain a shareholders' resolution giving the directors the necessary power and to do so quickly.

The current regime can be a hard sell to other jurisdictions when a company has a choice over the jurisdiction in which to restructure its debts. It can be counterintuitive for clients, and challenging to explain, that in order to access the Cayman procedure designed for restructuring and rescuing companies a petition to terminate the company's existence must be filed.

[2] *Re China Milk Products Group Ltd* [2011] (2) CILR 61
[3] *China Shanshui Cement Group Ltd* [2015] (2) CILR 255

However, Cayman has done an excellent job of educating jurisdictions like the U.S. and China about the use of a "soft" provisional liquidation to restructure a company, particularly through the use of a scheme of arrangement. This is evidenced by the recent restructuring of the US $3.8 billion ultra-deepwater drilling company, Ocean Rig[4].

The wheels are in motion to overhaul the "soft" provisional liquidation regime and replace it with a standalone restructuring regime, which would help cement Cayman as a jurisdiction of choice when it comes to restructuring an international group of companies. The proposal envisages the procedure being started by the presentation of a petition for the appointment of restructuring officers. Consistently with Cayman retaining its reputation as a creditor and investor friendly jurisdiction, a restructuring officer would have to be an insolvency practitioner. A moratorium would automatically come into effect upon the filing of the petition, which would have extra-territorial effect. Because the new restructuring procedure would be a collective insolvency procedure with a court appointed restructuring officer, it should have the benefit of being recognized in jurisdictions such as the U.S., U.K and Hong Kong.

With a good wind behind them, hopefully the new restructuring proposals will be in place in Cayman by early next year.

The BVI Experience.

BVI's insolvency laws are contained in the Insolvency Act 2003 and the Insolvency Rules 2005. Like Cayman, BVI's insolvency regime is heavily focused on corporate insolvency rather than personal bankruptcy. This reflects BVI's role as a major offshore financial centre with many more resident companies than residents – there are approximately 30 registered companies per head of population, which is probably the largest ratio in the world. BVI companies are often capitalized by debt rather than equity through either intra-group debt or external borrowing. It is therefore no surprise that the BVI court spends a significant part of its time dealing with corporate insolvencies and this has had a bearing on the amendments it has made to its insolvency laws.

Before the Insolvency Act came into force on 1 January 2004, BVI's insolvency laws were found in the Bankruptcy Act (Cap 8) and the Companies Act (Cap 285). The legislation was piecemeal and did not meet BVI's business needs. A comprehensive review of the insolvency laws led to the enactment of the 2003 statute.

However, there was an 18 month hiatus after the Insolvency Act 2003 came into force when no insolvencies were possible because the Insolvency Rules 2005 had not come into force, and key provisions of the Act were delegated to the rules.

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[4] *In the matter of Ocean Rig UDW Inc*. FSD 100,1010, 102 & 103 OF 2017 18 September 2017

The BVI strives to be a creditor-friendly jurisdiction due to the large number of structured finance vehicles incorporated in the BVI which employ leveraged finance but don't otherwise trade or have employees. There are therefore many similarities between the way Cayman and BVI approach formal insolvencies. For example, BVI's insolvency regime is predicated heavily towards the protection of secured creditors' rights. A secured creditor generally does not need to participate in a liquidation process because it can enforce its security interest directly against its collateral.

The main insolvency process is insolvent liquidation. Since liquidation is a class right, the BVI court will not make an order to wind up a company if it is opposed by the majority of creditors. Once a liquidator is appointed his or her duty is to collect in and realize the assets of a company and distribute the proceeds to the company's unsecured creditors *pari passu*.

When a BVI company goes into insolvent liquidation any mutual debts owed as between the company and a creditor are set off so that only the net sum is due either to the creditor or to the insolvent company. The BVI has incorporated IDSA Model Netting Legislation (pre-2007 form) into its Insolvency Act, a decision which was probably driven by the number of structured finance vehicles incorporated via BVI. Any netting agreement relating to financial contracts will prevail over the statutory insolvency set-off provisions. Financial contracts for these purposes are defined in some detail in the Insolvency Rules.

BVI's insolvency law also regulates receiverships, including administrative receiverships, which permit a receiver to be appointed pursuant to a floating charge over the whole or substantially the whole of a company's assets and undertaking. The prevalence of administrative receiverships is unsurprising given that BVI companies are often capitalized through debt, which is usually secured over the company's business and assets.

In keeping with being a creditor-friendly jurisdiction, BVI does not provide for any form of debtor-in-possession rehabilitation. The focus of the Insolvency Act is not on the rehabilitation of financially distressed companies. However the Insolvency Act does allow company voluntary arrangements with its creditors to enable it to continue trading, provided 75% of its unsecured creditors vote in favour. This is a concept taken from the English Insolvency Act. As in England there is little evidence that CVAs are being widely used to enable a distressed company to compromise its debts and continue to trade.

Whilst BVI has no statutory priority for funding a company in insolvency, the BVI Insolvency Act does permit the order of priorities in a liquidation to be altered consensually through inter-creditor agreements to allow a funder to receive security or priority in consideration for providing new money.

The BVI Insolvency Act also includes provision for administration orders to promote the rescue of a company in financial difficulty and supported by a statutory moratorium, which is similar to the English position. However, these provisions are not in force and there is currently no political intention to bring them forward. The reason is unclear, but it could be that a regime which alters the status of a secured creditor so that they can only enforce their security with the courts permission does not sit easily with BVI's desire to protect secured creditors. It is also questionable whether administration, which is primarily aimed at the rehabilitation of a trading company with employees, is suitable for structured finance vehicles.

Most corporate insolvencies in the British Virgin Islands involve a cross border element so it is no surprise that the Insolvency Act contains two parts dealing with cross-border insolvency. Part XVIII is based upon the Model Law but is not currently in force. The provisions in Part XVIII do not sit easily within the remaining structure of the Insolvency Act as they are predicated on the COMI concept, which is unknown in the BVI. If the BVI brought Part XVIII into force, the same issues highlighted above in relation to Cayman would arise. Like Cayman, BVI's corporate entities generally do not trade and a large proportion of their business is conducted outside of the BVI.

On the whole, the BVI's insolvency regime seems to be working well. It is therefore not surprising that the BVI government currently has no plans to amend the current insolvency regime and more importantly, there appears to be no push by its insolvency professionals that it should do so.

The Bermuda Experience.

Bermuda's first comprehensive corporate insolvency legislation was enacted in 1977. The Companies (Winding-Up) Act 1977 incorporated the provisions of Part IX of the UK Companies Act 1948. It is now found in Part XIII of the Companies Act 1981 but the law remains substantively the same. Bermuda's insolvency laws are thus closely aligned to those of England & Wales.

In a familiar story, Bermuda's corporate insolvency laws have evolved to protect the business conducted from its shores. Bermuda is the third leading insurance and reinsurance centre in the world. It is also a leading jurisdiction for establishing holding companies for international commercial operations carried out by companies controlled by U.S. and other foreign interests around the world and investment funds. It comes as no surprise to find that Bermuda is another creditor-friendly jurisdiction; hence being favoured by banks and financiers.

Bermuda's main formal insolvency process is, like Cayman and BVI, insolvent liquidation. It has no formal restructuring provisions. So when the dotcom bubble burst in the late 1990s, Bermuda had to address the issue of how to restructure the debt of Bermudian companies whose creditors had invested in instruments governed by New York law. In order to take advantage of a U.S. Chapter 11 Plan, Bermudan judges took a "common sense" approach to its insolvency legislation. Part XIII of the Companies Act 1981 requires that once the directors of a company realize the company is insolvent they have a duty to petition to wind the company up and appoint provisional liquidators to displace current management and to ensure the assets of the company are preserved and realized for the benefit of its creditors.

Bermuda's insolvency professionals argued that the existing provisions allowing for the appointment of provisional liquidators could be interpreted to allow for a new form of "soft" provisional liquidation, and the Bermudian insolvency judges agreed. A "soft" provisional liquidation provides the provisional liquidators with "soft" powers limited to supervising the existing board of directors' restructuring of the company in a provisional liquidation, under the overall supervision of the court. The appointment order may also authorize the filing of a chapter 11 petition in the U.S. The directors remain in office but the provisional liquidator oversees the provisional liquidation on behalf of the unsecured creditors.

This flexible approach to the interpretation of the legislation enables parallel restructuring proceedings to take place in Bermuda and the U.S., notwithstanding the absence of any formal restructuring process in Bermuda's insolvency laws. This was an important development in Bermuda's insolvency regime during the late 1990s because the majority of Bermudian companies are holdcos for a U.S. company, so the ability to conduct parallel restructuring proceedings is key. This regime is still in place today although Bermuda has taken no steps to formally codify this position. The reason is likely to be the bank of common law that has evolved since the 1990s entrenching "soft" provisional liquidations in Bermuda's insolvency laws.

Bermuda has not adopted the Model law and does not have any statutory provisions for the recognition of foreign office holders. Instead a foreign office holder must rely on the common law, which gives the Bermudian court a discretionary power to recognise a foreign office holder. If recognition is granted there is a positive common law duty to assist,[5] which has been applied where the foreign office holder has been appointed by a court of a competent jurisdiction according to broad principles of fairness, and consistently with public policy in Bermuda.

In fact, the Bermudian courts have taken a cooperative approach to recognising foreign bankruptcy proceedings and office holders. This has led to criticism in some quarters that certain judges have overly stretched the interpretation of the common law to ensure that the Bermudan court affords assistance to a foreign office holder.

The Privy Council decision in *Singularis*[6] has set some bounds on the extent of this cooperative approach. The Privy Council held that assistance under the common law could not go beyond the assistance that would be given to the officer holder in their home court.

There are no current plans for Bermuda to codify its insolvency laws in relation to cross-border co-operation or to update and modify its insolvency laws to provide a formal restructuring regime. Instead the insolvency professionals and Bermudian government seem happy to continue to work with their existing insolvency regime which has been in place now for 40 years.

[5] *In re Founding Partners Ltd* [2011] Bda LR 22.
[6] [2014] UKPC 36

Summary

Each of these jurisdictions has moulded and developed its insolvency laws to remain competitive in the financial sectors in which they are market leaders whether by reform or taking a "common sense" approach when it comes to the interpretation of existing legislation. As can be seen from the proposals for new restructuring legislation in Cayman, any future changes that may be contemplated by these jurisdictions are likely to balance the needs of having an orderly and effective insolvency regime with the need to ensure that they remain leading offshore financial centres for many years to come. Whilst none of these jurisdictions have adopted the Model law, they each demonstrate that when it comes to applications for the recognition of foreign office holders and requests for assistance, they are able to achieve outcomes, which are consistent with the objectives contemplated by the Model law.

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